What CEOs Need to Know About Corruption Prevention & Detection – The Eternal War

“How to Limit Opportunities for Internal and External Malfeasance”
Agenda

➢ Preface – Why Listen to Me
➢ Stakes of the Game
➢ Challenge of the Game
➢ Practical Game Solutions – The Forever War
Nancy’s Challenge to Me – Why We Are Here

“What CEOs (from the CEO/Owners perspective) need to know about Corruption Prevention & Detection”

Or in other words:

“How to limit opportunities for Internal and External Malfeasance”
The Forever War – The Goal

Protect

The Company

&

The CEO/Owners

From

Corruption
Preface - Why Listen to Me?

➢ Not an Academic sitting in the Ivory Tower.

➢ I have sat where you are sitting.

➢ It is all about Your Future and the Future of Your Business!
Stakes of the Game – Corruption’s Many Flavors

- Taking What Does not Belong to You & Hiding That Taking
  - Fraud
  - Theft
  - Pay-for-Play
  - False Statements for Benefit(s)
  - Many Others
Stakes of the Game - Corruption Involves Everybody

➢ Private Businesses
➢ Public Businesses
➢ Governments
➢ Non-Profits
➢ Individuals
➢ Organized Criminal Groups
Stakes of the Game - The Real Problem – Why Care????

Corruption

Destroys
Stakes of the Game - Hidden Cost of Corruption

➢ The 1% to 5% Myth
➢ Clearly More than 1%
➢ But Nobody Will Ever Know
Stakes of the Game – The Real Costs - Probably Trillions

- Enron
- Tyco
- Merrill Lynch
- Lehman Brothers
- Bear Sterns
- Countrywide
- AIG
- WorldCom
- RJR Nabisco
- Kodak
- General Motors
- Chrysler
- Penn Central
- Volkswagen

and on and on through time.
Challenge of the Game - Objective

Preventing or Recognizing Corruption before it’s too late.
Challenge of the Game - Key Driving Force of Corruption is Human Nature

Greed & Fear
At any time, day or night, 365 days a year, year after year, somebody is up to no good!
Challenge of the Game - The Bell Curve & Human Nature*

5%  |  90%  |  5%

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Challenge of the Game - My Friend: Jeff Skilling CEO of Enron & Chief Sorcerer

“I know the difference between right and wrong, but so far I’ve never had reason to act on that information.”

NYT
Challenge of the Game - Jeff Skilling CEO – Believer in the Old Pirate’s Philosophy

➢ Laws, Regulations & Business Policies are more like guidelines than rules. LOL

➢ Beware of the Slippery Deck- FIG Factor.

*Fear, Incompetence & Greed* will always find a way to ruin your day!
Challenge of the Game – Jeff’s Force of Personality

➢ Charming
➢ Brilliant
➢ Skilled
➢ Trusted
➢ Charismatic
➢ Powerful
➢ Respected

➢ Feared
➢ Authoritative
➢ Dominating
➢ Dangerous
➢ Ruthless

➢ Narcissistic
Challenge of the Game - The Sorcerer Apprentices – The Enron Mafia

- Chief Financial Officer
- Chief Accounting Officer
- Chief Trading Officer
- Vice-Chairman - Trading
- Arthur Andersen - External CPAs

- Arthur Andersen – Internal Auditors
- Regulators
- McKinsey????
- Law Firms????
- Many Others – Big & Small
Challenge of the Game - The Enron Mafia
- A Warning from the Real World

God’s Book
Of
Internal Controls

In case of Collusion!
Challenge of the Game – The Sorcerer – Perfectly Positioned

“The Indispensable Subordinate”
Challenge of the Game - Ken Lay
Chairman Enron – Missing-in-Action
“One thing that most people agree on is that white-collar crime finds its biggest accomplices at the top of the company—either through collusion or a lack of oversight.”

— *Journal of Business Strategy*
Challenge of the Game - Collusion & Conspiracy – The Threats You Face

➢ Manipulation.

➢ Subversion.

➢ Distraction.

➢ Replacement – “I’ve Got This”.

➢ Oversight Functions that Do not Work – The Auditors.
Challenge of the Game – Who’s Doing It? - Profile of the Enemy

➢ Middle to Senior Manager.
➢ Well Respected—Knowledge and Abilities.
➢ Often Highly Trusted.
➢ High probability of addiction.
➢ Lifestyle.
➢ Control Freak—Runs a Tight Ship.
➢ Emperor Complex—Forceful and Authoritative.
➢ Mr. Sensitivity or “The Nice Guy”.
71% committed by employees who held finance/bookkeeping & accounting position.

Average scheme lasted 4.6 years.

Nearly 7% had a prior criminal/fraud history.

Average stole more than $19,000 per month.

81% involved individual perpetrators.

57% of the incidents involved females.

Male perpetrators embezzled about two-and-a-half times as much as females.
➢ The average age at the commencement of their embezzlement was just over 43 years.

➢ 40 – 49 year old's most frequent culprits.

➢ Most appear to have been motivated by a desire to live a relatively more lavish lifestyle, rather than driven by financial woes.

➢ Nearly 24 percent in which a motivating factor was known involve gambling & addiction issues.

➢ The average prison sentence was 44 months.
Challenge of the Game – Profiles In Evil – What Is This Telling Us

➢ Almost Nothing Useful.

➢ General Lesson - Access, Authority & Motivation.

The Real Key to Identifying Who is Doing It

Profile versus Behavior
Challenge of the Game – Smoke Signals – Behavior Issues*

➢ Making things appear more complicated than they are the “Black Box”.

➢ Incredible performance: “We’re just smarter than everybody else”.

➢ Lack of information: “Don’t ask, you’re not smart enough to understand”.

➢ Lifestyle & Addiction.

➢ Odd occurrences and even odder explanations.

➢ Wives & Girlfriends – Husbands & Boyfriends.

➢ The rumor mill.
Practical Game Solutions – The Forever War*

1) Recognize that you’re in a game with serious consequences to failure.

2) Nurture situational awareness.

3) Act.

“Only the Paranoid Survive.”

Andy Grove - CEO Intel

“Trust but Verify.”

Ronald Reagan
Practical Game Solutions – The CEO’s Game – The Three Strategic Keys*

1) Visible Leadership

2) Organizational Design for “Checks & Balances”.

3) The Right Staff, Tools & Tactics.
The Tone at the Top

But What Does It Mean?

“I will not lie, cheat or steal and most importantly tolerate these behaviors in others.”
Practical Game Solutions - The Three Strategic Keys – #2 “Checks & Balances” – The Strategic Framework

➢ Threat Deterrence Strategy
➢ Prevention - Blocks & Barriers
➢ Detection & Response
Practical Game Solutions - The Three Strategic Keys – #2 “Checks & Balances” – The Strategic Framework*

Business Controls Structure
A Prevention Strategy That Works
Business Controls

Versus

Financial Internal Controls
Executive Level Strategic Controls

Financial & Operational Controls

Management & Financial Information Systems Controls

Corporate, Physical & Personnel Security

Crisis Management & Response
Practical Game Solutions – #2 “Checks & Balances” – Management Controls - A Broad Strategic Framework

➢ Business strategy, core skill & competitive position.
➢ Organizational style, structure & culture.
➢ Business processes: policies, procedures & systems.
➢ Staffing skills.
➢ The roles of inside & outside auditors, corporate security, corporate counsel & other oversights functions.
➢ Audit Committee & Corporate Governance.
➢ Internal audit & security.
Practical Game Solutions – #2 “Checks & Balances” – Management Controls – Segregation & Coordination

➢ Accounting versus Finance
  – *Controller versus CFO*
➢ Accounting versus Operations
  – *Strategic Business Unit & Financial Accounting*
➢ Internal Auditors & Security
➢ Corporate Counsel
➢ Board of Directors
Beware of the Silos

&

Things That Fall Between the Cracks
Practical Game Solutions – #2 “Checks & Balances” – The Oversight Elements

➢ Internal & External auditors.
➢ Corporate Security
➢ Corporate & Outside Counsel.
➢ The Consultants
➢ The Board
➢ Oversight Analytics
People

- Executive Level People
- Employees
- Vendors
- Partners
- Customers

Practical Game Solutions – #3 The Right Staff with the Right Stuff – People*
Dear IRS,

I have been cheating on my taxes and now I can't sleep nights. Please accept this $5,000.00 check. If I still can't sleep, I will send the rest!

Thank you,
<table>
<thead>
<tr>
<th>Detection Source</th>
<th>% of Detected Incidents</th>
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<tbody>
<tr>
<td>Tip</td>
<td>40%</td>
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<tr>
<td>Internal audit</td>
<td>15%</td>
</tr>
<tr>
<td>Management review</td>
<td>13%</td>
</tr>
<tr>
<td>By accident</td>
<td>7%</td>
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<tr>
<td>Other</td>
<td>6%</td>
</tr>
<tr>
<td>Account reconciliation</td>
<td>5%</td>
</tr>
<tr>
<td>Document examination</td>
<td>4%</td>
</tr>
<tr>
<td>External audit</td>
<td>4%</td>
</tr>
<tr>
<td>Surveillance/monitoring</td>
<td>3%</td>
</tr>
<tr>
<td>Notified by law enforcement</td>
<td>2%</td>
</tr>
<tr>
<td>IT controls</td>
<td>1%</td>
</tr>
<tr>
<td>Confession</td>
<td>1%</td>
</tr>
</tbody>
</table>
“I have a brief statement, a clarification and two denials.”
The CEO must be the chief advocate for anti-corruption.

It is the CEO’s primary job to direct company’s executives and drive oversight of their activities.

An independent and highly skilled audit committee is essential to maintain a robust system of “Checks & Balances” over all operations.

To be truly effective, a system of “Checks & Balances” must be independent of those it is charged with watching.

The CEO can use the company’s oversight functions to maintain a “Checks & Balances” system, there is no substitute for personal, direct involvement.

The CEO must be willing to direct inquiries into allegations of misconduct.
Practical Game Solutions – Road Map to Prevention – Final Thoughts

➢ **Whistleblowers** - One of the most effective compliance tools available to the CEO is the day-to-day vigilance of the company’s employees, vendors, partners and customers. All must be protected from retribution to avoid any possibility of corrupting the process.

➢ A **zero-based budgeting** process — requiring that the individual elements of the company’s budget be built from the bottom up, reviewed in detail, and justified — would have facilitated the identification of unusual spending in numerous corporate and operating units. This provides an in-depth view of spending as opposed to basing the current year’s spending, in aggregate, on last year’s spending, where irregularities may be buried and overlooked.

➢ Background checks must include review of potential **conflicts of interest**.

➢ Analytics.
What CEOs Need to Know About Corruption Prevention & Detection – The Eternal War

Feedback

Ideas

Comments

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Thank You

Center for Strategic Business Integrity

John L. Verna

Executive Director

WWW.CenterSBI.Com
At CSBI, our core mission is to professionalize the boardroom by improving and certifying the strategic decision-making, oversight and crisis management capabilities of Directors and their key Advisors.

In keeping with this goal, all our training programs strive to equip Directors and their Trusted Advisors with ideas, strategies, tactics and tools to drive success. In short, we train Directors to direct — not to be merely corporate governance technicians.

“The State of America’s Corporate Boards” has been part of our Board Leadership & Governance Course Series. These courses, along with our series on Strategic Decision Making and Integrity & Crisis Response, are designed to provide a practical framework for dealing with critical Board issues.
About the Presenter – John L. Verna CBA, CPA, CFE, CICA

➢ John L. Verna is founder and Executive Director of the Center for Strategic Business Integrity, an organization dedicated to improving Directorship through certification, training and advocacy for competent corporate decision making and effective oversight skills.

➢ John is a highly experienced business executive with over 35 years of strategic development, crisis management, investigations, integrity monitoring and corporate governance experience.

➢ John has been a member of the board of directors of several privately-held companies and has advised the boards of many Fortune 1000 and privately-held companies.

➢ John has worked to resolve a number of organizational crises including the Bankruptcy of Orange County California, Enron, the Federal Monitorship of the Los Angeles Police Department, the Monitorship of Purdue Pharma’s highly controversial narcotic OxyContin in conjunction with Giuliani Partners as well as many others.

➢ John holds an MBA in Strategic Business Development from Cornell University and a BSc with Honors in Management from Rider University.
Supplements
Financial & Operational Process Controls

➢ Revenue & sales processes.
➢ Manufacturing or service processes.
➢ Warehousing/logistic/inventory.
➢ Purchasing, including supplier & subcontractor selection & controls.
➢ Personnel and payroll processes.
➢ Treasury, financial accounting & reporting systems.
Practical Game Solutions – #2 “Checks & Balances” – Red Flags – The Seven Shenanigans

1. Recording revenue too soon
2. Recording bogus revenue
3. Boosting income with one-time gains
4. Shifting current expenses to a later period
5. Failing to record or disclose all liabilities
6. Shifting current income to a later period
7. Shifting future expenses into the current period
Information & Intellectual Property Controls & Security Review

➢ Management & financial information systems.
➢ Internet systems.
➢ Operational & communication systems integrity.
➢ Intellectual property & trade secret controls.
➢ Counter-intelligence program design.
Corporate, Physical & Personnel Security Design

- Strategies & polices.
- Facilities design & access.
- Loss prevention tactics
- Executive & staff protection
- Workplace safety & protection
- Counter-terrorism strategies.
- Cyber security.
Crisis Management Planning & Response Design

- Response to irregular business activity, natural disasters, terrorism & other corporate crises.
- Communications protocols & notification systems.
- Intelligence & reporting systems.
- Response strategies & team structures.
- Roles of management, key outsides, etc.
- Crisis simulations.
Evaluation Techniques

➢ Evaluate organization’s existing business controls environment

➢ Walk-throughs of operations, including interviews with management and operations personnel, review of documentation and penetration exercises.

➢ Review of prior incidents and identification of future threats to organization.

➢ Design control strategies, tactics and tools necessary to deter and/or detect business irregularities and threats.
Challenge of the Game – Danger Can Come from Many Directions

Functions
- Sales
- Purchasing
- Accounting
- Personnel/Payroll
- Finance
- Risk Mgt/Insurance
- Operations
- Maintenance
- Construction
- Deal Making

Levels
- General Mgt
- Line Mgt
- Support Mgt
- Staff

- People with Control & Access
Practical Game Solutions – The Three Strategic Keys – #1 Leadership Element

In Other Words:

➢ Tone
➢ Executive Decision Making Ability
➢ Oversight Skills – “Checks & Balances”
➢ Courage
The Seven Shenanigans

1. Recording revenue too soon
2. Recording bogus revenue
3. Boosting income with one-time gains
4. Shifting current expenses to a later period
5. Failing to record or disclose all liabilities
6. Shifting current income to a later period
7. Shifting future expenses into the current period
Industrial – Governmental/Judicial Complex

1) You can’t fight corruption alone.
2) As Individual Industrial Leaders
3) As a Group of Leaders
Stakes of the Game - The Real Costs - Probably Trillions

- Enron, Tyco, Chesapeake Energy, Merrill Lynch, Lehman Brothers, Fannie Mae, Bear Sterns, Countrywide, AIG, Washington Mutual, Adelphia, WorldCom, Global Crossings, RJR Nabisco, Kmart, Kodak, General Motors, Chrysler, Orange County California, the S&L Crisis, Penn Central, Integra, Volkswagen and on and on through time.
What Happened—
The Human Dimension

➢ Middle to Senior manager
➢ Well respected for both knowledge and abilities
➢ Often highly trusted
➢ Lifestyle
➢ Control freak, runs a tight ship
➢ Emperor complex, forceful and authoritative
➢ Mr. Sensitivity —→ The Nice Guy
➢ High probability of addiction
Challenge of the Game – Smoke Signals – Behavior Issues

➢ Recent changes in subjects’ behavior.
➢ Recent changes in subjects’ lifestyle.
➢ Creating appearance of the technical black box
➢ Odd occurrences and even odder explanations
➢ The Rumor Mill