

# Across the Board

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## Keeping Corporate Fraud In The Cross-Hairs

*Tough economic times can lead good people to rationalize inappropriate behavior*

Financial institutions have collapsed, many companies find themselves struggling to stay afloat, investors are pressing for stable returns and governments have stepped in to shore it all up. Without doubt, global economic conditions have put the corporate world under some of the most intense pressure in memory. Conditions become ripe for misconduct and fraud as this pressure meets opportunity. KPMG's 2008 Integrity Survey highlights this when it found 74 percent of U.S. workers surveyed witnessed misconduct on the job in the past year, and most blamed such activity on a corporate culture that promotes "do-whatever-it-takes" operating conditions.



### The fraud triangle

When investigated, it is found that most corporate frauds include one or more dimensions of what is known as the fraud triangle, incentives/pressure, opportunity and attitude/rationalization. Logically, corporate executives and board members should continually assess whether or not the control environment adequately considers and addresses the elements of the fraud triangle.

- *Incentives and pressure*

Intense pressure may stem from trying to operate profitably in an extraordinarily difficult economic climate or from age-old fear factors, such as the performance, or job loss.



Self-imposed pressure can also occur, as in the case of an individual who championed a particular market strategy and then focused on “managing” financial information to avoid letting the company down, when results appear destined to miss expectations.

Consider also that amid the tumult of poor economic conditions and poor stock performance, there may be pressures to “manage” current earnings lower to build “a rainy-day fund” for future quarters.

- *Opportunities*

Incentives and pressures often represent the spark that can set fraud in motion, but there must be the opportunity.

Opportunities to alter financial information are often open to people who directly touch accounting processes or who can influence how transactions are recorded.

Opportunities may exist when an individual has the ability distort reality by false or deceptive information. It can be accomplished, for example, by tweaking some area of subjective accounting, outright falsification of documents, and/or collusion with third parties.

For instance, reserve accounts (e.g. doubtful accounts, inventory reserves) can be adjusted to artificially low or high levels by distorting or fabricating facts. Some retail companies can move retail inventory items from one cost pool to another in order to increase or decrease gross profits. Detection often is difficult, especially in large retail companies with thousands of items in inventory. Detection is also difficult because it is basic human nature to trust your co-workers and management. Most of the time this trust is appropriate, but a healthy dose of skepticism can be a safety net.

- *Attitude rationalization*

Most people have a moral compass that helps them avoid committing a crime. But individuals under pressure can also rationalize their behavior to justify their actions, allowing them to maintain the belief that they did not violate their own morals. Some well known rationalizations include “nobody gets hurt,” “nobody will notice,” “I’m doing it for the good of the company,” “this is the way business is done,” or “it is just a timing thing so who cares.”

Once people have made up their minds to rationalize, they become invested in the answer. It is important to constantly access and question subjective areas of accounting.

## Red flags and pressure points

Management and corporate boards, especially audit committees, must monitor for conditions that can trigger one or more legs of the Fraud triangle as a key to fraud prevention.

### Loan covenants

The pressure becomes obvious when operating results or key ratios approach loan covenant thresholds. Corporate gate keepers should pay close attention to financial data that affects covenants, and monitor when corporate loans come due for renewal:

- What are the covenants?
- What are potential trouble spots?
- What reported numbers are most sensitive to change and how can they impact covenants?
- What situations can lead to financial manipulation?

### Liability accruals

There have been situations where companies have earnings per share above market expectations, but choose to report lower EPS to match competitors. This allows the company to establish a rainy-day reserve.

- An audit committee should inquire about unusual or unexpected changes in operating results, liabilities or subjective contra accounts (i.e., positive or negative).
- An added proactive step is to ask for after the fact monitor reports to establish if management's estimates are reasonable.

### Subjectivity in the balance sheet

To understand how susceptible data is to manipulation, directors should consider drilling down on subjective balance sheet accounts and their underlying assumptions and key drivers.

- Corporate overseers should monitor valuation allowances, assumed rates of returns on pension assets, processes to value illiquid assets, contingency accruals and environmental reserves.

- It is often helpful to think about these account movements in subjective areas in the context of what it takes to move EPS.

### Revenue recognition

It is helpful if corporate overseers understand how sale transactions can be manipulated. When is a sale a temporary revenue-generating slight-of-hand that will come back for credit? Credit memos can provide indications of abuse.

- Credit memo activity reviews should occur throughout the year, and it may help to graph them to look for patterns.

"Bill and hold" transactions have very specific tests that need to be met in order to record revenue. Specific controls and monitoring should be in place to ensure appropriate timing of revenue recognition.

- Large or unusual transactions near the end of a quarter should be flagged for specific review to be sure that revenue recognition criteria are met.

Audit committees should inquire about "round-trip" transactions and ask internal audit to compare customers' and vendors' names and to review unusual transactions between them.

### Management micromanaging

Pay close attention when executives with a hands-off management style suddenly take a particular interest, especially in routine transactions or when a large deal is critical to meeting objectives.

- Audit committees can gain insight by asking questions of management, corporate counsel, internal audit, and the external auditors.

Audit committees should fully understand business strategies and rationalizations for current acquisitions in this difficult environment, especially if debt financed. Companies that depend on acquisitions to achieve revenue and/or other earnings targets could face intense pressures when the returns are lower.

## Practice prevention

While current economic conditions can foster fraudulent behavior, companies can deter it by implementing appropriate prevention, detection and response plans. And when senior executives promote an ethical tone at the top environment, such plans can set an expectation for employees to do the right thing in the right way.

It is critical in difficult economic times for the corporate overseers to understand a company's financial health and where the enterprise is susceptible to fraud. After all, what you don't know is what gets you in trouble.

## More information

Audit Committee Institute (ACI) Thailand is sponsored by KPMG. The institute's primary mission is to serve as a forum and dedicated resource to keep audit committees informed of regulatory matters, company law and accounting and auditing issues. Ultimately the Institute seeks to enhance audit committees' awareness of, commitment to, and ability to discharge their responsibilities. To learn more about the Audit Committee Institute in Thailand or to access our resources please visit [www.acithailand.org](http://www.acithailand.org) or email us at [auditcommittee@kpmg.co.th](mailto:auditcommittee@kpmg.co.th)

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