

30TH NSAA ANNUAL CONFERENCE
TONE AT THE TOP:
HOW MANAGEMENT CAN PREVENT
FRAUD IN THE WORKPLACE
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James D. Ratley graduated from the University of Texas at Dallas, with a Bachelor's Degree in Business Administration. In 1971, he joined the Dallas Police Department as a police officer.

Mr. Ratley was assigned to several police department divisions including vice, child abuse, and internal affairs. He was a member of numerous department task forces which concentrated on major fraud cases.

In 1986, Mr. Ratley left the police department to join Wells & Associates, a forensic accounting practice, where he was in charge of fraud investigations. He handled investigations regarding internal frauds, conflicts of interest, and litigation support. In 1988, he was named Program Director for the Association of Certified Fraud Examiners and oversaw all aspects of the ACFE's training and education programs.

In 2006, Mr. Ratley was named President of the ACFE. In this role, he works to promote the ACFE to the public and other professional organizations and continues to assist in the development of anti-fraud products and services to meet the needs of ACFE's members. In addition, he is a member of the ACFE's faculty, and teaches regularly at workshops and conferences on a variety of fraud-related subjects.

In 2005, Mr. Ratley was awarded the Association of Certified Fraud Examiners' Cressey Award. The Cressey Award is the ACFE's highest honor. It is bestowed annually for a lifetime of achievement in the detection and deterrence of fraud.

Mr. Ratley is a member of the Association of Certified Fraud Examiners, Austin Chapter. He is a member of the American Society for Industrial Security and a member of the Board of Advisors for the Institute for Bank Director Education. He was also a Visiting Scholar at the University of Nebraska in Lincoln. In addition, he has been certified as a Master Peace Officer by the Texas Commission on Law Enforcement Standards and Education.

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What is the “Tone at the Top”?

The connection between fraud and the “tone at the top” of an organization has received international attention over the last few years. Tone at the top refers to the ethical atmosphere that is created in the workplace by the organization's leadership. Whatever tone management sets will have a trickle-down effect on employees of the company.

If the tone set by managers upholds ethics and integrity, employees will be more inclined to uphold those same values. However, if upper management appears unconcerned with ethics and focuses solely on the bottom line, employees will be more prone to commit fraud because they feel that ethical conduct is not a focus or priority within the organization. Employees pay close attention to the behavior and actions of their bosses, and they follow their lead. In short, employees will do what they witness their bosses doing.

Corporate greed at the executive level has destroyed hundreds of companies, drained stockholders of their investments, and left innocent employees without work. Ken Lay, Jeffrey Skilling, and Andrew Fastow from Enron; Bernie Ebbers from MCI/WorldCom; and Dennis Kozlowski at Tyco have become household names, and to many are synonymous with what is wrong with our corporate system. Furthermore, these individuals represent only a small percentage of the executives who have abused their posts of power to commit corporate fraud.

Over 100 public company CEOs have been sued over the last five years for committing white collar crimes. These CEO criminals were sending a clear (though perhaps unintentional) message to their employees that *committing*

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fraud is acceptable as long as it makes the company seem profitable. They were obviously not setting an ethical tone at the top for their employees.

Story of a Convicted Criminal: Walt Pavlo

Walt Pavlo is a convicted white-collar criminal who claims that he was pressured by his bosses to commit financial statement fraud at MCI/WorldCom. In January of 2001, Pavlo received a 41-month federal prison sentence for money laundering, wire fraud, and obstruction of justice. He was a Senior Manager in Billing Collections at MCI/WorldCom and dealt with customer payments, credits, and reconciliations of accounts. He felt pressure from upper level management at MCI/WorldCom to constantly achieve revenue growth in the company. Revenue projections for the company were laid out beforehand for each period, and employees were pressured to meet or exceed these projections.

As Pavlo watched his bosses manipulate the company's financial records, he soon began to manipulate them himself. Soon after, Pavlo's own employees would learn to conduct fraudulent activity under their boss. Pavlo and his supervisors met to devise ideas on how to cook the company's books. Financial records were manipulated by Pavlo, his superiors, and his colleagues in a widespread effort to fraudulently make the company look like it was meeting revenue growth projections, even though it wasn't. Pavlo learned how to conceal uncollectible debt, which boosted the company's assets and profits. Auditors eventually found unusual journal entries made by Pavlo and confronted him about it. It was then that he confessed to his fraudulent behavior.

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Similar to many other people who commit white collar crime, Pavlo didn't feel as though he was doing anything wrong in the beginning. He felt that he was doing his job and making his employers happy by altering the company's financial data. In the long run, he incorrectly thought, the problem would remedy itself.

Even a highly-educated and well-experienced employee can become a white collar criminal. Pavlo received an Industrial Engineering degree from West Virginia University and his MBA from the Stetson School of Business at Mercer University in Atlanta, Georgia. He left behind his wife and two young sons when he served a two-year prison sentence for his financial crimes.

Major Fraud Factors

There were three major factors that played a role in Walt Pavlo's downfall. These factors are also common in many other fraud cases, particularly in larger companies. The fraud factors present in Walt's case were:

- ❑ **Meeting analysts' expectations** – Upper management and employees can become preoccupied with meeting analysts' expectations. This preoccupation can lead to the pressure to commit fraud. In the case of Walt Pavlo, he felt extreme pressure from his superiors to meet revenue projections. Employees and executives alike knew where the numbers needed to be in order to meet those projections, and they would meet to discuss different ways to manipulate the records so that it looked like MCI/WorldCom was living up to analysts' expectations.
- ❑ **Compensation and incentives** – Compensation and incentive plans may encourage unacceptable, unethical,

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and illegal conduct. In Pavlo's case, in addition to his annual salary, he was eligible for thousands of dollars in stock options each year if he was able to meet his financial targets. He knew there was a financial incentive for cooking the books, so he manipulated the numbers. This created a financial gain for him and kept his bosses happy at the same time.

- **Pressure to reach goals** – The degree of fear and pressure associated with meeting numerical goals and targets also play a major role in fraud. It goes without saying that the more pressure and fear that an employee feels to meet revenue goals, the more likely they are to do whatever it takes to meet those goals. Pavlo stated that he learned how to conceal uncollectible debt and artificially boost the company's assets and profits from his supervisors. With their help, he delayed write-offs and made the revenue numbers seem more attractive by making them look like they were collectible. Not only was this unethical, it was also illegal.

Why Employees Don't Report Unethical Conduct

Obviously, there are many different forms of misconduct that go on in the workplace and are observed by employees every year. Yet, many employees do not report this unethical conduct. According to the National Business Ethics Survey, only 55 percent of employees in 2005 said that they reported misconduct that they observed in the workplace. This was a 10 percent decrease from the previous survey in 2003.

In the past, employees under age 30 with little tenure (less than three years) were the least likely of any group to report ethical misconduct. This was due to their fear of retaliation from management and coworkers. They also felt that managers would consider them "trouble makers" if they

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reported unethical conduct. Middle managers and senior managers were most likely to report misconduct. However, in 2005, there was no significant statistical relationship between age/tenure and reporting. The top reasons for not reporting unethical conduct, according to the 45 percent of employees who did not report misconduct, are:

- **No corrective action** – Employees who were cynical of their organizations felt that nothing would be done if they came forward and reported the misconduct that they observed. In 2005, 59 percent of those who did not report misconduct felt as though no corrective action would be taken if they *had* reported unethical conduct. However, the NBES states that these employees may have had an unrealistic expectation for how organizations should handle misconduct reports. Privacy restrictions may prevent the company from telling the whistleblower how the report was handled and what punishments were assessed to the suspicious perpetrator. The company should stress the privacy factor in order to boost confidence in these employees that their reporting will be handled appropriately, even if the whistleblower may not find out about it.
- **No confidentiality of reports** – Another concern for those who do not report misconduct is the fear that if they were to come forward with a report, their identities, as well as their suspicions, would be revealed.
- **Retaliation by superiors** – Not surprisingly, this same group of employees also felt that if their identities were exposed, they would have to suffer retaliation from the superiors. The fear of retaliation caused them not to

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report misconduct.

- **Retaliation by coworkers** – Similar to retaliation by superiors, employees who withheld reporting unethical behavior in the workplace feared that their coworkers would find out who blew the whistle and retaliate against them.
- **Unsure whom to contact** – A small number of the employees who did not report misconduct (18 percent in 2005) said they were unclear whom to contact in order to raise their suspicions of unethical conduct.

Employees who witnessed their company actively following its code of ethics were the *most* likely to report misconduct in the workplace, according to the 2005 NBES. They were also more likely to be satisfied with their company's response to reported misconduct. Those who work for organizations that implement formal ethics programs were considerably more prone to reporting the misconduct that they observed. It is important to note that those who do not report misconduct may have had a poor experience in the past with trying to do so. Executives must reach out to those disenfranchised employees to make sure that they know their identities will be kept confidential if they report unethical behavior in the workplace.

Negative Work Environment

In a negative work environment, there will be low or nonexistent levels of employee morale or feelings of loyalty to the company. In this setting, employees will be more prone to committing fraud that will hurt the company, since they feel no obligation to protect it. The following are some of the components that make up a negative work environment, according to the AICPA report "Management

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Antifraud Programs and Controls: Guidance to Help Prevent, Detect Fraud”:

- ❑ Top management does not seem to care about or reward appropriate behavior
- ❑ Lack of recognition for proper job performance
- ❑ Negative feedback
- ❑ Perceived organizational inequities
- ❑ Autocratic management, rather than participative management
- ❑ Unreasonable budget expectations or other financial targets
- ❑ Low organizational loyalty
- ❑ Fear of delivering “bad news” to supervisors and/or management
- ❑ Less-than-competitive compensation
- ❑ Poor training and promotional opportunities
- ❑ Unfair, unequal or unclear organizational responsibilities
- ❑ Poor communication practices or methods within the organization

Positive Work Environment

Conversely, a positive work environment will help deter fraud while improving the morale and loyalty of employees. According to the AICPA’s “Management Antifraud Programs and Controls: Guidance to Help Prevent, Detect Fraud” report, when employees are in a positive work environment, they will be more reluctant to commit fraud that will hurt the organization. When employees have positive feelings about an organization they work for, the occurrence of misconduct is reduced. To create and maintain a positive work environment, management should ensure that:

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- ❑ Recognition and reward systems are in tandem with goals and results
- ❑ Equal employment opportunities exist
- ❑ Team-oriented, collaborative decision-making policies are encouraged
- ❑ Compensation and training programs are professionally administered

Important Steps to Take

There are several steps that business leaders can take to convey the message of individual and corporate responsibility and accountability to its employees and investors:

- ❑ **Set an ethical tone at the top** – Upper management has to lead by example and actions. These actions should include rewarding ethical behavior while punishing unethical actions. There should be sanctions for engaging in, tolerating, or condoning improper conduct.
- ❑ **Establish a code of ethics** – Organizations should produce a clear statement of management philosophy. It should include concise compliance standards that are consistent with management's ethics policy relevant to business operations. This code of ethics should be given to every employee who will be required to read and sign it. It should also be given to contractors who work on behalf of the organization for their review and signature.
- ❑ **Carefully screen job applicants** – According to the ACFE's *Fraud Examiners Manual*, one of the easiest ways to establish a strong moral tone for an organization is to hire morally-sound employees. Too often, the hiring process is hastily conducted.

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Organizations should conduct thorough background checks on all new employees, especially managers and those who will be handling cash. These background checks should include a thorough examination of the candidate's educational credentials, criminal record, history of employment, and references. Speaking with former employers or supervisors can provide valuable information about a person's reputation for trustworthiness, moral conduct, and loyalty.

- **Assign proper authority and responsibility** – In addition to hiring qualified, ethical employees, it is important to place these individuals in situations where they are able to thrive without resorting to unethical conduct. Organizations should provide employees with well-defined job descriptions and performance goals. Performance goals should be routinely reviewed to ensure that they do not set unrealistic standards. Training should be provided on a consistent basis to ensure that employees maintain the skills to perform effectively. Regular training on ethics will also help employees identify potential trouble spots and avoid getting caught in compromising situations. Finally, management should quickly determine where deficiencies in an employee's conduct exist and work with the employee to fix the problem.

- **Mandate fraud and ethics training for staff** – It must be mandatory for all employees (including upper-level personnel) to receive fraud prevention and detection training. This training should cover the company's stance on corporate compliance: its code of ethical conduct, the company's procedures and standards, as well as employees' roles and responsibilities to report misconduct in the organization. It should also inform

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employees about what kinds of acts and omissions are prohibited by law and by the organization to help them avoid situations that could lead to criminal conduct. New employees must be required to attend this training. The company should provide on-going and continuing training for all employees. These training sessions should be used as a tool to communicate and reinforce the organization's values, code of conduct, and expectations. Common training techniques include lectures, training films, and interactive workshops. Compliance standards should be regularly emphasized.

- **Implement effective disciplinary measures** – No control environment will be effective unless there is consistent discipline for ethical violations. Consistent discipline requires a well-defined set of sanctions for violations and strict adherence to the prescribed disciplinary measures. If one employee is punished for an act and another employee is not punished for a similar act, the moral force of the company's ethics policy will be diminished. The levels of discipline must be sufficient to deter violations. It may also be advisable to reward ethical conduct. This will reinforce the importance of organizational ethics in the eyes of employees.

- **Implement a confidential hotline** – Hotlines have proved to be a very effective reporting mechanism. According to the ACFE's 2006 *Report to the Nation on Occupational Fraud and Abuse*, occupational frauds were more likely to be detected by a tip than by any other means such as internal audits, external audits, or internal controls. Additionally, organizations with hotlines had a median loss of \$100,000 per scheme and detected their frauds within 15 months of inception. By

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contrast, organizations without hotlines suffered twice the median loss (\$200,000) and took 24 months to detect their frauds. The mere mention of an anti-fraud, confidential hotline can deter fraud. When employees are aware of workplace ethics, their likelihood of engaging in misconduct decreases, according to the NBES survey. An organization can place an advertisement in the staff break room with a hotline number that employees can call to confidentially report suspicious fraudulent activity in the workplace. Promoting anti-fraud hotline numbers will send the message that the company is encouraging an ethical environment by allowing employees to fearlessly report misconduct.

- **Establish a whistleblower policy** – Companies should establish and communicate a whistleblower protection policy to allow employees to come forward and report misconduct in the workplace. This policy should allow employees to report or seek guidance regarding actual or potential criminal conduct by others within the organization while retaining anonymity or confidentiality, without fear of retaliation. Additionally, in many organizations, whistleblowers may be protected by state and federal law. Therefore, you should consult with your legal counsel to train and educate employees about whistleblower protections.

Here are the ways to create a robust and successful whistleblower program:

- Implement a 24/7 hotline staffed with trained interviewers;
- Nurture ongoing dialogue by assigning a unique identification number to an anonymous caller,

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so he or she can call back to respond to questions; and

- Protect confidentiality by not using caller ID, e-mail tracking, or other means of tracking communication

Remember that the anti-fraud hotline should protect an employee's identity. Any posters or company communications that promote the anti-fraud hotline should emphasize clearly that reports and employee identities will remain confidential. Employees should be well aware of the fact that they will remain anonymous if they call an anti-fraud hotline. Those who are on the other end of the line, taking these anti-fraud reports, should fully understand the significance of keeping the whistleblower's identity completely confidential, as well as the details of the investigation.

- **Follow through with reports of misconduct and promote effective internal controls** – Organizations must have a standard procedure for dealing with fraud allegations. The management team must conduct a full-fledged investigation when misconduct is reported. After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately and to prevent further similar offenses – including any necessary modifications to its program to prevent and detect violations of the law. Those at the top of the organization are responsible for clearly stating and upholding the message that all employees will be required to act within the company's ethical code of conduct. This message *must* be enforced in order to prevent and deter fraud in the organization.

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- ❑ **Prevent reprisals** – The organization should make every effort to protect the identity of and prevent reprisals against whistleblowers.

- ❑ **Create a culture of doing the right thing** – By implementing all of the above steps, and making sure that everyone in the organization (especially those at the top) are actively maintaining corporate standards, a culture of “doing the right thing” will be created. This is the ultimate goal that should *always* be the striving point.

Conclusion

In summary, there are four steps that an organization’s leadership can take to create and maintain a good ethical climate within an organization:

- ❑ **Communicate what is expected of employees:**
The first step executives need to take is to state clearly and convincingly what the organization’s values and ethics are and the behavior that is expected from each employee. This should be done through the implementation of a written code of ethics and a formal training program. The policy should be continually reinforced through communications from the organization’s leaders.

- ❑ **Lead by example:**
The second step is to lead with integrity. Employees take their work ethic cues from those at the top of the organization. Executives cannot just talk about acting ethically, executives also have to “walk the walk” and show employees how to act by setting the example. Management must demonstrate their commitment to ethics through both their words and their actions.

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❑ **Provide a safe mechanism for reporting violations:**

The third step is to create an environment of safety for employees to report misconduct. Those who know about, or are suspicious of, fraudulent behavior or other ethical violations should be able to come forward and report misdeeds without the fear of retaliation from upper level management or their colleagues. Executives need to strongly convey the message that reporting misdeeds is highly-valued by the company and those who do the reporting will be protected to the highest degree.

❑ **Reward integrity:**

The fourth step is to reward integrity. Companies should not reward employees only for meeting financial goals. If executives see ethical behavior, they should be rewarded for it. Employees should know that meeting the bottom line is not the only measure of success. Acting with integrity and ethics should also be rewarded by the company and should be integrated into existing employee incentive programs to encourage ethical behavior.

Remember, employees look to management for direction. Management must be conscious of the signals it sends to its employees. Creating an ethical tone at the top will cut losses due to fraud and improve loyalty and morale. Preventing fraud is good business, and it starts at the top.

