

Fraud Response Management:
Is your organization prepared to
execute an efficient and effective
response?



Some organizations have designed and tested disaster plans to help them respond to unforeseen catastrophes that could have the potential to threaten their very existence. These organizations have learned, often times through personal experience, that the time to plan is before catastrophe hits and not after. Yet some of these same organizations may not have applied this same thinking to the business risks associated with fraud and, consequently, may not have adequate processes in place to deal with allegations of fraud and misconduct. This risk oversight could be worrisome considering the potentially significant impact of fraud.

An effective Fraud Response Management program is designed to allow the organization to react to various types of fraud and misconduct allegations in a measured and consistent manner. The overarching goal of a fraud response program is to protect the organization from the economic, reputational and legal risks associated with the fraud allegation. Specifically, a fraud response management program may encompass:

- the procedures and processes through which an organization is alerted to allegations of potential fraud and misconduct;
- the manner in which those allegations are initially and subsequently communicated within the organization;
- the assignment of responsibility and accountability for handling those allegations;
- decision making authority;
- the methods and procedures by which allegations are investigated;
- consideration of legal implications, documentation and evidentiary procedures;
- reporting of investigation results within the organization;
- remedial recommendations; and,
- procedures for dealing with outside parties.

These processes, when effectively designed and implemented, can become one of the most critical elements of an organization's anti-fraud program. These steps, however, should be tailored to fit the organization. Failing to implement an effective fraud response management program as part of your organization's overall anti-fraud programs and controls may put your organization at significant risk. Fraud happens and will

A recent Association of Certified Fraud Examiners ("ACFE") survey suggests that the typical fraud lasts two years from the time it began until the time it was caught by the victim organization. The same survey suggests that U.S. organizations lose 7% of their annual revenues to fraud. Applied to the projected 2008 United States Gross Domestic Product, this 7% figure translates to approximately \$994 billion in fraud losses.¹

likely continue to plague organizations and world markets for some time. Preparedness is part of the solution.

Some important considerations when designing an effective fraud response management program can include:

- monitoring compliance with applicable legal and regulatory standards;
- confirming that the complaint intake system provides for anonymous reporting;
- defining roles and responsibilities for those involved in the fraud response management process;
- establishing clear and meaningful investigative protocols to include interviewing, evidence collection, computer forensic examinations, and analysis;
- identifying competent fraud investigation resources, especially global response teams, in advance of a crisis;
- utilizing a case management system that allows the organization to efficiently track and log the progress and resolution of fraud allegations;
- establishing consistent reporting within and outside the organization; and,
- identifying processes and control improvements enterprise-wide to help gain efficiencies and prevent recurrences.

As organizations expand their global presence, it can be important that they have a well devised Fraud Response Management program in place that allows them to respond appropriately to allegations of fraud and misconduct around the world. This can be especially important in light of the world economic conditions

¹ Source: ACFE 2008 Report to the Nation — the 7% estimate is based solely on the opinions of CFEs [certified fraud examiners] who are in the trenches fighting fraud on a daily basis, rather than on any specific data or factual observations. Thus, this figure should not be considered a literal representation of the true cost of fraud facing U.S. organizations.

because the risk of fraud can increase in an economic downturn. The economic downturn can also create the added challenge of compelling organizations to be more efficient with their resources, including those utilized for responding to and managing fraud allegations.

When an allegation of fraud surfaces, the organization decides how to proceed and to what extent it may investigate. In some instances, outside counsel is retained to conduct an investigation: for example, 10A-type investigations² involving allegations of misconduct by senior management of the organization. Sometimes, organizations may rely on their own internal investigative groups that sit within the internal audit, compliance, legal or security functions to address the allegations. Such efforts, should be well managed as that can aid companies in avoiding duplication of efforts and allow for better coordination in investigating and responding to potential fraud allegations. The investigation process itself can be disruptive to normal business operations and can bring rise to a host of potential legal and regulatory risks that can have consequences beyond actual fraud losses.

The fact that tips continue to be the most effective means of detecting fraud suggests that organizations could improve their detection efforts by establishing formal structures to receive reports about possible fraudulent conduct.³

Legal and regulatory background

In the U.S., there are a myriad of laws at the Federal and state levels, as well as requirements set forth by various regulatory bodies and industry groups, related to fraud allegation response. A number of these regulations are discussed below. With the current global financial crisis and the recent discovery of several significant frauds, it seems logical that new regulations and a renewed focus on fraud response could be forthcoming. Further, more countries around the world are imposing additional anti-fraud and anti-corruption provisions on businesses.⁴

² The term "10A" refers to Section 10A of the Securities Exchange Act of 1934. Examples of investigative matters that fall into this category include items such as financial misstatements or Foreign Corrupt Practices Act violations.

³ Source: ACFE 2008 Report to the Nation

⁴ Germany is a prime example of a foreign government imposing responsibility on a nationally based entity to conduct a large internal investigation into allegations of fraud and corruption.

"Regulators and judges are increasingly asking not just whether a company has an anti-fraud, anti-money laundering, or corporate ethics policy in place, but they are also asking how well such programs work and whether their quality and results make sense. They are asking, in other words, how good are they? This trend raises the stakes for those charged with governance."

– Frank Hydoski, Deloitte Financial Advisory Services LLP

The United States Sentencing Guidelines ("USSG") provide specific criteria that include organizational mechanisms for reporting and responding to allegations of fraud. The USSG provide that the culpability score for organizations is generally determined by six factors for consideration by the sentencing court — four factors that may increase the ultimate punishment and two that may mitigate it.⁵ Failure to have a proper fraud response management program might be viewed as tolerating and/or condoning the activity. It is important to note that just having a compliance or ethics program may not be sufficient to result in a reduction of the culpability score. The USSG expressly provides that an organization will not be eligible to receive a favorable adjustment for having an effective compliance and ethics program if the organization delays reporting an offense and/or if individuals within certain levels of the organization "participated in, condoned or were willfully ignorant of the offense." Failure to properly respond to allegations of fraud or misconduct by ignoring such allegations is a dangerous game for organizations to play.⁶

The Sarbanes-Oxley Act ("Sarbanes-Oxley") requires a public company's audit committee to implement procedures for the receipt, retention and handling of allegations of fraud and misconduct with respect to financial reporting and internal controls. Section 301 requires an anonymous means (e.g., a hotline) for the reporting of allegations of fraud and misconduct. The law imposes a responsibility on the company's audit committee to address any reported allegations of fraud that could impact the company's financial statements, accounting

⁵ According to USSG, aggravating factors include: involvement or tolerance of criminal activity; prior history of the organization; violation of an order; and obstruction of justice. Mitigating factors include: existence of an effective compliance and ethics program ("ECEP"); and either self-reporting, cooperation, or acceptance of responsibility.

⁶ The USSG and related commentary may be found at <http://www.usssc.gov>.

and internal controls. Sarbanes-Oxley also requires⁷ public company executives to certify financial information of the company and attest to whether any matters have come to their attention that would potentially compromise the accuracy of that financial information or the underlying related internal controls. An allegation of fraud or misconduct that has not been properly responded to by the organization could jeopardize such a certification and subject the executives involved to severe criminal penalties.

Other Federal corruption statutes, including the Foreign Corrupt Practices Act,⁸ set forth the legal framework, for covered entities and relevant transactions, regarding the maintenance of accurate books and records, reporting of violations, establishment of controls to prevent and limit misconduct, and cooperation with federal investigations. Anti-money laundering, anti-terrorist financing, and related banking laws have created specific responsibilities for financial institutions to investigate and report on potential violations. Implicit in these statutory requirements is the establishment of an effective fraud response program that can facilitate compliance. Further, the Securities and Exchange Commission ("SEC") has indicated that it does take into consideration in its evaluation of a company's response to an alleged fraud whether the company thoroughly reviewed the nature, extent, origins, and consequences of the conduct and related behavior.⁹ In addition, some states have imposed laws requiring certain organizations to investigate allegations of fraud and even to create investigation groups within their

Room for improvement...

According to participants of the July 2008 Deloitte Dbrief on financial fraud in an economic downturn, less than half of the 1,200 respondents (46%) believe their organization has established protocols for conducting investigations, including identifying resources available to use.

⁷ See Sections 302 and 906 of the Sarbanes-Oxley Act.

⁸ The Foreign Corrupt Practices Act of 1977 (FCPA) prohibits bribery of foreign officials for the purpose of obtaining or keeping business, and the Anti-Kickback Act of 1986 prohibits bribery of government employees in relation to awarding of federal contracts.

⁹ SECURITIES AND EXCHANGE COMMISSION, SECURITIES EXCHANGE ACT OF 1934, Release No. 44969/October 23, 2001, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions. <http://www.sec.gov/litigation/investreport/34-44969.htm>

organizations. Some states also require insurers to have effective procedures and resources to deter and investigate fraud, including the creation and operation of Special Investigative Units ("SIU"). For example, in New York State § 409 of the New York Insurance Law mandates that insurers have a SIU as part of their Fraud Prevention Plan.

Common law doctrines found in some states¹⁰ create fiduciary obligations for officers and directors of organizations that would cover investigating and resolving incidents of fraud in order to prevent and mitigate harm to the company. The SEC stressed that this duty existed even prior to the advent of Sarbanes-Oxley. In a speech given by the former SEC Commissioner Roel Campos, in which he discussed corporate responsibility, he stated that "There have not been any new or different theories or standards of liability imposed on directors in the aftermath of Sarbanes-Oxley by Commission or SRO [self-regulatory organizations] rules." Commissioner Campos further indicated that "the duty of care generally requires directors to exercise an objective, reasonably prudent standard of skill and care in the discharge of their functions. This obligation includes an oversight responsibility to see that the corporation functions within the law to achieve its purposes."¹¹

"Passivity is not an option."

– Commissioner Roel C. Campos, U.S. Securities and Exchange Commission

This duty arises if an officer or director learns of facts suggesting that management may have engaged in fraud or that the corporation's prior financial statement public filings may be inaccurate.¹² Failure to faithfully exercise such duty could expose officers and directors to liability. Commissioner Campos indicated that the "situations where directors have to be worried about an SEC action against them are where they act very unreasonably and

¹⁰ The legal issues and interpretations differ from state to state.

¹¹ Speech by SEC Commissioner: How to be an Effective Board Member by Commissioner Roel C. Campos, U.S. Securities and Exchange Commission, HACR Program on Corporate Responsibility

¹² The leading Delaware cases addressing the duty of oversight and related issues are *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963); *In re Caremark Int'l Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Boeing Co. v. Shrontz*, No. 11,273, 1992 Del. Ch. LEXIS 84 (Del. Ch. Apr. 20, 1992); *In re Dataproducts Corp. Shareholders Litig.*, [1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,227 (Del. Ch. Aug. 21, 1991). See also Charles Hansen, *The Duty of Care, The Business Judgment Rule, and The American Law Institute Corporate Governance Project*, 48 BUS. LAWYER 1355, 1359 (Aug. 1993).

in bad faith. Where you see SEC actions against directors is where information regarding possible improper accounting practices or possible improper recognition of revenue is actually brought to the attention of directors and a reasonable director, acting in good faith, would investigate. If the directors do not conduct an independent investigation, they are not acting reasonably or in good faith and should not be protected by the business judgment rule. It is that simple and it is not a different analysis after Sarbanes-Oxley.” Commissioner Campos went on to emphasize that “Passivity is not an option.”

The board of directors should be informed of suspected fraud so that they can decide whether and how to investigate. The board may delegate to the organization’s internal investigations group the responsibility for collecting, investigating and reporting potential allegations of fraud and misconduct to the board and may implement definitive protocols specifying which matters should be immediately brought to the board’s attention. For example, the board may have a different view of an embezzlement of \$5,000 by an accounts payable clerk than it may have of financial statement manipulation by a member of senior management. Again, an independent investigation by an outside party is sometimes necessary or advisable.

From a global perspective, various jurisdictions around the world have enacted their own versions of Sarbanes-Oxley in countries such as Japan, China, and member countries of the European Union. Some nations have also passed corruption statutes. For example, the Organization for Economic Co-operation and Development (“OECD”) Anti-bribery Convention has resulted in the quasi-globalization of the US FCPA law. The OECD Anti-bribery Convention has been ratified by 30 OECD countries and seven non-OECD countries. Separately, the BASEL II accord issued by the Basel Committee on Banking Supervision¹³ promotes a risk-based approach to help address potential failures that banks can face from operational and financial risks. The second “pillar” of BASEL II provides guidance on risk management and supervisory assessment for banking institutions. Both the assessment of the risk of fraud, as

well as the effective response to allegations of fraud, can be critical components of any banking institution’s risk management program.

The Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) has issued some of the most comprehensive guidance for organizations with respect to risk management and specifically fraud risk management. Risk response is a key component of COSO’s Enterprise Risk Management (ERM) integrated framework. ERM is such an important concept that Standard & Poor’s recently announced it would consider ERM, of which risk response is a core component, in its ratings.¹⁴ As such, there may be a financial cost for companies that do not have a conscientious fraud response management program in place.

In July 2008, new guidance was published by the Institute of Internal Auditors (“IIA”), the American Institute of Certified Public Accountants (“AICPA”) and the Association of Certified Fraud Examiners (“ACFE”) to help executives, boards of directors, audit committees, and other personnel within the organization create a strong fraud risk management program. Entitled “Managing the Business Risk of Fraud: A Practical Guide”, the guidance shares leading fraud risk management practices and discusses how the different elements of the fraud risk management process can work together to create a more effective whole. The guidance stresses a number of fundamental concepts that relate to fraud response management. Specifically, the guidance highlights the importance of setting roles and responsibilities within the organization and emphasizes monitoring key performance metrics.¹⁵

¹³ The Basel Committee on Banking Supervision is an institution created by the central bank Governors of the Group of Ten nations. It was created in 1974 and meets regularly four times a year. Its membership is now composed of senior representatives of bank supervisory authorities and central banks from the G-10 countries and representatives from Luxembourg and Spain.

¹⁴ For more information on the S&P announcement, see <http://www2.standard-andpoors.com/spf/pdf/events/CRTconERM5908.pdf>.

¹⁵ <http://www.acfe.com/documents/managing-business-risk.pdf>

Potential components of a Fraud Response Management program complaint system

Allegation system

This refers to the process(es) by which allegations are handled. An effective system can receive, manage, and track allegations. Other factors to consider may include the mode of administration of the hotline and the reporting mechanism.

Allegation triage

This involves the assignment of the matter to the appropriate party for investigation in accordance with established roles and responsibilities. It further involves the decision as to the level of investigation warranted based upon the nature, scope, and seriousness of the allegations.

Case investigation

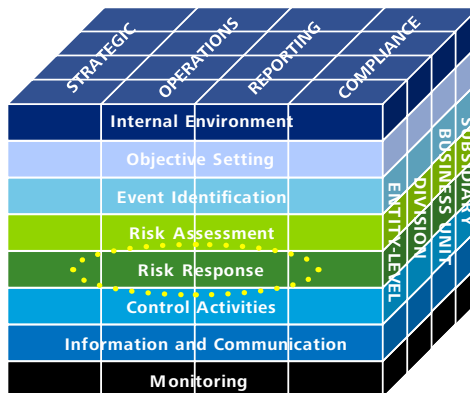
This involves the execution of the actual investigation steps based upon existing guidelines, policies, and procedures. Investigation execution can follow well-designed protocols and legal guidance, as appropriate.

Case management

This component of the program involves oversight of the investigation process, as well as the collection of critical information relative to performance. Established metrics and expectations can aid in efficient as well as effective investigation execution.

Reporting and communication

This aspect involves the effective and timely reporting of investigation results to the appropriate stakeholders. It also involves interim updates and the reporting of identified control issues.



Source: Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management — Integrated Framework

Benefits of internal investigations

A carefully planned and properly executed investigation can address a number of organizational objectives. First, the investigation can help determine the extent of potential liabilities and/or losses that may exist by gathering relevant information and facts. Such data can often be critical to various stakeholders in the organization including senior management, the board of directors and audit committee, shareholders, outside auditors, and others. Second, a properly executed investigation can result in partial or full recovery of losses, stop future losses and help mitigate other potential consequences.

Organizations need to understand the potential liabilities associated with the incident and take steps to reduce criminal or regulatory exposure through self-reporting and timely cooperation with government authorities.¹⁶ Indeed, a properly executed investigation can reduce the likelihood of a separate government investigation of the matter or at least reduce the scope of potential enforcement actions. A properly executed investigation can also help shape public perception by showing that the organization made a good-faith effort to investigate and understand the potential misconduct. Lastly, the investigation can assist the organization in developing and implementing a remediation plan that helps address internal control, disciplinary and other critical issues that may have been identified during the investigation.

¹⁶ The United States Sentencing Guidelines provides specific criteria that include effective organizational mechanisms for reporting allegations of fraud as well as appropriate responses including cooperation with governmental authorities.

Some leading characteristics of Fraud Response Management programs

Once the need for an investigation arises, it should be conducted in a timely and thorough manner. Timely investigations can be viewed positively by regulators and prosecutors and generally produce more precise results because witness recollections are fresh and documents are more likely to be available. The investigation should gather, in a lawful manner, sufficient data and evidence in support of any potential litigation or inquiries from regulatory entities. Generally, the investigation process should also seek to identify control weaknesses and management missteps that may have impacted the timely prevention or detection of the incident.

Roles and responsibilities

According to the American Institute of Certified Public Accountants ("AICPA") publication, *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention: The Audit Committee and Oversight of Financial Reporting*, the organization's board of directors and audit committee have oversight responsibility for antifraud programs and controls, while it is management's responsibility to design, implement, and maintain those programs.¹⁷ An effective fraud response management program can help set the organizational tone regarding governance practices and ethics. Roles and responsibilities with respect to the stakeholders at various levels of the organization should be clearly defined. Boards and audit committees should consider asking management questions that can help them understand more fully what fraud response management within the organization entails and to confirm what management is doing to make it effective. Having a clear and consistent process for handling allegations of fraud and misconduct in the organization, as well as defining fraud response management roles and responsibilities for various stakeholders such as: Legal, Internal Audit, Compliance, Security, Investigations, and Human Resources, are two steps that can help an organization become more efficient in addressing the challenges of fraud.

Some additional measures that can help in developing an effective fraud response management program are described broadly below.

Allegation system

- Understanding how allegations make their way into the investigations group and facilitating complete reporting is important. Various channels for receiving complaints may include: General Counsel, Compliance, Human Resources, Regulators, law enforcement, internally generated targeting, and various business units. Complaints may come in via e-mail, written letter, telephone calls to personnel, and other means rather than via the hotline.
- Investigation groups can facilitate receipt, management and tracking of allegations.
- Exceptions, such as allegations not being tracked in a central system, can be identified and the reasons thereof understood.
- Once there is an understanding of the nature and variety of complaints that are received, organizations might consider categorizing where appropriate.
- Investigation groups may analyze complaints by type and source, etc.

Allegation triage

- Clearly defining who makes the determination as to when a complaint should be escalated to a formal investigation can help establish accountability around the process as well as provide for efficient and timely case investigation.
- It is important to document the criteria and rationale utilized to make such determinations.
- Having clear protocols relating to investigator assignment and supervisory assignment, as well as referrals both within and outside of the organizations can aid in establishing a consistent approach to investigative matters as well as providing for timely notifications.
- Documentation standards should be implemented as that can help facilitate organizational recall and consistency.

¹⁷ *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention: The Audit Committee and Oversight of Financial Reporting*, http://www.aicpa.org/audcommctr/download/achilles_heel.pdf

Case investigation

- The investigation approach can include creation of work plan.
- Investigation execution can include a step for scoping — and may include business unit records, external records, geographic considerations, potential legal considerations and identification of potential interviewees.
- Evidence should be handled and safeguarded appropriately in order to preserve it for admissibility purposes in potential litigation.
- Investigators should be competent in their interviewing skills.
- Conducting interviews in a consistent manner can assist with maximizing the information obtained and establishing a pattern demonstrating equal treatment of interviewees.
- It is important to note that some key investigative steps might require approvals and authorizations.

Case management

- It can be helpful to have metrics developed that can be applied for tracking the progress of cases.
- Case status can be reviewed on a regular basis by the Supervisor/Manager/Director to monitor case progress.
- Documenting case status meeting results and following up on action items is important.
- Case files should be up to date and complete.

Communication and reporting

- Having an effective and consistent communications protocols between the Investigations group and stakeholders can also be important.
- Types of communications that may be considered in the assessment process are those communications that exist between the investigations group and:
 - Corporate management
 - Audit committee
 - Other departments
 - Internal audit
 - Regulators and law enforcement

Assessing the performance of Fraud Response Management programs

The economic downturn has forced some organizations to evaluate operational efficiencies and emphasize performance indicators as a determinant of the value that a department, such as internal audit or internal investigations, brings to the organization. These performance indicators can vary by organization and by industry. The results of these performance indicators can be considered within the context of the organization itself. Investigation scope and procedures should be designed to answer key questions such as: What happened? Who was involved? Over what time period did it happen? Why and how did it happen? What was the impact (financial, reputation, and regulatory)? Could it happen again? Organizations should consider whether their investigations are performed as efficiently, considering both the investment of time and resources, as possible.

A comprehensive performance assessment of an organization's fraud response management program can significantly assist the organization's efforts to improve the efficiency and effectiveness of its response to fraud allegations. Legal, compliance, and fraud risks may be reduced both domestically and internationally. Further, significant cost savings can be realized by limiting fraud losses, deterring future fraudulent behaviors and through fraud response process optimization. An organization that invests in a fraud response management assessment could see cost savings and return on investment in the form of:

- More efficient use of resources
- Lower investigative costs
- Loss recovery and prevention
- Increased detection of internal and external fraud
- Lower compliance risk
- Enhanced tracking metrics

The potential value of an effective fraud response management program can be realized in different ways and across various industries. Below are several real-world examples of how organizations have benefitted from the implementation of an effective fraud response management program.

- Prior to establishing a claims investigation group, a services company annually paid out millions of dollars relating to insurance claims, many of which were false. After establishing an antifraud investigation group, the company saved millions of dollars annually in false claims, thus repaying the cost of the group many times over.
- A financial services firm realized greater efficiencies in its fraud response management program by improving the organization’s method for receiving, triaging and investigating allegations of fraud and misconduct. A key outcome of the organization’s project was the development of an “investigation playbook” that provides protocols and procedures to increase their investigative effectiveness. The firm lowered its fraud risk by helping to create a broad entity-wide fraud policy, developing global fraud management strategies, and developing an enhanced fraud risk assessment process.
- After undertaking an in-depth performance assessment of their special investigations group, a large health plan increased their averted and recovery rates on fraudulent claims made by health care providers. Policies and operating procedures were strengthened and streamlined, and performance metrics were developed in order to enhance effective and efficient management of the investigations group.

There are many other organizations that have benefitted in similar ways from implementing or optimizing their fraud response management programs. Keep in mind, however, that the fit and approach to fraud response management is something that can be tailored to the needs of each organization with the guidance of fraud professionals. There are no “canned” solutions for effective fraud response management.

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