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**Detecting fraud in consumer products companies: Real stories in
the marketplace**

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Detecting fraud in consumer products companies: Real stories in the marketplace

January 22, 2014



Assurance • Tax • Consulting

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McGladrey consumer products focus



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- McGladrey serves over 4,600 consumer products companies from across the country
- Specialty practices include food and beverage, retail and apparel
- To sign up for our monthly retail industry commentary or learn more about our industry focus, visit our website at http://mcgladrey.com/content/mcgladrey/en_US/what-we-do/industries/consumer-products.html
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Poll Question #1

- Which best describes your company's industry?
 - a) Apparel/textile/accessories manufacturer, wholesaler or distributor
 - b) Other consumer products manufacturer, wholesaler or distributor
 - c) Retailer (non-food)
 - d) Food and beverage distributor
 - e) Food and beverage retailer/restaurant
 - f) Other

Today's presenters



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Agenda

- Anti-Corruption Laws and Fraud Risks Associated with Global Businesses
 - Overview of global anti-corruption laws and FCPA
 - Dodd-Frank whistleblower provisions
 - FCPA enforcement and penalties
 - DOJ/SEC Resource Guide
 - Effective compliance programs – Process and best practices

- Third Party Intermediaries - Understanding who they are and how they may pose a threat

- Fraud Scenarios – Recent trends and early detection strategies

- Immediate Next Steps if a Potential Fraud is Detected

Timeline of Major Global Anti-Corruption Laws

- 
- 1977** U.S. Foreign Corrupt Practices Act (**FCPA**)
 - 1997** Organization for Economic and Cooperative Development (**OECD**) Anti-Bribery Convention
 - 1998** U.S. International Anti-Bribery Act (*FCPA broadened*)
 - 2010** U.K. Bribery Act (*Enactment*)
 - 2011** 8th Amendment to the Criminal Law of People's Republic of China
 - 2011** U.K. Bribery Act (*Implementation*)
 - 2011** Dodd-Frank Act Final Rules effective – Including Whistleblower Provisions
 - 2012** DOJ / SEC's Joint Resource Guide on the FCPA

Overview of the FCPA – Provisions

Anti-Bribery Provisions

- Prohibits U.S. person, U.S. company or any other person in the U.S. from corruptly paying or offering to pay anything of value directly or indirectly to a foreign official to:
 - Secure an improper advantage
 - Influence a foreign official in his official capacity
 - Induce him to violate the law
 - Assist in obtaining, directing or retaining business
- Proof of actual knowledge of a payment or promise to pay is not required

Accounting Provisions

- Requires SEC-registered or reporting issuers maintain books, records and accounts in reasonable detail that accurately and fairly reflect transactions and dispositions of assets and implement adequate system of internal accounting controls
- No materiality standard

Overview of the FCPA – Jurisdictional Reach

Anti-Bribery Provisions

- Issuers
 - Officers, directors and employees of Issuers
 - Foreign nationals and entities (including agents) that commit an act in the U.S.
 - Domestic Concerns (individuals/entities)
-
- The International Anti-Bribery Act of 1998 expanded FCPA jurisdiction such that territorial nexus is no longer required

Accounting Provisions

- Issuers
- Individual officers, directors and employees of issuers
- Subsidiaries, joint ventures and affiliates owned and controlled (more than 50% voting power) by the issuer

IRS Involvement in FCPA

- If a taxpayer admits to making payments that violate the FCPA, amendments to their returns may need to be filed, giving rise to potential civil penalties and interest
- Improper deductions of payments that violate the FCPA's anti-bribery provisions can result in civil penalties imposed by the IRS

Accuracy Related

- 20% of underpayment

Fraudulent Filings

- 75% of underpayment

Dodd-Frank Act - Whistleblower Provisions

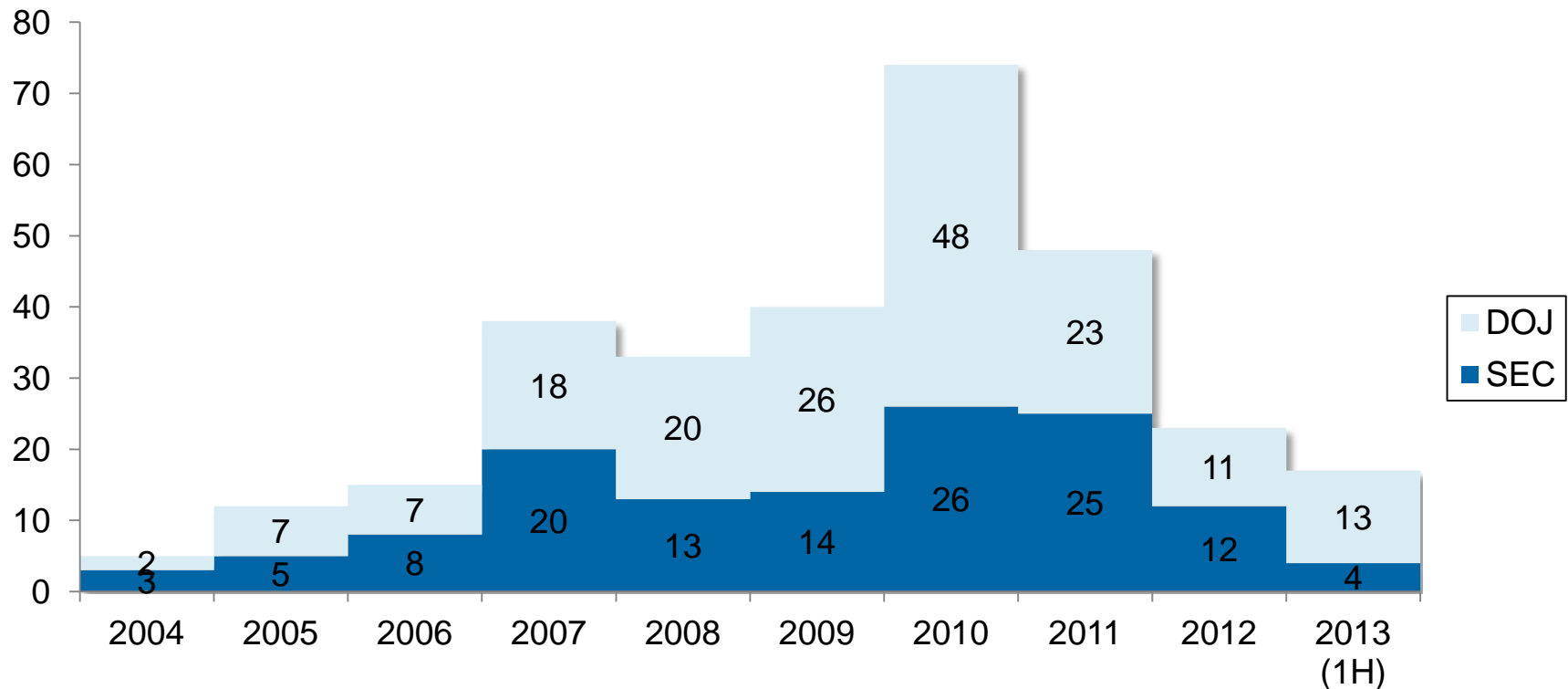
- Final rules became effective on August 12, 2011
- FCPA investigations in the past have been heavily dependent on self-reporting by companies
- Dodd-Frank Act Whistleblower Provisions could result in a significant increase in the number of FCPA investigations:
 - Qualifying rewards equal to **10 to 30 percent** of total recoveries

FCPA Enforcement and Penalties

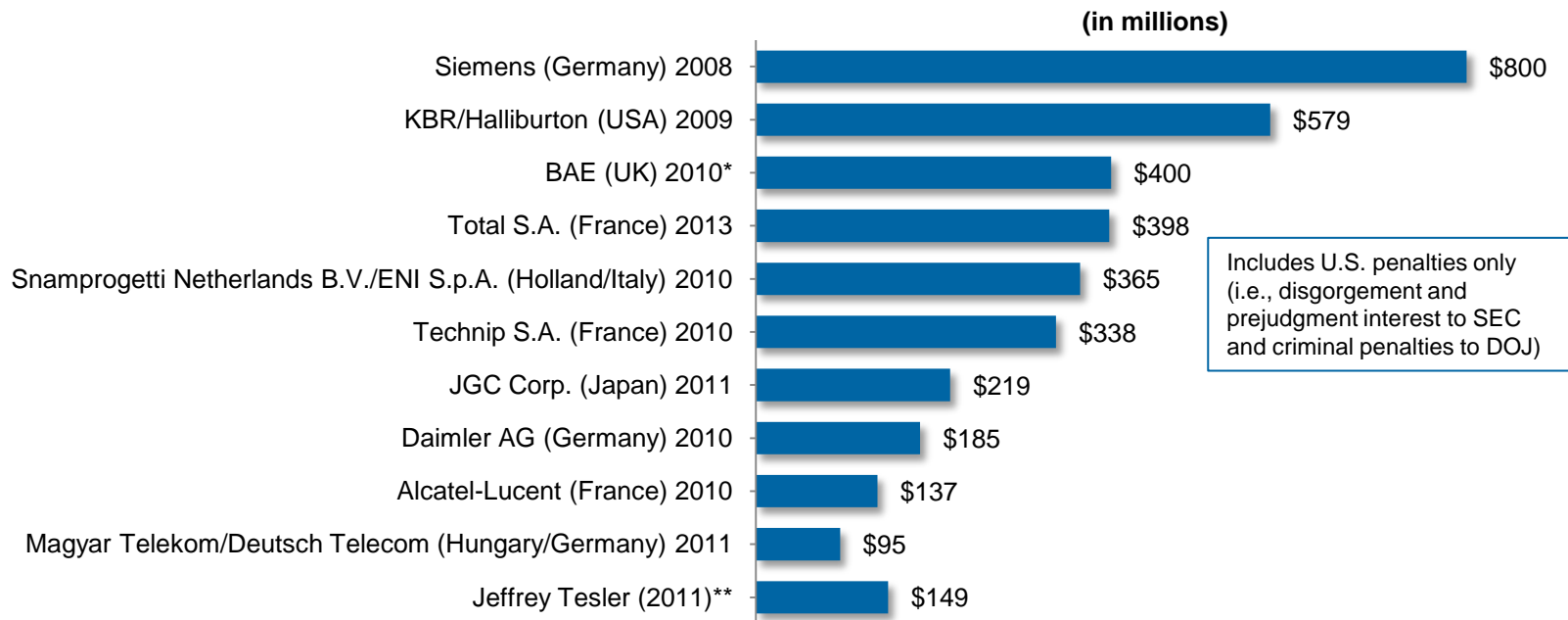
	Anti-Bribery Provisions	Accounting Provisions
Criminal	<p>Individuals</p> <ul style="list-style-type: none">▪ <u>Imprisonment</u>: up to 5 years for each conspiracy and substantive count▪ <u>Fines</u>: up to \$250,000 or twice the pecuniary gain from the offense or twice the loss to the victim	<p>Individuals</p> <ul style="list-style-type: none">▪ <u>Imprisonment</u>: up to 20 years for willful violations▪ <u>Fines</u>: up to \$5 million
	<p>Corporations</p> <ul style="list-style-type: none">▪ <u>Fines</u>: up to \$2 million per violation or twice the pecuniary gain from the offense or twice the loss to the victim	<p>Corporations</p> <ul style="list-style-type: none">▪ <u>Fines</u>: up to \$25 million per willful violation
Civil	<ul style="list-style-type: none">▪ <u>Fines</u>: up to \$50,000 for individuals and \$500,000 for business entities▪ Debarment from contracting with U.S. government	<ul style="list-style-type: none">▪ <u>Fines</u>: \$100,000 for individuals or the gross amount of pecuniary gain and \$500,000 for organizations or the gross amount of pecuniary gain▪ Disgorgement of gains (including interest)

FCPA Enforcement Settlements (2004 – First Half 2013)

- 2011 saw the 2nd highest number of FCPA enforcement actions in history
- 22 of the DOJ actions in 2010 stem from a single industry sweep at a Las Vegas military and law enforcement products trade show



Top FCPA Monetary Settlements



* Includes non-FCPA international bribery charges paid by BAE Systems

** Individual, Jeffrey Tesler of the U.K., subject to an FCPA-related forfeiture of \$149 million in 2011

- Beyond penalties, FCPA investigations alone can be costly:
 - e.g., Weatherford International & News Corp. each recently disclosed spending well over \$100 million on FCPA investigations

Global Corruption Law Compliance Report*

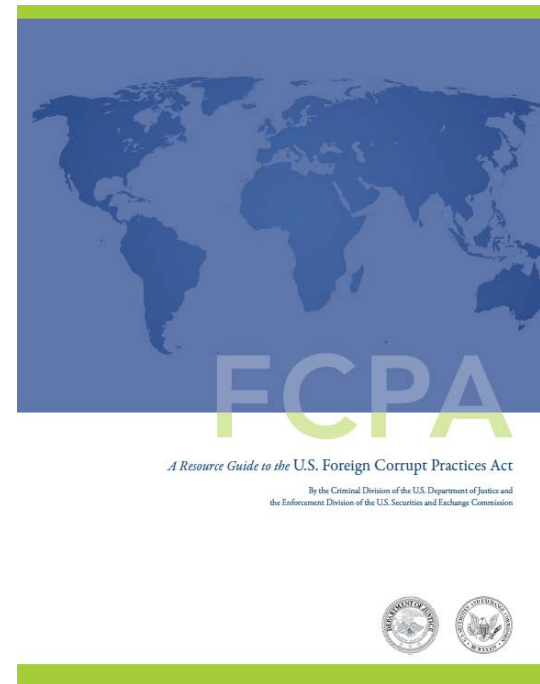
Findings - Key Themes

- Surveyed middle-market companies, particularly smaller ones, say they have more work to do to effectively respond to global corruption risks.
- Executives say the level of monitoring and self-policing activity taking place today is higher than three years ago.
- Executives rank non-financial obstacles above financial ones as a challenge in addressing global corruption risks.
- Third-party due diligence and monitoring and M&A activity continue to be major sources of global corruption risk.
- Regular training remains an area of opportunity for companies to improve their corruption law compliance.
- New whistleblower provisions in the Dodd-Frank Act increase the stakes and regulatory risks for FCPA compliance.

* Jointly published by McGladrey LLP and the Institute of Internal Auditors

DOJ/SEC Resource Guide

- In November 2012, the DOJ and SEC jointly issued *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (“FCPA”).
- Although the guidance did not really break any new ground, it does serve to consolidate 35 years of precedent and best practices that have arisen over time.
- With respect to FCPA Compliance, the guidance identifies ten (10) “Hallmarks of Effective Compliance Programs.”



10 Hallmarks of Effective Compliance Programs



Key Takeaways

Is your anti-corruption actually working? Some questions you should ask:

- What are your specific corruption risks, and how vulnerable are you?
- Have you defined the term “foreign official” in the context of your business?
- Are your internal controls proportionate to the pressures faced by your employees and third-party representatives?
- How are other organizations addressing similar challenges?
- What proactive steps should you be taking to confirm the program is working?

Polling Question 1

A clearly articulated policy against corruption that is committed to by senior management is an example of:

- A. Oversight
- B. Risk assessment
- C. Tone at the top
- D. Code of Conduct

Third Party Intermediaries

Risk, Due Diligence and Compliance

Third Party Intermediaries Risk, Due Diligence and Compliance

Third Party Intermediary - Definition

- A third party intermediary assists the company in some aspect of its foreign business and often includes sales agents, distributors and brokers.
- Intermediaries can also include those acting in an advisory or advocacy role such as lobbyists, attorneys and consultants.
- The FCPA defines an intermediary as any agent of the company; the UK Bribery Act is broader and extends the definition to any person associated with the company.

Third Party Intermediaries: Risk, Due Diligence and Compliance

Risks of Using Third Party Intermediaries

- Ninety percent of FCPA cases brought by the U.S. government involve conduct by third parties (*source: Association of Corporate Counsel*).
- A company need not have had intent or knowledge of bribery on the part of a third party intermediary in order for the company or individuals to be criminally and/or civilly prosecuted under the provisions of the FCPA or UK Bribery Act.
- A company has less control over the actions of third party intermediaries.
- Company's should maintain heightened awareness if doing business with government representatives, particularly in higher risk countries such as China.

Third Party Intermediaries: Risk, Due Diligence and Compliance

Conduct Due Diligence

- Background searches (criminal; business) and other third party risk assessment tools.
- Local investigation of third party for reputation and business practices.
- Due diligence should also apply to joint venture partners.

Ensure Compliance

- Ensure that third parties are aware of and comply with local laws, as well as the company's policies and procedures, ethics, and code of conduct.
- Conduct anti-corruption training with third parties.
- Require contracts and ability to audit third parties with which the company does business internationally.

Polling Question 2

A third party intermediary generally doesn't include the following:

- A. Sales Agent
- B. Consultant
- C. Government Official
- D. Lobbyist
- E. None of the Above

Fraud Scenarios

Recent Trends and Early Detection Strategies

Recent Trends: Theft and Embezzlement

- Controls over cash have generally improved; we are not seeing as many embezzlement cases where employees have been able to write checks to themselves or establish phony vendors (better segregation of duties).
- Recent cases have involved company credit cards used for personal or other unauthorized expenses as a means to embezzle funds from companies.

Case A

- Employee submits and processes his/her own personal credit card bill through the company's accounts payable system.

Case B

- Employee incurs personal charges on a company-paid credit card.

Case C

- Employee issues corporate cards in the entity's name – real life example of \$5 million in online gambling charges.

Early Detection Strategies

- Enhance quality and frequency of review and approval process (e.g., ensure that immediate supervisor reviews any company-paid credit card expenses before credit card is paid).
- Identify any segregation of duties issues in the accounts payable function.
- Perform periodic or monthly review of cash disbursements and vendors.

Recent Trends: Financial Statement Fraud

- Financial statement fraud is still prevalent, particularly in companies not subject to Sarbanes-Oxley.
- Employees are not necessarily “cooking the books” for personal financial gain (i.e., compensation) but to ensure the survival or continued success of the company and to avoid termination.

Case A

- An employee made \$6 million of false accounting entries simply to validate the forecast for which he was responsible and keep his job. This caused the company to violate its bank covenants.

Case B

- A company’s subsidiary was over-charging vendors for rebates to increase gross margin.

Early Detection Strategies

- Proper review and approval of accounting entries is critical, even at the highest level (e.g., CFO review of any entries made by Controller, and so on).
- Thorough review of monthly reported results vs. budget/forecast vs. prior periods by senior management.
- Thorough analysis of balance sheet accounts on a monthly basis by senior accounting/finance personnel.

Polling Question 3

Early detection techniques for financial statement fraud may include the following:

- A. Review of journal entries
- B. Periodic review of forecasts and budgets vs. actual results
- C. Monthly balance sheet account analyses
- D. Evaluation of internal controls
- E. All of the above

Immediate Next Steps if a Potential Fraud is Detected

Do's and Don'ts

Do's

- Advise senior management, general counsel and external counsel.
- Best practice: external counsel engages forensic accountants. If applicable, Audit Committee engages counsel separate from corporate counsel, particularly in the case of a public company.
- Preserve data (especially electronic) / lock down electronic hardware (desktops, laptops, etc.).
- Manage communications / be discreet.
- Advise insurance company.
- Advise law enforcement if applicable (after consulting with counsel and insurance company).
- Advise auditors (important).

Do's and Don'ts

Don'ts

- Investigate the matter yourself.
- Engage internal audit to lead the investigation.
- Terminate suspected perpetrator(s) before discussing with counsel.
- Conduct your own interviews without counsel and forensic investigators present.
- Retrieve electronic data from servers, networks, desktops, etc. – even with the assistance of IT group.
- Be uncooperative with regulators.

Polling Question 4

If you suspect that a potential fraud may have occurred, you should consider the following:

- A. Discussing the matter with the appropriate colleagues
- B. Conducting a preliminary investigation of the circumstances
- C. Discuss the matter with professional counsel
- D. Ask internal audit to look into it
- E. Hire forensic accountants

Addressing your questions



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- **It is now time for our Q&A session.**
- **Click the “Q&A” button, type your question in the open area and click “Q&A button” to submit.**

Thank you for attending!

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Follow-up materials

- The presentation slides and a link to the call recording will be sent to all participants within a few days of the webinar

Appendix

10 Hallmarks of Effective Compliance Programs



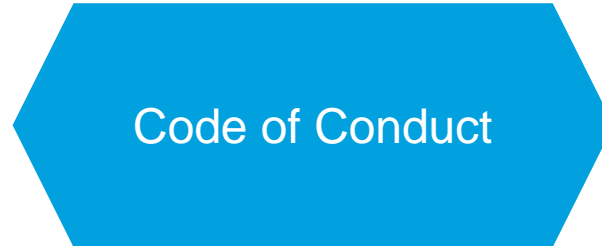
Hallmark 1

Tone at the Top

- Is there a commitment from senior management and a clearly articulated policy against corruption?
- Is senior management setting an unambiguous example?
- Does mid-level leadership set the same tone as executive leadership?
- Is your compliance framework simply a paper program, or does it serve to create and support a culture of compliance?

Hallmark 2

- Do you have a code of conduct and related compliance policies and procedures?



- Is your code clear, concise, and accessible to all employees?
- Is your code available to employees in their local language?

Hallmark 3

- Has the company assigned responsibility for compliance to specific senior executives?
- Does your program's owner have direct access to the organization's board or audit committee?



Oversight,
Autonomy,
Resources

- Are the resources allocated to compliance proportionate to the complexity of the organization, industry, geographic footprint, and specific business risks?

Hallmark 4

- Is your compliance program a “one-size-fits-all” approach? Such programs are generally ineffective, and perhaps even counter-productive.
- DOJ and SEC give meaningful credit to companies that implement a comprehensive risk-based compliance program in good faith

Leading Practices:

- Evaluate corruption risk by country
- Identify and include “red flags” as part of the risk assessment
- Incorporate FCPA controls into SOX control infrastructure



Risk Assessment

Hallmark 5

Training and Continuous Advice

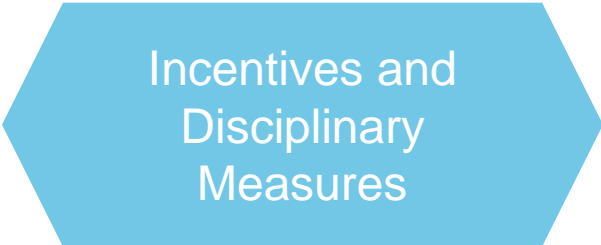
- How effective is the communication of relevant policies and procedures throughout your organization?
- Is your training tailored based on level, roles and responsibilities, and types of interaction with government officials, etc.
- Is all training delivered in the local language?



Leading Practices:

- Consider a risk-based approach to training
- Incorporate real-world scenarios in simulation-based training
- Vary your training delivery models

Hallmark 6



Incentives and Disciplinary Measures

- Does your company publicize disciplinary actions internally?
- Do you offer rewards for ethics and compliance leadership?
- Are you consistent in the disciplinary and incentive actions that you take?

Hallmark 7

- Do you know your vendors?
- Do you understand the business need for including third-parties in various transactions?
- Are you performing ongoing monitoring of third-party relationships?

Third-Party Due
Diligence and
Payments



Leading Practices:

- Incorporate anti-corruption clauses in all agent and vendor contracts and agreements
- Evaluate all agent agreements at least annually
- Perform risk-based vendor audits on a regular basis

Hallmark 8

- Does your program provide for truly anonymous hotlines?
- Do you have an efficient and reliable process for investigating allegations?

Confidential
Reporting, Internal
Investigation

Hallmark 9

- Are you performing periodic testing and review of your compliance program?
- Can you demonstrate that your program is continually evolving to reflect changing business conditions?
- What is actually being done differently, as a result of allegations and identified weaknesses?



Continuous
Improvement

Hallmark 10

- Do your pre-acquisition due diligence and post-acquisition integration approaches adequately consider corruption risk?
- Inadequate due diligence may lead to a continuation of corrupt practices, or the “acquisition” of existing liability.
- If not practical during due diligence; have you considered a thorough post-acquisition FCPA due diligence process?

Leading Practices:

- Ensure your anti-corruption policies and procedures are quickly applied to the newly acquired company
- Train all newly acquired personnel who present corruption risk on your policies and procedures
- Conduct an FCPA-specific audit of the newly acquired company as soon as possible

Mergers and
Acquisitions



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