Fraud Findings

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THE ABUSE OF EXECUTIVE POWER

An inattentive board of directors allows a CEO's wrongdoings to go unnoticed.

It was 9:35 on a Wednesday morning in New York at the board meeting of a multi-billion-dollar, publically traded company. The CEO, Richard Tompkins, was in a rage. The chairman of the board had just told him to resign or he would be fired. Tompkins' reaction was classic, immediate, and violent. He was the shareholders' greatest nightmare.

Tompkins was brought in to execute the turnaround of the company and initially had done a reasonable job. He claimed he needed a team he could trust and did not have time to evaluate the existing group, so he brought in a new chief operating officer, chief financial officer (CFO)/controller, chief information officer, human resources (HR) director, general counsel, purchasing agent, CAE, and external auditor—all friends and former colleagues. The board, anxious for the company to be saved, voted in favor of every organizational change Tompkins steamrolled through. But over the next several years, rumors of executive abuse began, including insider land deals and related-party transactions, excessive equipment and service purchases from related parties, unusual consulting contracts, inappropriate personal expenses, personal use of the company airplane, extravagant golf outings and parties, unnecessary foreign travel, and company vehicle abuse.

During this period, even the chairman, who was busy with other ventures, took little time to fully understand what was going on inside the company. Meanwhile, the internal auditors, while formally reporting to the audit committee, were under the day-to-day control of the CFO, Tompkins' close friend. As long as the earnings looked good, the board was happy to show up and vote "present."

When the recession took hold and revenues dried up, multiple frauds began to surface, rounds of layoffs commenced, and whistleblower calls started pouring in to the HR director, with no effective or independent follow-up. The calls then were diverted to corporate counsel, who wrote them off as disgruntled former employees, assuring the chairman that there was no basis to these unfounded allegations. The audit committee chairman, an outside member of the board brought in by Tompkins, put his faith in the audit system and did not give the disgruntled former employees adequate consideration.

All these activities finally came to light because of Harriet Stevens, a quiet and humble accounts payable employee who identified a US$2.5 million bridge construction project over the company's pond that was awarded to the CEO's son, a building contractor. Stevens first called the company's ethics hotline. When

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nothing happened after her report, she called the chairman of the board.

The chairman was independent of management and the largest shareholder in the company. His interests were well aligned with the shareholders. He called in independent investigators, which he initially paid for out of his own pocket. As the inside business process consultants reviewed company operations, they fed the outside team with various leads, which allowed the investigators to identify and target various companies and individuals for investigation and approach. This effort, combined with the numbers coming from the inside team, allowed the investigators to identify and document numerous serious irregularities and outright frauds perpetrated by Tompkins and his cohorts.

Tompkins' multiple frauds were successful—at least for a time—because he had complete and unquestioned control over the day-to-day operations of the business, including the ability to circumvent existing weak controls. Tompkins was able to pack the company with yes-men and friends—some of whom actively participated, enabled, or otherwise conspired with him in several frauds. The external auditors were completely ineffective in probing deeply enough to ferret out the misdeeds. They were eager to maintain their new Fortune 100 client and did not want to rock the boat. Consequently, they failed to recommend a stronger and tighter business control structure to prevent some of the shenanigans. While the outside auditors were aware of the internal control weaknesses surrounding Tompkins' inappropriate activities, they failed repeatedly to directly confront these issues.

The board was little more than a rubber stamp for Tompkins. Whatever he did in the name of saving and running the company was always approved. All of the independent directors sat on multiple boards, leaving them insufficient time to direct and monitor the company's executives. Several lacked the depth of skill to understand the company's operations and competitive position. In particular, the audit committee chairman placed far too much reliance on the work and opinions of the outside auditors and the CFO.

During the early phases of the CEO's irregular activities, the magnitude of the transactions fell far below the "materiality levels" of the outside auditors. This fact, combined with the CFO's willingness to hide questionable spending within the forest of the company's transactions, effectively camouflaged the CEO's activities.

The board was faced with a vexing dilemma. It needed to decide whether to pursue criminal or civil action against the CEO or let him go quietly to avoid a scandal, which would negatively affect the shareholders. In the end, it chose the quiet path.

Lessons Learned

- The chairman is, or should be, the chief advocate for the shareholders, and completely independent of management. It is the chairman's primary job to direct the company's executives and drive oversight of their activities in the name of the shareholders.
- An independent and highly skilled audit committee chairman is essential to maintain a robust system of checks and balances over all operations. To be truly effective, the chairman must be independent of those he or she is charged with watching.
- The CAE must report to the audit committee and have his or her budget, compensation, mission, career path, and hiring/firing authority fully insulated from executive management.
- The chairmen of the board and the audit committee must devote material time to their duties. While the board can use the company's oversight functions to maintain a checks and balances process, there is no substitute for personal, direct involvement.
- The board must be willing to direct inquiries into allegations of misconduct, and have unquestioned confidential spending authority to conduct reviews and investigations as it deems necessary.
- One of the most effective compliance tools available to the board is the day-to-day vigilance of the company's employees. When an individual employee detects wrongdoing, he or she must have an effective and safe method to report observations, such as a third-party ethics hotline that reports to the chairman of the board and audit committee. All employees 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. Ia

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