

# DIRECTOR

Issue 143 | April 2009



INSTITUTE  
OF CORPORATE  
DIRECTORS

Corporate Governance

## Challenges and Changes Responding to Increased Fraud Risk in a Down Market

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### Declining Markets Increase the Risk of Fraud

It is generally accepted that when the economy takes a downturn, instances of fraud increase. A recent poll conducted by Deloitte discovered that nearly two-thirds (63.3 percent) of executives polled expect accounting fraud to increase during the next two years.<sup>1</sup> This increased fraud risk should be on the minds of all Directors, as the board plays an important role both in safeguarding against fraud and in dealing with instances of fraud should they occur.

Types of fraud on the increase during economic hard times may be divided into two main categories, with different likelihoods, different impacts on the company and different responsibilities for Directors. The first is fraud which impacts the business or operations of the company, and the second is fraud relating to the company's financial disclosures.

<sup>1</sup> Deloitte Poll: *Nearly Two-Thirds of Executives Anticipate Uptick in Accounting Fraud, Resulting from a Down Market*. Deloitte Financial Advisory Services LLP, January 9, 2009.

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## Protecting Against Fraud Impacting Business or Operations

This type of fraud is a direct threat to the assets of the company. In the current economic climate in which income and cash flows are much more at risk, the incentive for employees, suppliers or others to commit fraud is significantly higher. At the same time, resource limitations due to staff reductions or simply a change in priorities may lead to slippage in internal controls.

The primary responsibility of the board in safeguarding against these types of fraud is the oversight of risk and internal controls. The board must ensure that controls are not seen as an area that can be scaled back in order to economize. Key responsibilities of Directors include:

- **Tone at the top** – The board bears responsibility for satisfying itself as to the integrity of the corporation's executive officers and their creation of a culture of integrity throughout the organization. Directors should be well acquainted with members of the executive management team and listen for presentations or responses to questions that are evasive or inconsistent. The audit committee should also ask both internal and external auditors about concerns in this area. Finally, the board should consider this issue specifically at in camera meetings of the board on a periodic basis.
- **Code of conduct** – The board's role includes adoption of a code of conduct and monitoring compliance. It is critical that the code is reviewed regularly and that employees, contractors, and sometimes suppliers are asked to acknowledge that they are familiar with the code and undertake to comply with it.
- **Whistleblowing** – Securities laws require issuers to establish a whistleblowing program, overseen by the audit committee, relating to financial reporting and accounting matters. In many public companies, all whistleblowing (financial and otherwise) is folded into one program. The existence of an effective whistleblowing policy, and prompt and serious attention paid to complaints made, may bring to the board's attention areas of fraud risk within the company.
- **Compensation practices** – The control environment and senior management's behavior

can be negatively impacted when compensation schemes reward the wrong behaviours. Boards should ensure that executive compensation programs support and reward behaviour consistent with the code of business conduct and ethics.

In cases where preventative efforts fail and fraud affecting the business or operations of the company is alleged to have occurred, the board has another important duty – ensuring that the allegations are appropriately addressed. Where an incident is not material to the company from a financial or reputational perspective and where the conduct of senior management is not at issue, it will typically be appropriate for management to deal with the issues.

During a management-led investigation, the board should be satisfied that management is handling the situation appropriately and should expect to receive regular reports. In some cases, it will be appropriate for management to retain outside counsel, as well as other consultants, either to secure specialized expertise or to support the independence of the process. It will be the board's responsibility to make any final determinations. Accordingly, the board should ensure that it probes the reports and tests the conclusions reached.

## Addressing the Possibility of Fraud Relating to Financial Disclosures

The second major type of fraud that Directors should be aware of in this economic downturn is improper or omitted disclosures in financial statements. In a down market, falling stock prices lead to increased pressure on management to meet performance targets. This pressure then increases the likelihood of inappropriate earnings management and fraud. While this type of fraud may be less common, the impact on the company is substantially greater and the board will play a much greater role in its investigation and resolution.

Evidence of fraud relating to financial disclosures may surface as a result of the company's regular review procedures. The internal audit function may detect patterns of minor non-compliance or major deviations from established policy. The external auditors are also a source of fact-finding and analysis in connection with their audit that may lead to the

uncovering of fraud. It may also come to light when reported by an employee or uncovered by an external party such as a regulator.

The consequences of fraud relating to financial disclosures can be devastating. When financial statement disclosure needs radical correction, investor confidence in the corporation may be shaken, impacting negatively on stock prices, sometimes for a prolonged period. It also often leads to regulatory action and penalties.

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The erosion of customer trust or confidence is also a serious result. Although not shown on the balance sheet, corporate reputation is one of an organization's most important assets. Whether or not wrongdoing has actually occurred, damage may result simply from the allegations having been made.

The board's response to such an allegation of fraud can determine the survival of the company. A thoughtful process, overseen by the board as appropriate, can not only resolve the problem but preserve and promote the company's relationships with regulators, engender stakeholder confidence, and restore reputation.

Some key elements of Directors' responsibilities in dealing with an allegation of fraud relating to financial disclosures include:

- **Establishment of a special committee** – A special committee of independent Directors is generally established. The board should approve a mandate for the special committee that sets out the scope of its authority and provides the resources necessary for it to discharge its responsibilities. Once appointed, the role of the committee is to retain the appropriate experts to conduct the investigation and to oversee their work.
- **Role of Directors during the investigation** – The duties of Directors who sit on a special committee are no different from their duties in any other aspect of their responsibilities as Directors. They must act in accordance with their fiduciary duty and duty of care. They must be free from conflicts of interest. Recourse to legal counsel and other experts is critical to discharging the duty of

care. The members of the special committee must review the advice received critically and ask questions as necessary to satisfy themselves about the advice on which they are relying.

- **Outcomes of the investigation** – At the conclusion of an investigative process, action will generally need to be taken by the board, after considering recommendations from the special committee. Such actions may include financial restatements, changes to company policies or business practices, and termination of employees or executives.
- **Cooperation with regulators** – In the case of fraud relating to financial disclosures, dealing with regulators will be an important focus for the board. The ideal result is for the regulator to be prepared to rely on the corporation's own internal investigation and be satisfied that the remedial action taken by the board obviates the need for any sanctions. Securities regulators have developed guidelines for cooperation which are intended to encourage issuers to self-police their compliance with securities laws, self-report breaches that come to light and self-correct the behaviours that led to the failure to comply.
- **Disclosure of the investigation** – Whether and when the wrongdoing that prompted the investigation or the fact of the investigation itself should be disclosed is a decision that must be carefully considered by the board with the assistance of its counsel. When disclosure of the fraud is necessary, well-managed communications can reap benefits in terms of stakeholder confidence and preservation of the company's reputation. The board's responsibilities include oversight of the company's communication policy, and Directors should ensure that there is a well thought-out strategy in place.

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*The RMGB publication **20 Questions Directors Should Ask about Responding to Allegations of Corporate Wrongdoing**, by Carol Hansell, MBA, LL.B. and Beth Deazeley, LL.B. is available at [www.rmgb.ca](http://www.rmgb.ca)*