Fraud & Corporate Governance: What Boards Can Do To Help Prevent Fraud

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Baker Tilly Fraud Summit
Feb. 23 -25, 2021

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Howard Brod Brownstein: Speaker Introduction

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Agenda

- A Board's fiduciary duties of oversight
- The Board's oversight of Management's actions to prevent fraud.
- The Board's oversight of Management's response if and when fraud occurs.
- The Board's oversight of reputational risk as it relates to fraud

Polling question one

Have you ever and/or do you now serve on a board of directors? (Answer as many as are applicable)

A. Publicly-Held Company
B. Privately-Owned Company
C. Nonprofit

The Danger of Fraud

"Large frauds have led to the downfall of entire organizations, massive asset and investment losses, significant legal costs, incarceration of key individuals, and erosion of confidence in capital markets, government, and not-for-profit entities."

"No matter how talented individuals are in the organization, if they lack a strong ethical compass, the organization is taking on an unacceptable risk."

COSO Fraud Risk Management Guide

The Role of the Board

- Boards "oversee", rather than "do". The rule is "Noses in, fingers out!"
- Corporations are governed by state law based upon the state of incorporation, often Delaware (or modeled on Delaware).
- Corporations may also be subject to an overlay of state or federal regulatory compliance, based on the company's industry, as well as securities and stock exchange regulatory compliance for publicly-held companies. While Boards must oversee the corporation's compliance, it's important to recognize that governance does not consist only of compliance with applicable regulation.
- The Board hires Management, sets its compensation and evaluates its performance.
- A key Board responsibility is oversight of the management of risk.

Board Fiduciary Duties

Board members are "fiduciaries", meaning they are required to act in the interests of others rather than themselves.

The Fiduciary Duty of Care

- A fiduciary must act on an informed basis after due consideration of the relevant materials and alternatives reasonably available to them, and engaging in appropriate deliberation about the action.

The Fiduciary Duty of Loyalty

- A fiduciary must act in the best interests of the corporation and its shareholders, rather than for any other reason.
- A fiduciary must not act for its own benefit, to the detriment of the company.
- Potential conflicts of interest must be disclosed fully, followed by appropriate action where required, e.g., resignation, recusal, etc.

Potential Liability for Breach of Fiduciary Duties

- Liability for a duty of care violation requires gross negligence. When a director acts with gross negligence, the protections of the "business judgment rule" (discussed below) no longer apply.
- Liability for a duty of loyalty violation typically stems from failure to disclose a possible conflict of interest, or if disclosed, failure to take appropriate action.
- Courts generally assess the <u>process</u> employed by directors in making a business decision, not the wisdom of the decision itself.
- A board should follow certain procedures and document its actions to show that it has acted on an informed basis:
  - Proper board meeting minutes
  - An agreed-upon process for deliberation and decision making
  - Retention of experienced advisors with relevant expertise

The Business Judgement Rule and Other Potential Protections from Liability

- The "Business Judgement Rule" is a deferential standard whereby courts will not second-guess board actions when problems occur, as long as appropriate board processes were followed. A board should follow certain procedures and document its actions to show that it has acted on an informed basis:
  - Proper board meeting minutes
  - An agreed-upon process for deliberation and decision making
  - Retention of experienced advisors with relevant expertise
- Liability for a duty of care violation requires gross negligence. When a director acts with gross negligence, the protections of the Business Judgment Rule no longer apply.
- Liability for a duty of loyalty violation typically stems from failure to disclose a possible conflict of interest, or if disclosed, failure to take appropriate action.

So, how does fraud figure into all this?

- The Board's oversight of the management of risk includes the risk of fraud. Whenever a major fraud occurs – as with any major company problem – an immediate question is "Where was the Board?"
- A company's risk of fraud stems from its specific activities and geography, so each company's fraud risk may be different, although there may be similarities.
- Since a Board's oversight of management of risk begins with identifying the risks to which the company is exposed, understanding fraud risk requires analysis of the company's activities and understanding where fraud might occur.
- With so much business and company communications conducted online, as well as digital recordkeeping, the risk of cyber fraud is virtually everywhere. And that is only one type of fraud risk.
- A company's most valuable asset doesn't appear on its balance sheet – its reputation. Fraud can not only cause financial losses and other problems, it can also damage a company's brand and its reputation.

Polling question two

Thinking just of your board roles, have any of the companies or organizations on whose boards you serve had instances of fraud?

A. Yes

B. No

C. Not sure

D. Not applicable

So, how does fraud figure into all this?

- The Board's oversight of the management of risk includes the risk of fraud.
- Whenever a major fraud occurs – as with any major company problem – an immediate question is "Where was the Board?"
- A company's possibly most valuable asset doesn't appear on its balance sheet – its reputation. Fraud can not only cause financial losses and other problems, it can also damage a company's brand and its reputation.
- One of the biggest dangers in risk management – and the Board's oversight of it – is "denial", the normal human tendency to assume that one already knows what needs to be known. However, it is a central tenet of risk management to recognize that risks change over time, and new risks arise, even when activities remain the same.
- Perpetrators of fraud target both new activities – where risk management may not have caught up – as well as finding new ways to infiltrate existing activities.

Fraud Risk During the Pandemic

- Any sort of company distress or dramatic change potentially changes the risks to which the company is exposed, and causes new risks to arise
  - Following the 2008-09 financial crisis, 84% of companies cited some level of fraud occurrence
- Employees working remotely, lack of in-person interaction and examination of records, expense reductions and layoffs, all make reporting and information less reliable, as well as increases cyber risk
- Crisis conditions may invite more first-time fraudsters
- Management is paying more attention to matters other than fraud risk
- Pressure is increased to deliver financial results.

Board oversight of fraud risk management

- A company's risk of fraud stems from its specific activities, so every company's fraud risk may be different, although there may be similarities.
- Since a Board's oversight of management of risk begins with identifying the risks to which the company is exposed, understanding fraud risk requires close analysis of the company's activities, and understanding where fraud might occur.
- With so much business and company communications conducted online, as well as digital recordkeeping, the risk of cyber fraud is virtually everywhere. And that is only one type of fraud risk.
- And as state previously, risk management – and the Board's oversight of it – requires regular refreshment: What new risks may have arisen? How have previously recognized risks potentially changed?
- Just as "Think like an activist" is the rule for a Board's view of potential shareholder activism, "Think like a fraudster" is valuable advice for oversight of fraud risk management.

Potential Board Actions – I

- Identify a Board committee, e.g., the audit committee, to focus on oversight of risk management, and report back to the Board. Having a separate Risk Committee is an underutilized tool for Board oversight of risk management, since the Audit Committee may lack capacity and/or not consist of the optimal Board members for risk oversight.
- Oversight of risk management should begin with creating an exhaustive list of every risk to which the company is exposed, together with anything that may already be in place to manage each risk, e.g., metrics, reports, insurance, contingency plans, etc. (Many large insurance brokers offer a free "risk review" that may help identify risks, as well as to identify where insurance may be inadequate.)
- <u>Fraud Risk Assessment</u>: Each risk area should then be reviewed to determine whether it involves a vulnerability to fraud, e.g., wherever there is movement or retention of funds, valuable company records or confidential information, system interfaces with vendors, customers and others, etc.

Potential Board Actions – II

- Review the Company's internal audit function from a fraud perspective, and whether it is appropriately staffed for the company's size and complexity.
- Institute fraud mitigation procedures, and ensure systems are in place for monitoring fraud "red flags".
- Consider hiring a cyber security firm to detect hacking vulnerability.
- Monitor social media.
- Conduct exit interviews.
- Strengthen FCPA, anticorruption and ethics training.
- Ensure whistleblower "hot line" facilities and procedures are available and properly monitored, with direct board oversight.
- Ensure employees are given cyber threat training, especially those working from home.

Case Examples of Fraud – I

U.S. Mortgage

- $1Bil mortgage co. with offices around the country
- Became private-label/back-office mortgage dept. for 125 credit unions
- Sold mortgages to Fannie Mae and others that it was supposed to hold and service for credit unions - $138Mil total
- Fannie Mae and credit unions didn't audit USM to confirm assets being serviced
- Outside audit firm distracted from phony records through personnel change
- Employee knew of mortgage-sale fraud, and was being investigated for unrelated crime, "dropped a dime"
- CEO (son of founder) sentenced to 14 years
- Board of private company were insiders and friends of owner

Case Examples of Fraud – II

Remo Drug

- $900Mil distributor of health and beauty aids, plus some pharmaceuticals, to independent drugstores
- Company's credit line had matured, terms of extension/forbearance agreement limited compensation of family member executives
- Company sold friendly customers items at zero cost and owners received payment in cash
- In disclosing to lenders, company grossly understated the issue, but lenders' auditors found the rest ➔ company liquidated
- Board of private company composed of insiders and friends of owners, no inquiry into narrowing profit margins

Fraud "Red Flags" (List Incomplete)

- Use of third-parties or consultants to deal with trading counterparties, governments, etc.
- For public companies, possible insider trading
- Inappropriate interaction with government officials
- Inadequate inventory control
- Unexplained increases in amount or frequency of purchases from vendors
- Assets not under adequate physical control
- Inadequate documentation of sales, hours or activities connected to incentive compensation
- Financial results that exactly meet forecasts or budgets.
- Higher than normal customer returns/credits, excessive payment terms

Polling question three

Do you believe that Boards can help reduce the risk of fraud?

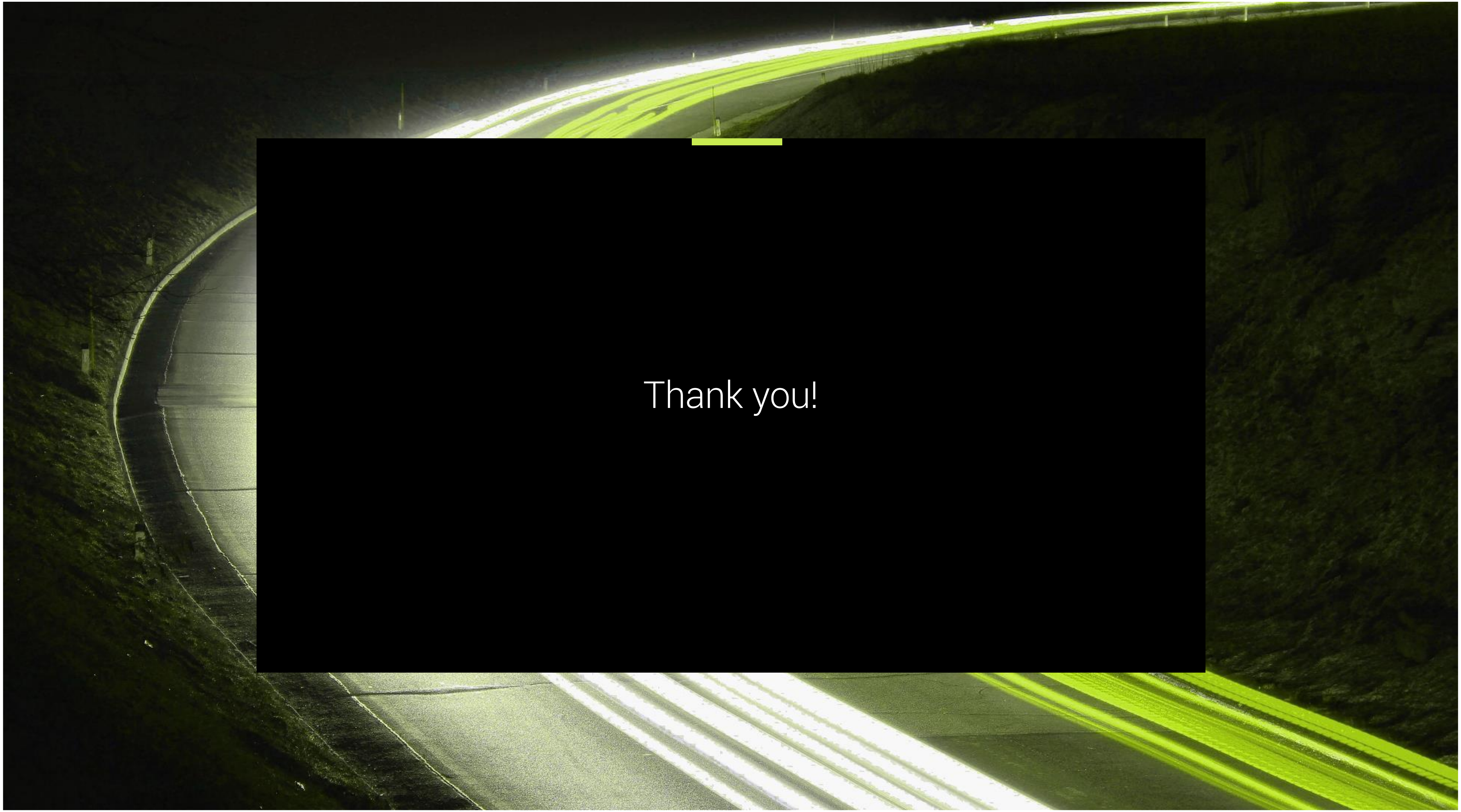
A. Yes
B. No
C. Unsure
D. Not applicable

“A fraud has occurred – now what?”

- Boards should investigate how the fraud occurred, and if/how it might have been prevented. A special board committee might be appropriate.
- Consider using outside resources, since internal resources may be in the crosshairs.
- Failure of prevention systems may indicate weaknesses elsewhere.
- Beware of management declining accountability, e.g., blaming the perpetrator.
- Oversee communications with insurance carriers and law enforcement.

Additional Materials

- Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Fraud Risk Management Guide* , 2016
- Association of Certified Fraud Examiners, "Coronavirus Pandemic Is a Perfect Storm for Fraud", 2020, https://www.acfe.com/press-release.aspx?id=4295010491
- Association of Certified Fraud Examiners, "Occupational Fraud: A Study of the Impact of an Economic Recession", 2009, https://www.acfe.com/occupational-fraud.aspx
- Association of Certified Fraud Examiners, "Fraud in the Wake of COVID-19: Benchmarking Report", 2020, *https://www.acfe.com/covidreport.aspx*
- Leigh Jones, "Don't Be a Victim: 9 Signs of invoice Finance Fraud", *Commercial Factor*, August 2018



Thank you!

Disclosure

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