

COMPLIANCE

Opportunity in a Downturn: The Value of an Anti-Fraud Program

By Glenn M. Pomerantz and Timothy L. Mohr

The wide-ranging economic downturn has had a significant effect on businesses and will likely continue for some time. Macroeconomic strains may cause financial reporting pressures on management. Given the magnitude of the current financial crisis, companies may cut costs in overhead areas associated with oversight and monitoring. These factors can lead to increased pressure and opportunity for fraud, in turn, suggesting a greater need for aligning the expectations of stakeholders with management action through corporate governance. In addition, as companies consider how to position themselves for the eventual financial recovery, new research suggests that forward-thinking organizations that implement comprehensive fraud prevention programs will be more likely attract capital when liquidity returns to the capital markets.

BDO Consulting has released findings of a study entitled “The Value and Effectiveness of Corporate Anti-Fraud Programs” (Study), which provides—among other findings—both quantitative and qualitative data to evaluate the support for anti-fraud activities of management, boards of directors and investors. The Study surveyed sophisticated investors (specifically, private equity investors) on a variety of dimensions regarding their experience with corporate fraud; the prevention and early detection of fraud; and the economic value driven by a comprehensive anti-fraud program.

The results of the Study and our interpretations based on our experiences as investigators indicate that a comprehensive anti-fraud program may significantly improve a company’s ability to reduce fraud and attract capital. Specifically:

- Sophisticated investors are twice as likely to rate their own investments favorably in the

area of developing and implementing controls for preventing and detecting corporate fraud when compared to US companies overall.

- Sophisticated investors who have experienced fraud in their investments are less likely to associate themselves with having invested in companies with well-regarded fraud controls.
- Sophisticated investors who believed in the effectiveness of fraud controls are twice as likely to state that their investments are in companies with well-regarded fraud controls.

The Study found that the financial impact of corporate fraud can be significant, and that nearly one-third of sophisticated investors are willing to pay a premium to invest in companies with anti-fraud programs!¹

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- Private equity investors who had been exposed to corporate fraud indicated that the largest instance of corporate fraud in their portfolio ranged from less than \$100,000 (16 percent) to \$100 million or more (8 percent), with 38 percent indicating that their largest individual instance of exposure to corporate fraud was \$1 million to \$5 million.
 - The median amount of corporate fraud reported by private equity investors was \$2.3 million per incident.
 - Approximately one-third (29 percent) of private equity investors indicated that they would pay more for a company that had a comprehensive anti-fraud program. Among those private equity investors who indicated they would pay more, the median premium was five percent (with 14 percent indicating they would pay 10 percent or more).
 - Approximately one in four (27 percent) respondents believe that the problem of corporate fraud is more important than three years ago (while approximately 69 percent believe the importance remains the same).

Significant Findings

The Study determined that sophisticated investors prefer that a key segment of the corporate governance community—the Audit Committee—take an active role in fraud control. A significant majority (86 percent) of respondents indicated that they prefer to have an anti-fraud program implemented and monitored under the direction of the Audit Committee. The Study also asked sophisticated investors to rate the companies in their own portfolios in terms of developing and implementing controls for preventing and detecting corporate fraud.

Over 50 percent of the private equity investors gave their investments high ratings on this dimension (rated 8, 9 or 10 on a scale where 1 = poor and 10 = excellent). When asked to rate US companies overall (including those not in their own portfolios), less than 25 percent of the private equity investors indicated that they perceived this overall pool of companies to have high ratings for preventing and detecting corporate fraud.

Significantly, sophisticated investors indicated that they are more likely to perceive the companies

in their portfolios as having better anti-fraud controls than US businesses overall. This is consistent with another finding where 84 percent of respondents stated they typically consider the risk of fraud when they make investments. These findings suggest that governance professionals may be able to position their companies to attract capital by developing and implementing effective anti-fraud controls.

The Study also asked sophisticated investors whether they had been exposed to corporate fraud in their investments. Approximately 37 percent of private equity investors indicated that they had been exposed to an instance of corporate fraud within their investments. This finding underscores the pervasive nature of fraud and the potential value that can be driven by governance professionals when implementing a comprehensive anti-fraud program. The 60 percent of sophisticated investors who indicated that they had not been exposed to corporate fraud in their investments are also instructive—in that these investors are significantly more likely to believe in the effectiveness of anti-fraud programs.

Governance professionals may interpret this finding to suggest that sophisticated investors are likely to associate their belief in the efficacy of an anti-fraud program with the lack of fraud in their portfolios. This efficacy may be due to the ability of a comprehensive anti-fraud program to prevent fraud, as well as the potential to detect fraud early. Early detection of corporate fraud often curtails its impact since fraudsters commonly initiate fraud on a small scale and rapidly expand their activities if they recognize that the risk of detection is low.

The Study also asked sophisticated investors whether they would pay more for companies with a comprehensive anti-fraud program. As noted above, approximately one-third (29 percent) of private equity investors indicated that they would pay more for an investment in a company with a comprehensive anti-fraud program, with the median premium being five percent. Those sophisticated investors who believe that the problem of corporate fraud is very serious or somewhat serious are twice as likely to state they would pay more (as compared to respondents who do not believe that corporate fraud is a serious problem). In response to an open-ended question, 17 percent of those who would pay more for a company with an anti-fraud program indicated that such a program would

add to the firm's value. The remaining 83 percent indicated that such a program would point to the existence of fraud controls, provide a sense of trust and serve as a stamp of quality.

Sophisticated investors were also asked if a company in compliance with Section 404 of the Sarbanes-Oxley Act is adequately protected from fraud. Approximately 41 percent of private equity investors indicated that SOX 404 compliance alone does not adequately protect a company from fraud (an additional 37 percent are not sure if SOX 404 compliance alone adequately protects a company from fraud). Governance professionals may interpret this finding to suggest that sophisticated investors may find significant value in an anti-fraud program which is more comprehensive than SOX 404 compliance.

Implications for Governance Practices

A major implication of the Study is the preference by sophisticated investors that the Audit Committee take responsibility for overseeing the implementation and monitoring of anti-fraud controls. In our experience, an active Audit Committee can prevent fraud by setting an expectation that a company will implement the elements of a comprehensive anti-fraud program. Further, an active Audit Committee is able to respond quickly and appropriately to indicators of fraud as they arise. Early and vigorous action in the face of fraud can significantly reduce the impact of an individual instance of fraud and prevent future fraud by sending a message regarding the company's commitment to an anti-fraud culture.

Sophisticated investors were asked to value specific anti-fraud elements. The elements with the highest values (8, 9, or 10 on a scale where 1 = "not valuable at all" and 10 = "extremely valuable") are:

- Conducting criminal and other background checks on potential employees (72 percent of respondents rated this element highly).
- Maintaining a Board and Audit Committee with oversight responsibilities for preventing and detecting fraud (62 percent).
- Monitoring of anti-fraud controls to verify that anti-fraud controls are effective and to update

anti-fraud controls as the business changes over time (60 percent).

- Timely and well-communicated, comprehensive policies and procedures (code of conduct, conflicts of interest, Foreign Corrupt Practices Act) that reflect management's commitment to appropriate behavior (56 percent).

Among the high-value implications for governance professionals is the ability to add underutilized (and cost-effective) anti-fraud program elements. The Study found that sophisticated investors believe that only 31 percent of the companies in their portfolios conduct background checks on existing employees pursuant to promotions when promoted to positions of trust (and the efficacy of these checks were rated highly by only 13 percent of private equity investors). Our experience leading major corporate investigations shows that conducting background checks on employees during their tenure (and particularly when elevated to positions of trust) would have reduced many organizations' exposure to fraud. Our investigators have witnessed millions of dollars of employee fraud go undetected within organizations lacking an investment in a comprehensive anti-fraud program.

Interestingly, the most high-value element of a comprehensive anti-fraud program and the most under-utilized element are both influenced by the need to perform background checks on employees. Enhanced due diligence on new or newly-promoted employees to positions of trust is one of the most cost-effective investments in an organization's fraud prevention arsenal.

Handling Objections

The majority of sophisticated investors (88 percent) saw a benefit to a comprehensive anti-fraud program. The Study also identified reasons the minority of sophisticated investors give for not expecting a benefit when companies implement fraud controls or for their unwillingness to pay a premium when investing in a company with a comprehensive anti-fraud program. Only 11 percent of private equity investors indicated that they saw "no real benefit at all" to having all twelve elements of an anti-fraud program at a potential investment target.

The Study further polled this minority of respondents to determine the reasons for indicating a comprehensive anti-fraud program had “no real benefit at all,” as well as those respondents who indicated they would not pay more for a company with a comprehensive anti-fraud program and found the following as reasons for their responses (among others):

- “We conduct our own investigation” (offered by 16 percent of respondents who indicated they would not pay more for an investment in a company with a comprehensive anti-fraud program).
- “It may not eliminate fraud” (eight percent)
- “The benefits are hard to quantify” (six percent)

Boards and governance professionals face these objections on an ongoing basis. In our experience, these objections understate the importance of the effect of a multi-pronged approach of a comprehensive anti-fraud program on a company’s overall culture. Further, these objections are addressed directly by the results of the Study:

- Sophisticated investors rate their own portfolios significantly more strongly in terms of having well-regarded fraud controls than US companies as a whole. One interpretation of this finding is that private equity investors and other sophisticated investors may be more likely to perceive companies with comprehensive anti-fraud programs as desirable investments.
- Sophisticated investors who invested in companies with well-regarded fraud controls are also less likely to report having experienced fraud. One interpretation of this finding is that companies with well-regarded anti-fraud controls are more likely to be able to prevent fraud (or detect it earlier).

These objections are also evident in the finding that nearly one-third of sophisticated investors would be willing to pay a premium when investing in companies with a comprehensive anti-fraud program. Additionally, the value of a comprehensive anti-fraud program is reinforced by our experience as investigators and the logic of financial valuation:

- Corporate frauds erode stakeholders’ confidence in management. The resulting decline in stakeholder confidence may have a far greater and long-lived impact than the amount of any individual fraud. Companies depend on their reputation to maintain credit, retain talent and preserve customer loyalty.
- Companies that are valued on the basis of a multiple of earnings may be damaged by a corresponding multiple of the amount of a fraud (i.e., an unidentified fraud that reduces earnings by \$2.0 million at a company valued at a multiple of five times earnings has caused that company to be valued \$10.0 million less than its appropriate value).
- The synergistic effect of multiple elements in a comprehensive anti-fraud program creates a culture where fraud is minimized (as opposed to the limited organizational impact of a one-time investigation which often results in minimal actions).

Conclusion

The Study strongly suggests that sophisticated investors perceive implementing or enhancing anti-fraud controls to be associated with significant benefits to companies. The Study suggests that an organization that champions a comprehensive anti-fraud program will reap the rewards of a lower per-incident cost of frauds, the corresponding preservation of company value in the face of serious threats to corporate reputation and a potential premium paid by sophisticated investors.

As fraud pressures and opportunities mount during the current financial crisis, a comprehensive anti-fraud program provides immediate protection to organizations and helps governance professionals align management actions with stakeholder requirements. In addition, when financial markets flow more freely and recover in the future, we believe that companies perceived to have strong anti-fraud controls will benefit first from investments by sophisticated investors. This value can be driven by the corporate governance community as investors may accelerate a flight to quality investments when liquidity flows again.

Notes

1. The BDO Consulting Study examined the opinions of partners and other senior executives at 100 private equity firms throughout the United States. Participants were asked for their opinions regarding the seriousness of corporate fraud among U.S. companies, the risk of fraud in their investments, how important anti-fraud measures are to them, and

which measures they consider the most effective in preventing fraud.

The OSR Group, a leading national public opinion and marketing research firm, conducted interviews for The BDO Consulting Study. The survey is based on a total of 100 interviews among partners and other senior executives within private equity firms based in the United States. A total of 23 interviews were conducted online and 77 by telephone in February 2008.

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