Bribery in International Business Transactions
IV. LIMITING LIABILITY:
CORPORATE GOVERNANCE AND FRAUD PREVENTION STRATEGIES

Introduction
The business community represents the frontline in the fight against corruption and money laundering. In response to evolving legal frameworks and growing societal pressures, companies must improve corporate governance policies and implement comprehensive compliance programs. Such measures not only help corporations to minimize their liability and maintain long-term liability, but also to ultimately protect their reputations.

The final chapter of this course begins with an overview of several major international initiatives to improve corporate governance, followed by a discussion of strategies to comply with relevant laws and regulations and to prevent fraud. Specific policies to combat bribery and prevent money laundering are also introduced. Chapter 4 includes one case study and concludes with a set of review questions.

International Corporate Governance Initiatives

*Corporate governance* refers both to the policies that dictate how a company pursues its objectives and monitors performance and the relationships between a company’s management, board of directors, shareholders, and other stakeholders. Interest in corporate governance increased significantly following the East Asian Financial Crisis of the late 1990s and several high-profile cases of corporate malfeasance and bankruptcy in the early 2000s. Numerous international initiatives to improve corporate governance have subsequently been developed and embraced by interested parties. Policy makers understand that sound corporate governance promotes market stability and economic growth; investors wish to see more effective safeguards to protect their investments; and companies have recognized the connection between improved corporate governance and increased competitiveness.

**OECD Principles of Corporate Governance**
Developed in 1998 and revised in 2002, the OECD *Principles of Corporate Governance* (OECD Principles) were designed to assist OECD and non-OECD countries in evaluating and improving their respective legal, regulatory, and institutional frameworks for corporate governance. The Principles also provide guidance to companies, shareholders, and other parties responsible for developing corporate governance policies. As a concise set of non-binding standards and practices, the Principles reflect that no single model for effective corporate governance exists and serve as a reference source for policy makers to develop frameworks that respond to their specific circumstances.
Ensuring the Basis for an Effective Corporate Governance Framework
The purpose of an overall framework for effective corporate governance is to promote efficiency, integrity, and transparency in markets. Corporate governance frameworks must be consistent with the rule of law and clearly articulate the division of responsibilities among relevant supervisory, regulatory, and enforcement authorities. Such authorities must have access to the resources necessary to fulfill their obligations in a professional and objective manner.

The Rights of Shareholders and Key Ownership Functions
The relationship between the owners and management of a company is a critical aspect of corporate governance. The basic rights of shareholders should include the right to:
1. Secure methods of ownership registration.
2. Share in the profits of the corporation.
3. Convey or transfer shares.
4. Obtain relevant information on a timely and consistent basis.
5. Participate and vote in general shareholder meetings.
6. Elect and remove members of the board of directors.

The Equitable Treatment of Shareholders
All shareholders, including foreign and minority shareholders, should be treated equally and have the opportunity to obtain effective redress for any violation of their rights. Insider trading and abusive self-trading should be expressly prohibited. In addition, board members and key executives should disclose to the board whether they have a material interest in any transaction or matter directly affecting the corporation.

The Role of Stakeholders in Corporate Governance
Corporate governance frameworks should encourage active cooperation between corporations and relevant stakeholders to create wealth, jobs, and financial sustainability. Such stakeholders include employees, customers, suppliers, and creditors. In addition, an effective framework should be complemented by an efficient process to enforce creditor rights.

Disclosure and Transparency
The timely and accurate disclosure of relevant information concerning the ownership, governance, financial situation, and performance of a company is a key element in improving corporate transparency. The Principles recommend that, at a minimum, the following information be disclosed regularly:
• Major share ownership and voting rights
• Company objectives
• Information about members of the board and key executives, including remuneration, qualifications, and the selection process
• Governance structures and policies, including corporate governance code
• The financial and operating results of the company
• Related-party transactions
• Foreseeable risk factors
• Issues regarding employees and other stakeholders
• To provide objective assurance that the financial information disclosed is accurate, an annual audit should be conducted by an independent, competent, and qualified auditor.

The Responsibilities of the Board
Members of the board of directors should be held to a high ethical standard and expected to act in good faith, with due diligence and care, for the best interests of the company and its shareholders. The major functions fulfilled by the board should include:
• Guiding corporate strategy, major plans of action, risk policy, annual budgets, and business plans
• Monitoring the effectiveness of the company’s governance practices and making appropriate changes
• Setting performance objectives
• Overseeing major capital expenditures, acquisitions, and divestitures
• Selecting, compensating, reviewing, and replacing key executives in a transparent manner
• Managing potential conflicts of interest management, board members, and shareholders
• Ensuring the integrity of the corporation’s accounting and financial reporting systems and overseeing disclosure

UN Guidance on Good Practices in Corporate Governance Disclosure
In 2006, the UN released its Guidance on Good Practices in Corporate Governance Disclosure (UN Guidance). Like the OECD Principles, this document seeks to improve corporate transparency and accountability to facilitate sustained economic development. The UN Guidance draws upon various international recommendations and instruments to encourage countries and corporations to implement the best practices, tailored to their specific legal requirements and local traditions. In particular, the Guidance emphasizes the disclosure of information relevant to a company’s financial condition, objectives, structure, and overall performance.

Financial Disclosures
The board of directors is responsible for providing high-quality disclosures to a company’s shareholders and other stakeholders regarding its financial and operating results. To reinforce a commitment to transparency, such disclosures may describe the duties of the board in overseeing the production of financial statements and any estimates used. In addition, the disclosure of significant related-party transactions will assist shareholders and stakeholders to determine whether management is operating in
their best interests. A related-party transaction is one in which there is a preexisting relationship between the parties involved that often presents a conflict of interest.

**Non-Financial Disclosures**

In addition to financial and operating results, the disclosure of material information regarding the structure, policies, and management of a company will enhance its transparency. The UN Guidance identifies disclosure of the following information among its recognized best practices:

- **Company objectives**—While a company’s objectives traditionally refer to its economic goals, a growing number of investors are attracted to company objectives that reflect a commitment to environmental and social stewardship programs.

- **Ownership and control structures**—Information concerning the ownership of a corporation, particularly the concentration of shareholdings, and the exercise of voting rights is of significant value to prospective investors. The board of directors should disclose any changes to either the ownership or the control of a company as soon as practicable.

- **Governance structures**—Companies should disclose information regarding the role, function, and composition of their boards of directors that accurately describes the members’ duties, qualifications, and remuneration and the mechanisms to evaluate their performance.

- **Policies**—Information about the corporate ethics policy and the impact of any environmental or social stewardship commitments on the company’s performance should be disclosed. In addition, the board should discuss any mechanisms it has adopted to protect the rights of stakeholders and the role of employees in developing its structure of corporate governance.

- **Material foreseeable risks and transactions involving significant assets**—The board should report on its risk management objectives and the internal control systems in place. Sufficient disclosure should be made prior to any major transactions, such as mergers or the sale of substantial assets.

- **Auditing functions**—The board should disclose the scope and responsibility of the internal audit function, as well as the level of management to which it reports. When external auditors are used, the board should express confidence in their independence, integrity, and competence, and should describe the selection and approval process for the external auditor.

**Timing and Means of Disclosure**

The UN Guidance stresses substance over form for the disclosure of relevant information, particularly regarding issues that require immediate or continuous disclosure. Annual reports and other traditional means of communication should be supported by alternative channels. The use of company websites is an appropriate method for conveying updated information to interested stakeholders.
Corporate Compliance and Fraud Prevention

A rigorous compliance program is an essential element of effective corporate governance. Companies that commit themselves to ethics policies and measures to comply with applicable laws and regulations limit their liability considerably, even when a violation does occur. The United States Sentencing Guidelines establish that, upon conviction of a federal charge, an organization may receive a significantly reduced fine if it is shown to have adopted a program to prevent and detect violations of the law. According to the Sentencing Guidelines, the following factors are relevant to determine whether an effective compliance program is in place:

- **Size of the organization**—The size of an organization will determine the level of formality necessary to prevent and detect violations of the law. Larger organizations should adopt written policies that clearly define the standards and procedures for their employees and agents to follow.

- **The nature of a business or industry**—The nature or operating structure of an organization may present inherent risks for violations that management must take steps to prevent and detect. For instance, if a company’s sales personnel exercise discretion in setting the price or representing the material characteristics of a product, it should have measures in place to address the risk of fraud. In addition, organizations must be cognizant of the specific laws and regulations that apply to their industry. For example, companies that handle toxic substances must ensure that they are handled and disposed of properly.

- **Prior history of the organization**—Organizations must enact measures to prevent recurring violations of applicable laws and regulations. A failure to follow industry practice or prevent persistent misconduct clearly undermines a company’s claim to have implemented an effective compliance program.

General Elements of an Effective Corporate Compliance Program

To effectively comply with all applicable laws and regulations, the Sentencing Guidelines advise organizations to exercise due diligence and promote a culture of ethical behavior. The following elements have been identified and endorsed as common features of successful compliance programs.

*Established Standards and Procedures*

Explicit standards for appropriate conduct and procedures to reduce the likelihood of criminal behavior should be expressed and disseminated throughout the organization. The corporate fraud prevention strategies discussed in the next section provide examples of such standards and procedures.

To help establish their companies’ standards and procedures, management should implement written fraud policies that specifically spell out who in an organization handles various fraud matters under different circumstances. This type of policy is also important because it helps management inform and educate its employees about prohibited acts and notify them of how to report violations.
A sample fraud policy is contained in Appendix C.

**Oversight by Board of Directors**
A culture of ethical behavior requires active oversight from the highest level of the organization. Overall responsibility for the implementation and operation of a compliance program rests with the board of directors or an equivalent governing body. Responsibility for the day-to-day operation of a compliance program may be assigned to one or more individuals who report directly to the governing body.

**Exclusion of Certain Individuals from Management Positions**
An organization must take reasonable precautions to ensure that individuals who have engaged in illegal activities or other conduct inconsistent with the compliance program are not hired or promoted to a position of significant authority.

**Training**
An organization should offer periodic and practical training to its employees regarding the standards and procedures of its compliance and ethics program.

Training programs, which should be based on the organization’s operations and needs, should inform employees about the company’s stance on corporate compliance. They should also inform employees about what kinds of acts and omissions are prohibited by the law and by the organization. The training should be designed to help employees identify and avoid situations that could lead to criminal conduct. Some common training techniques include lectures, films, interactive workshops, and computer-based courses.

Additionally, fraud awareness training should cover areas such as proper and improper payments, facilitation payments, gifts (e.g., hospitality gifts, travel expenses, entertainment expenses, etc.), and red flags of improper activity.

Furthermore, the training should vary among employees. General training, which should be appropriate for the majority of personnel, should include the basics of anti-corruption laws and regulations. Conversely, specific training, which should be geared toward those employees who are assigned to foreign locations or higher-risk positions, should provide more in-depth information. For example, purchasing agents and sales representatives should be given specific training that includes information about red flags related to their responsibilities.

Training, however, should not be a one-time event. Simply handing out a copy of the company’s compliance policy at the beginning of an employee’s tenure is insufficient.
**Monitoring**
A system to monitor and evaluate the effectiveness of a compliance program should be in place. In addition, organizations should provide channels for employees to report violations without fear of retaliation and resources for guidance on appropriate conduct.

**Incentives and Discipline**
A compliance program should provide employees with proper incentives to act in accordance. Conversely, any violations and criminal conduct must be met with strict enforcement and disciplinary measures. Organizations must take remedial actions following any violations to prevent similar misconduct in the future.

The above measures endorsed by the United States Sentencing Guidelines are broadly defined to allow flexibility in designing effective corporate ethics policies and compliance programs. The fraud prevention strategies discussed below provide greater detail and are directly applicable to the creation of compliance systems.

**Corporate Fraud Prevention Strategies**
Fraud can be difficult to detect because it often involves concealment through the falsification of documents or collusion among management, employees, or third parties. Therefore, it is important to place strong emphasis on prevention to reduce opportunities for fraud and deterrence to dissuade individuals from committing fraud. Compared to the time and money expended in fraud detection and investigation, effective prevention and deterrence measures prove far more cost effective.

There are three fundamental measures that entities can implement to help prevent and deter fraud:
1. Creating and maintaining a culture of honesty and high ethics
2. Evaluating the risks of fraud and implementing the processes, procedures, and controls needed to mitigate those risks and reduce the opportunities for fraud
3. Developing an appropriate oversight process

**Creating a Culture of Honesty and High Ethics**
Each organization is responsible for creating a culture of honesty and high ethics and communicating expectations of acceptable behavior to its employees. Such a culture serves as the foundation for how an organization conducts its business and instills a strong set of core values among all employees. It also allows an entity to develop an ethical framework to address the misappropriation of assets, fraudulent

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7 The material reflected herein is derived from the document issued jointly by the American Institute of Certified Public Accountants, Association of Certified Fraud Examiners, Financial Executives International, Information Systems Audit and Control Association, Institute of Internal Auditors, Institute of Management Accountants, and Society for Human Resources Management as an Appendix to the American Institute of Certified Public Accountants’ Statement on Auditing Standards No. 99, “Consideration of Fraud in a Financial Statement Audit.”
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financial reporting, and other forms of corruption. To create a culture of honesty and high ethics, organizations should:

- Establish a culture of honesty by setting the tone at the top
- Create a positive workplace environment
- Hire and promote appropriate employees
- Provide thorough training programs that include fraud awareness
- Confirm employee compliance with a code of conduct
- Enforce consistent disciplinary measures

Setting the Tone at the Top
Research strongly suggests that leading by example is the best method to reinforce a culture of honesty. The directors and officers of any corporation should provide this example for ethical behavior by setting the tone at the top. Management cannot act one way and expect its employees to behave differently. Senior financial officers hold a particularly important role in corporate governance. As members of the management team, they are uniquely capable and empowered to ensure that all stakeholders’ interests are appropriately balanced, protected, and preserved.

A code of conduct is an effective tool for fostering a corporate culture based on a strong value system. Effective codes will reflect the core values of the organization and guide employees to make appropriate decisions in performing their duties. Relevant topics for a code of conduct include basic concepts of ethics, confidentiality, conflicts of interest, intellectual property, sexual harassment, and fraud. A code of conduct should be developed in a participatory and positive manner, allowing management as well as employees to take ownership of the code’s content. However, management is still responsible for reinforcing the code of conduct and ensuring it is communicated to all personnel in a coherent fashion.

To truly be effective, a code of conduct should be reinforced through regular educational programs. These programs ensure that employees fully understand ethics policies and are prepared to make ethical decisions and understand how to interpret the ethics policies.

It obviously does little good for an organization to have a fraud or ethics policy that is not communicated to its employees. Communication can be accomplished in several ways (e.g., during initial employee orientation, an interoffice memorandum, posters displayed in common areas, etc.), but such policies should be presented in a positive, nonaccusatory manner.

A sample of a typical Code of Business Ethics and an Annual Compliance Questionnaire are provided in Appendix D.
Creating a Positive Workplace Environment

Research also indicates that malfeasance occurs less frequently when individuals feel positively about their employers than when they feel abused, threatened, or ignored. Negative workplace environments diminish morale and can affect employees’ attitudes about committing fraud. Management should take care to reduce incidence of the following factors, which have been commonly identified as detracting from a positive work environment:

- Top management that does not seem to care about or reward appropriate behavior
- Negative feedback and lack of recognition for job performance
- Perceived inequities in the organization
- Autocratic rather than participative management
- Low organizational loyalty or feelings of ownership
- Unreasonable budget expectations or other financial targets
- Fear of delivering bad news to supervisors and/or management
- Less-than-competitive compensation
- Poor training and promotion opportunities
- Lack of clear organizational responsibilities
- Poor communication practices or methods within the organization

Hiring and Promoting Appropriate Employees

Each employee brings a unique set of values and a personal code of ethics to the workplace. Some employees will behave dishonestly when tempted by a perceived opportunity or confronted with sufficient pressure. Naturally, the tendency for dishonest behavior varies among individuals. To successfully prevent fraud, an entity must have effective policies in place to minimize the likelihood of hiring or promoting individuals prone to dishonest behavior. This is particularly relevant when promoting individuals to positions of trust.

Training

New employees should receive prompt training that covers the entity’s values and its code of conduct. Such training should include an element of fraud awareness to stress that fraud imposes costs and other detrimental effects on the entity and employees alike. Training should explicitly convey that all employees have a duty to report certain matters, including actual knowledge or suspicions of fraud, and information on how to report them. Senior management should affirm its expectations that all employees will fulfill this duty. In addition to training at the time of hiring, all employees should receive periodic training to reinforce the culture of honesty. Some organizations may consider ongoing training for certain positions, such as purchasing agents or employees with financial reporting responsibilities. Training should be specific to an employee’s level of responsibility within the organization, geographic location, and assigned responsibilities.
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Confirmation
Management needs to clearly articulate that all employees will be held accountable for acting in accordance with the entity’s code of conduct. All employees within senior management and the finance function, as well as employees in other areas that might be exposed to unethical behavior, should be required to sign a code of conduct statement annually, at a minimum.

Requiring periodic confirmation by employees will reinforce the code and deter individuals from committing fraud or other violations. In addition, it might identify problems before they become significant. Such confirmation may include statements that the individual understands the entity’s expectations, has complied with the code of conduct, and is not aware of any violations other than those the individual lists in his response.

Although people of low integrity may not hesitate to sign a false confirmation, most will want to avoid making a false statement in writing. Honest individuals are more likely to return their confirmations and to disclose what they know, including conflicts of interest or other personal exceptions to the code of conduct. Thorough follow-up by internal auditors or others regarding non-replies may uncover significant issues.

Discipline
How an entity reacts to incidents of alleged or suspected fraud will send a strong message throughout the entity and deter future occurrences. The following actions should be taken in response to an alleged incident of fraud:
• Conduct a thorough investigation of the incident
• Take appropriate and consistent actions against violators
• Assess and improve relevant controls
• Reinforce values, codes of conduct, and employee expectations through unambiguous communications and training

The consequences of committing fraud must be clearly communicated throughout the entity. For example, management can issue a strong statement that dishonest actions will not be tolerated and that violators may be terminated and referred to the appropriate authorities. If wrongdoing occurs and an employee is disciplined, it can be helpful to communicate that fact—without identifying the employee or disclosing any personal information—in a newsletter or other regular communication to employees. Seeing that other people have been disciplined for wrongdoing can be an effective deterrent, increasing the perception that violators will inevitably be caught and punished. It can also demonstrate the entity’s commitment to an environment of high ethical standards and integrity.
Evaluating Anti-Fraud Processes and Controls

Fraudulent financial reporting and the misappropriation of assets can only occur when there is a perceived opportunity to commit and conceal the act. Organizations should proactively reduce fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, and (3) implementing and monitoring appropriate preventive internal controls and deterrent measures.

Identifying and Measuring Fraud Risks

Management has the primary responsibility for establishing and monitoring all aspects of an entity’s fraud risk assessment and prevention activities. Fraud can occur in organizations of any size or type, and almost any employee is capable of committing fraud under the right circumstances. However, the nature and extent of risk assessment activities should be commensurate with the size of the entity and complexity of its operations. Accordingly, management should develop a fraud risk assessment program that reflects the needs of the entity and allows for oversight from the board of directors or audit committee.

Fraud risks are often considered part of an enterprise-wide risk management program, though they may be addressed separately. The fraud risk assessment process should consider the vulnerability of the entity to fraudulent activity—fraudulent financial reporting, misappropriation of assets, and corruption—and determine whether exposure to those risks could result in a material misstatement of financial statements or loss to the organization. In identifying fraud risks, organizations should consider relevant organizational, industry, and country specific characteristics that influence the risk of fraud.

Mitigating Fraud Risks

It may be possible to reduce or eliminate certain fraud risks simply by changing the entity’s activities and processes. An entity may choose to sell certain segments of its operations, cease doing business in certain locations, or reorganize its business processes to eliminate unacceptable risks. For example, the risk of misappropriation of funds may be reduced by implementing a central lockbox at a bank to receive payments instead of receiving money at various locations. The risk of corruption may be reduced by closely monitoring the entity’s procurement process. The risk of financial statement fraud may be reduced by implementing shared service centers to provide accounting services to multiple segments, affiliates, or geographic locations of an entity’s operations.

Implementing and Monitoring Appropriate Internal Controls

Although some risks are inherent to an entity’s industry or location, most can be addressed with an appropriate system of internal control. Once an assessment of fraud risks is completed, an entity can identify the processes, controls, and other procedures that are needed to reduce the identified risks. Effective internal controls will include a well-developed control environment, an effective and secure information system, and appropriate control and monitoring activities. Due to the importance of
information technology in supporting operations and the processing of transactions, management also needs to implement and maintain appropriate controls, either automated or manual, over computer-generated information.

Developing an Appropriate Oversight Process
To effectively prevent and deter fraud, an organization should have an appropriate oversight function in place. Oversight can take many forms and be performed at any level by individuals or groups within and outside of the entity. Oversight should begin at the top by the audit committee but may also be conducted by management, internal auditors, independent auditors, and Certified Fraud Examiners.

Audit Committee or Board of Directors
The audit committee—or a board of directors where no such committee exists—should evaluate all aspects of an entity’s fraud prevention and deterrence program, including the tone set by the top, the fraud risks identified by management, and the anti-fraud measures implemented. An audit committee should ensure that senior management implements appropriate measures to protect investors, employees, and other stakeholders. Such active oversight can help reinforce the entity’s commitment to creating a culture of “zero tolerance” for fraud. In addition to guaranteeing that management fulfills its responsibilities, evaluation and oversight by an audit committee serves as a deterrent to fraudulent activity by senior management itself. The audit committee also plays a vital role in helping the board of directors with respect to the entity’s financial reporting processes and the system of internal control.

In exercising its oversight authority, the audit committee should encourage management to provide mechanisms for employees to report their concerns about unethical behavior, actual or suspected fraud, and violations of the entity’s code of conduct or ethics policy. Periodic reports should be filed with the committee describing the nature, follow-up proceedings, and eventual resolution of any fraudulent or unethical conduct. Typically, an audit committee charter will grant the committee authority to investigate any alleged or suspected wrongdoing brought to its attention. Legal, accounting, and other professional consultants may be retained as needed to advise the committee and assist in investigations. However, all audit committee members should be financially literate and each committee should have at least one financial expert.

The audit committee must consider the potential for management to override controls and initiate, participate in, or direct the commission or concealment of fraud. If senior management is involved in fraud, the next layer of management may be the most likely to be aware of it. As a result, the audit committee should establish an open line of communication with members of lower management levels to assist in identifying and investigating fraud at the highest levels of the organization.
Management
Management is responsible for overseeing the activities carried out by employees and generally does so by implementing and monitoring the processes and controls discussed previously. Publicly traded companies should include a statement in the annual report acknowledging management’s responsibility for the preparation of financial statements and the maintenance of effective internal control systems. This will help improve public understanding of the distinct functions performed by management and auditors. Logically, the statement should be presented in close proximity to the formal financial statements. For example, it could appear near the independent auditor’s report or in the financial review or management analysis section.

Internal Auditors
Internal auditors perform key functions to deter, as well as detect, fraud and may be extremely helpful in the oversight process. Internal auditors can examine and evaluate the adequacy and effectiveness of an entity’s internal control systems based on its specific exposure to fraud-related risks. After gaining specialized knowledge of an entity’s operations, auditors may be able to recognize indicators that suggest the commission of fraud. In addition, internal auditors can conduct proactive auditing to search for corruption, misappropriation of assets, and financial statement fraud. The internal auditors should have an independent reporting line directly to the audit committee to enable it to express any concerns about management’s commitment to appropriate internal controls or to report suspicions or allegations of fraud involving senior management.

Independent Auditors
Independent auditors can assist management and the board of directors by providing an assessment of the entity’s process for identifying, assessing, and responding to the risks of fraud. The board of directors should have an open and candid dialogue with the independent auditors regarding management’s risk assessment process and the system of internal control. Such a dialogue should include a discussion of the susceptibility of the entity to fraudulent financial reporting and the entity’s exposure to misappropriation of assets.

Certified Fraud Examiners
Certified Fraud Examiners may assist the audit committee and board of directors with aspects of the oversight process either directly or as part of a team of internal or independent auditors. Certified Fraud Examiners can provide extensive knowledge and experience about fraud that may not be available within a corporation. They can provide more objective input into management’s evaluation of the risk of fraud (especially fraud involving senior management, such as financial statement fraud) and the development of appropriate anti-fraud controls that are less vulnerable to management override. They can assist the audit committee and the board of directors in evaluating the fraud risk assessment and the fraud prevention measures implemented by management. Certified Fraud Examiners also conduct