The State of Fraud Risk Management

BUSINESS ETHICS LEADERSHIP ALLIANCE (BELA) FRAUD RISK MANAGEMENT WORKING GROUP

BUSINESS ETHICS LEADERSHIP ALLIANCE

CAQ CENTER FOR AUDIT QUALITY

AFC ANTI-FRAUD COLLABORATION

ACKNOWLEDGMENTS

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Introduction

The Business Ethics Leadership Alliance (BELA), along with the Center for Audit Quality (CAQ) and Anti-Fraud Collaboration (AFC), brought together representatives from 16 multinational companies across a wide range of industries to form a working group and discuss the current state of fraud risk management (FRM) at their organizations.

Many organizations have faced significant disruptions and challenges during the COVID-19 pandemic. Considering the impact of various sources of change on controls and processes that could affect an organization's business model and risk profile, the working group agreed it was important to examine the fundamentals and arising challenges of effective FRM in today's climate.

This exploration included conversations about the current and goal states of FRM programs at working group member organizations, how they map internal and external sources of risk to establish a baseline risk profile, and how they strive to embed FRM into their overall corporate culture.

This publication, the first of three in a series on trends and best practices related to FRM, offers insights into how fraud risk governance shifted during a period of heightened fraud risk and spotlights the current and goal state of FRM programs, how to enhance the effectiveness of FRM programs in light of the pandemic, and how corporate culture can influence an organization's approach to FRM.

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Fraud Risk Management Maturity: Where are Organizations Today?

To establish a foundation for our work, we asked participants about the current state of their FRM programs. The working group acknowledged that FRM should be developed with the specific needs of each organization in mind, given that FRM programs are not one size fits all. To provide context to their input, participants were asked to consider the anti-fraud maturity assessment model below to compare to their program's maturity level.

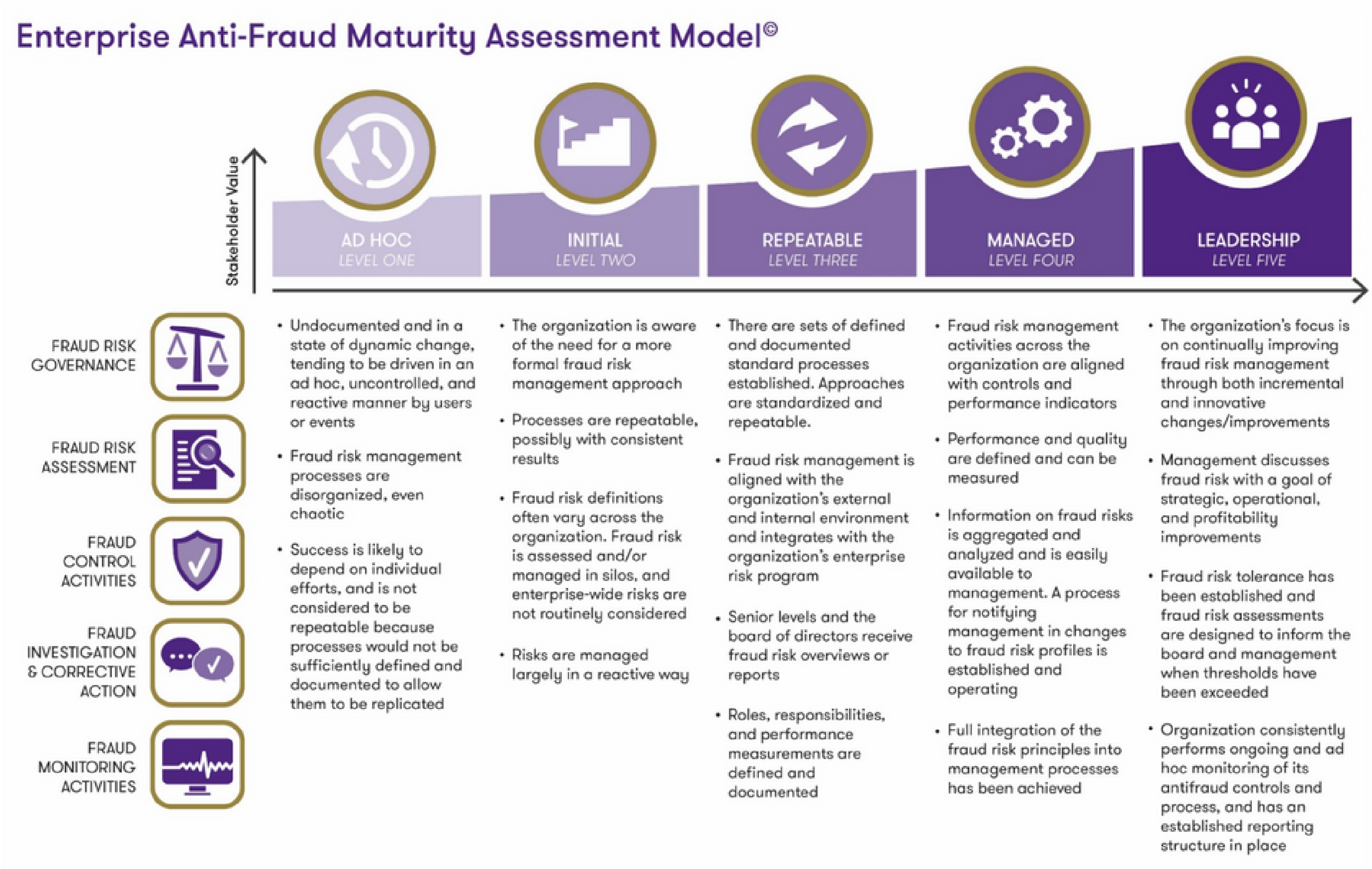

Image from *The Anti-Fraud Playbook: The Best Defense Is a Good Offense*, published by Grant Thornton and the Association of Certified Fraud Examiners, March 2021.

Program maturity is a constantly evolving metric. A number of working group members considered their programs at a lower maturity level, as they are currently engaging in initial fraud risk assessments, developing consistent processes, and convening key stakeholders to create a more formalized approach to their FRM programs.

A member organization that was not as far along on the maturity assessment model has aimed to improve their organization's FRM program by understanding the general business and fraud risks through the use of surveys and risk assessments. They have also established a mitigation process and a cross-functional working group in an effort to identify fraud risks.

Efforts to improve program maturity have evolved over time at each member organization. One working group member stated that their program has historically been focused on protecting customer assets and risk management as the first line of defense. Their current challenge, however, is creating controls for—and bringing greater attention to—decentralizing internal FRM. Another member's maturity journey started with the Evaluation of Corporate Compliance Programs issued by the Department of Justice (DOJ) Criminal Division in June 2020. Following the DOJ's guidance, the member organization created a risk matrix with 20 to 30 fraud risks rated along a scale of the likelihood of occurrence and severity of impact. Those ratings were then incorporated into the member organization's annual enterprise risk management process.

FRAUD RISK MANAGEMENT IS FAR FROM A CHECK-THE-BOX EXERCISE.

FRM requires continuous cross-functional collaboration, regular reporting and monitoring, and the incorporation of myriad of external and internal risk factors.

One member organization has made great strides in its FRM efforts, moving from the "ad hoc" end of the maturity assessment model to the repeatable level. The member reflected that the key to moving up the maturity ladder included more comprehensive fraud risk mapping, increased frequency of risk reporting to the business units and leadership (i.e., annually to quarterly), and incorporation of risk mapping results into the overall organizational risk assessment findings.

Meanwhile, the majority of working group members rated their organization's FRM programs near the middle of the maturity model above, at the "repeatable" level. At this level, standardized and repeatable processes are in place; FRM aligns with the organization's internal and external environments; leadership receives fraud risk updates; and roles, responsibilities and performance measurements are defined and documented. Members in the middle of the maturity assessment model noted that fraud and anti-bribery risk assessments are separate from their organizations' overall enterprise risk management programs—particularly risk assessments which are conducted annually. Fraud risk assessments are conducted within the organization's various business functions and are then reviewed by the compliance function. The member organizations also use cross-functional FRM teams that meet quarterly to ensure that each business unit is adhering to federal laws and regulations, and are operating within their organization's risk profile.

Another member organization has achieved a maturity level described as being in between "repeatable" and "managed." The organization achieved this level of maturity by using guidance from auditors and regulators to expand its FRM programs, implement suites of fraud controls in each line of business, and collaborate closely with its internal investigations team.

The remaining few organizations noted they were moving toward the more mature end of the assessment model, which boasts organizational alignment across controls and measurement; the ability to analyze risks across functions; and more advanced proactive monitoring capabilities. No matter where they rated their programs on the chart, all working group members are currently intending to develop their programs to achieve a higher level of maturity.

In addition to taking stock of each organization's program maturity levels, the working group sought to understand the risk environments their programs faced, what members perceived as the most pressing drivers of fraud risks both internally and externally, and how members strived to stay ahead of key risk triggers.

APPROACHES WORKING GROUP MEMBERS TAKE TO IDENTIFYING SOURCES OF EXTERNAL VS. INTERNAL RISK

External

- Enterprise risk assessments and management
- Collaboration with internal audit
- Guidance from government agencies
- Broad risk assessments taken in tandem with enterprise risk management
- Focused program for external risks
- Case management system in collaboration with external organizations

Internal

- Audits and reporting
- Cross-functional working group conducting an organization-wide fraud risk assessment
- Guidance from government agencies
- Internal committees that meet quarterly
- Governance committee
- Focused program on internal risks

The working group members consistently identified collaboration as the most important and effective element in keeping their fraud risk management programs ready to face the constantly changing number and type of risks. Whether this came in the form of collaborating with other business units or functions or with external stakeholders like government regulators, collaboration is key for a successful fraud risk management program.

Fraud Risk Management in Times of Crisis

Member organizations noted that they have been facing a period of heightened fraud risk during the pandemic. Their growing concerns include cybersecurity threats, third-party risks, supply chain disruptions, and loss of physical control of workspaces and company assets. The new challenges they face include conducting investigations remotely, responding to concerns with hybrid work environments, protecting data privacy, retaining talent deterring and detecting new fraud schemes, and so on.

In its report *Mitigating the Risk of Common Fraud Schemes: Insights from SEC Enforcement Actions*, the AFC recommends that organizations update their fraud risk assessments to consider the pandemic's potential impact. The AFC identified 12 examples of financial fraud schemes that may be more prevalent in the current environment:

- Fabrication of revenue to offset losses
- Understatement of accounts receivable reserves as customers delay payments
- Manipulation of compliance with debt covenants
- Unrecognized inventory impairments
- Over or understating accounting estimates to meet projections
- Misleading plans to remain a going concern
- Improper capitalization and amortization costs
- Big bath write-offs or inappropriate timing of write-offs
- Intentional failure to disclose the pandemic's impact - including impact on forecasts of future cash flows and other activities
- Passing off falsely disclosed underlying issues as attributed to the pandemic
- Overstated business interruption insurance claims that sweep in costs unrelated to the pandemic
- Cookie jar reserves by companies that may be outperforming expectations during the pandemic

Working group members have also noted a shift in priorities regarding their FRM programs. Given that certain fraud risks have changed during the pandemic, organizations may need to adapt by making their own changes too. Member organizations have turned their focus to increasing revenue management; altering team roles and processes due to quickly evolving changes to their work environment; and increasing their level of skepticism when engaging government contractors, vendors, and other third parties.

Although certain fraud risks have been higher during the pandemic, the overall outcomes in terms of the impact to member organizations' FRM programs have been positive. When asked about the most significant impact to their FRM programs during the pandemic, 70 percent of members noted an increase in collaboration with other business functions, internal and external auditors, and employees from all levels to enhance their organization's FRM efforts. Audit committees are also increasingly playing a role in fraud risk management, with a recent survey of audit committee members finding that 96 percent of respondents ranked financial reporting and internal controls—including fraud risk—as a top area of focus in the past year. Many members also increased the frequency of various FRM activities at their organizations as a result of the pandemic. Such activities included quarterly risk update meetings, routine risk assessments, risk-related discussions with management, and enhanced use of technology. Overall, the focus on such activities has contributed to an increase in organizational alignment on their FRM approach.

Throughout the COVID-19 pandemic, organizations have had to adapt to new realities across their business functions—including those that house FRM. Organizations are shifting their priorities for managing fraud risks to align with work-from-home (WFH) environments; updating data protection policies; and addressing new and emerging threats in cybersecurity, data privacy, supply chain management, and third-party risks.

INCREASING CONCERNS

- Cybersecurity threats
- Third-party corruption activities
- Supply chain fraud
- Loss of physical control of workspaces

NEW CHALLENGES

- Conducting investigations remotely
- Concerns about reopening offices
- Data protections for work from home employees
- Talent retention
- Data exfiltration concerns
- New opportunities for work-from-home situations

The Role of Culture in Fraud Risk Management

Culture can impact many aspects of an organization from value creation to risk mitigation. A strong corporate culture can influence the attitudes, actions, and performance of employees throughout all levels of the organization as well—including those responsible for managing fraud risks within each business function.

The working group members asserted that communication and training are two key areas on which their organizations have focused to create an ethical culture, which embraces their company values and emphasizes 'doing the right thing.'

MANY MEMBERS USE CULTURE SURVEYS TO ASSESS AND EMBED CULTURE INTO THEIR ORGANIZATIONS.

TYPES OF CULTURE SURVEYS USED:

- General culture surveys
- Survey focused on inclusivity
- A non-mandatory "people pulse" survey
- Ethisphere Culture Assessment

Communication efforts are essential to enhance fraud risk mitigation. Employees should be frequently educated on and reminded of indicators of potential red flags, different types of fraud schemes, and lessons learned from past investigations. More importantly, organizations should provide clear guidance on how employees can report misconduct and other inappropriate activity.

Working group members also shared several examples of communication strategies, including investigation outcomes (without disclosing confidential information), particularly when disciplinary action is involved; sending culture related communications that highlight company values, purpose, and code of conduct; and equipping managers with tools to engage in more frequent discussions with their teams about ethical conduct.

Members also noted that it is important for organizations to communicate positive actions and outcomes, such as celebrating employees who make ethical decisions and highlighting the power of integrity related to compliance.

Training is also necessary to embed an ethical culture throughout the organization's various business functions. Member organizations conduct training annually and/or biannually, with their training programs typically focusing on reviewing and acknowledging a code of conduct, and learning key subjects including but not limited to conflicts of interest, gifts and entertainment, and reporting misconduct.

Analysis of Ethisphere's Culture Quotient (CQ) Data Set in the Ethical Culture Insight Report series has shown that ineffective training and communications have huge impacts on mitigating fraud risk. Employees who rate their training and communications as not effective were:

- **67 percent** less likely to identify misconduct than a colleague who found the training and communications effective.
- **Three times less** likely to indicate that they observed more complex or nuanced types of misconduct, such as misuse of company intellectual property, trade controls violations, or bribery.

Conclusion

FRM is a constantly evolving field, and the current environment has significantly impacted the fraud risk landscape for many organizations. The pandemic has not only disrupted the ways in which organizations operate, it has changed the lens through which organizations perceive their fraud risks. Regulators and gatekeepers have also made changes to keep up with the rapidly evolving fraud risk landscape. As new rules and regulations regarding cybersecurity, data privacy, and financial disclosures are being set, organizations may need to reevaluate their policies and procedures to address the associated risks. Organizations should also consider whether their FRM programs may have new vulnerabilities and if any changes to their organization's level of fraud risk tolerance could potentially impact the organization's approach to their overall FRM efforts.

Learn more about how you can identify your organization's strengths and gaps with an Ethisphere Culture Assessment. A dedicated ethical culture survey can help you meet regulatory guidance recommendations, identify risks before they escalate, tap into data and insights from Ethisphere's dedicated culture data set, and understand peer practices and employee perceptions of ethics and culture at your organization.

You can also learn more about how to measure culture in the AFC's *Assessing Corporate Culture: A Proactive Approach to Deter Misconduct*. The report shares insights into the importance of finding the right tools to assess culture as well as considerations regarding the ownership of culture, while highlighting the unique role of auditors and other financial reporting stakeholders.

The key to protecting companies from fraud is for all members of the financial reporting ecosystem to demonstrate vigilance, a resolve to exercise skepticism, focus on culture and attention to risk. Visit the Anti-Fraud Collaboration for thought leadership, education, and research to support all members of the financial reporting supply chain to deter and detect fraud.

ABOUT THE BUSINESS ETHICS LEADERSHIP ALLIANCE (BELA)

Founded by Ethisphere, the Business Ethics Leadership Alliance (BELA) is a globally recognized organization of leading companies collaborating to share best practices in governance, risk management, compliance, and ethics. BELA's membership has since grown to a global community of companies that recognize the inherent value of promoting ethical leadership and a world-class compliance culture. Learn more about BELA by visiting http://bela.ethisphere.com.

ABOUT ETHISPHERE

Ethisphere is the global leader in defining and advancing the standards of ethical business practices that fuel corporate character, marketplace trust, and business success. Ethisphere has deep expertise in measuring and defining core ethics standards using data-driven insights that help companies enhance corporate character. Ethisphere honors superior achievement through its World's Most Ethical Companies® recognition program, provides a community of industry experts with the Business Ethics Leadership Alliance (BELA), and showcases trends and best practices in ethics with *Ethisphere Magazine*. Ethisphere also helps to advance business performance through data-driven assessments, benchmarking, and guidance. For more information, visit https://ethisphere.com.

ABOUT THE CENTER FOR AUDIT QUALITY (CAQ)

The Center for Audit Quality (CAQ) is a nonpartisan public policy organization serving as the voice of U.S. public company auditors and matters related to the audits of public companies. The CAQ promotes high-quality performance by U.S. public company auditors; convenes capital market stakeholders to advance the discussion of critical issues affecting audit quality, U.S. public company reporting, and investor trust in the capital markets; and using independent research and analyses, champions policies and standards that bolster and support the effectiveness and responsiveness of U.S. public company auditors and audits to dynamic market conditions.

ABOUT THE ANTI-FRAUD COLLABORATION

The Anti-Fraud Collaboration (AFC) represents the collaborative efforts of the Center for Audit Quality, Financial Executives International, the National Association of Corporate Directors, and the Institute of Internal Auditors, organizations that actively engage in efforts to mitigate the risks of financial fraud. The AFC is dedicated to advancing the discussion of critical anti-fraud efforts through the development of thought leadership, awareness programs, educational opportunities, and other related resources focused on enhancing the effectiveness of financial fraud risk management.