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Analysis

Risk Assessment

TARP Financing Recipients Should Expect Government To Inquire Into Internal Controls, Ask How Money Is Spent

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The Troubled Assets Relief Program, and perhaps other economic stimulus programs¹ yet to be developed, place the government in uncharted territory—as a minority, and potentially a majority, shareholder in many publicly traded and private financial and non-financial services companies. But will the government behave like the typical shareholder or creditor?

As any government contractor can attest, the specific set of rules and practices that come with conducting business with the government are uniquely different from operating in the commercial sector. Private parties settle through negotiation and, as a last resort, civil litigation. Disputes with the government often are settled through regulatory action and, worse, criminal prosecution.

Recipients of TARP and other federal aid will soon fall under the microscopes of prosecutors, regulators, legislators, and investigative reporters. The special inspector general of TARP, who is a former federal prosecutor, has expressed concern that TARP recipients are not reporting or

internally tracking the use of TARP funds, and he has committed to Congress that he will conduct an “across-the-board review” to answer the question, “Where did the money go?”² The special inspector general has established both audit and investigation divisions and is “committed to robust criminal and civil enforcement” of fraud, waste, and abuse.³

One should not underestimate government ingenuity in applying criminal statutes and regulatory schemes to new circumstances. Reputation and brand value, estimated at 20 percent to 40 percent or more of market capitalization, is at even greater risk, particularly from grandstanding politicians and publicity hounds.

Watch for Catch-22

For some companies, it will feel like a Catch-22. Take mortgage restructuring, for example. The government wants creditors to restructure loans to avoid foreclosures. What will the critics say when financial institutions become the victim of loan restructuring frauds perpetrated by the same actors behind the mortgage crisis?

No CEO wants to be subpoenaed to appear before a grand jury, regulator, or Congress or to face a television camera explaining why monies have

² Letter of Jan. 22, 2009, from Neil M. Barofsky to Sen. Charles Grassley, available at <http://grassley.senate.gov/private/upload/Letter-from-Special-IG-Neil-M-Barofsky-to-Senator-Chuck-Grassley.pdf>

³ Special Inspector General “Initial Report to the Congress,” page 14, Feb. 6, 2009, available at <http://www.sig tarp.gov>.

been “wasted” or “misspent.” Following are very low-cost, practical steps that companies can take to help mitigate those risks.

Some really good news first. Acting affirmatively to prevent and detect fraud, waste, and abuse more than pays for itself. Effective fraud risk management produces an eight-to-one return on investment for financial services companies.⁴ Strong antifraud controls reduce fraud by at least 30 percent.⁵ So not only is risk mitigated, the bottom line should increase from improved operating efficiency, reduced spending, and asset preservation.

The Sarbanes-Oxley Act reaches only material financial misstatements and controls over financial reporting. Recipients of TARP and other government funding programs, while they can leverage SOX controls, should be careful not to overrely on them as effective compliance controls. Readers familiar with the “COSO Cube” will recall that the internal controls and enterprise risk management frameworks differentiate between controls over financial reporting and controls over compliance.

Satisfying government expectations warrants companies to apply the same rigor to compliance controls as they do for financial reporting. It is important to remember that financial statement materiality is irrelevant. Companies might, as a starting point, link and assess existing programs’ controls to (1) specific TARP and other government stimulus programs and (2) expectations typically required by the government outside of

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⁴ Rodney Nelsestuen, “Enterprise Fraud Management in Financial Services: Restoring Confidence in an Uncertain World,” The Tower Group Inc., September 2007.

⁵ “Kroll Global Fraud Report,” 2008.

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TARP. This comparison can be leveraged to enhance controls, if needed, and develop monitoring and auditing procedures for front-line management, compliance, and internal audit.

The single most important step that a company can take to mitigate misconduct risk is to provide tools and training for front-line operations and finance personnel. Operations and finance compose the first and second line of defense. Legal, compliance, and internal audit functions form a critical, but third, line of defense. Because most compliance, internal audit, and law departments are one step removed, it is dangerous to rely exclusively on them as the principal line of defense. Front-line operations and finance personnel need not become auditors or compliance experts. They must, however, become competent to identify likely legal and reputation risks and to assist management in managing them.

The Treasury Department has not applied the government procurement regulations to the TARP program or its participants. That said, understanding Federal Acquisition Regulation, Truth in Negotiation Act, and other federal procurement requirements, e.g., project accounting, can help to avoid trouble.

Mitigating legal and reputation risk requires a detailed assessment of “what could go wrong.” Some scenarios relate directly to conditions or “strings” attached to government funding programs. For example, the TARP’s term sheets for loans to the automotive industry require corporate expense policies relating to holiday parties, travel, sponsorship events, consulting agreements, etc. The policies must provide for internal reporting and oversight and require violations and amendments to be reported to the Treasury Department. Participants should actively consider scenarios of how the government or critics might allege that they violated such conditions.

“No strings” scenarios are less obvious and perhaps more dangerous. Government funding recipients should anticipate being held accountable, at a minimum by politicians and the media, for any perceived fraud, waste, or abuse—the argument again being that money is fungible.

Guarding against these risks requires a comprehensive, “bottoms up” assessment of fraud, waste, and abuse scenarios. The risks are most effectively assessed when looking at

them from the perspective of the prosecutor, regulator, congressional investigator, or journalist.

Companies subject to the Sarbanes-Oxley Act have experience in linking controls to identified risks. Remember, though, that SOX extends only to scenarios that are reasonably likely to cause a material financial misstatement. The issue of reputation, while extremely significant, is therefore beyond the scope of SOX.

Identifying controls is not enough, however. Ineffective controls are no better, and perhaps worse, than having no controls at all because the company might let down its guard, erroneously believing that it is protected.

Risk indicators are red flags that suggest a fraud might be occurring.

Companies should evaluate design and validate operating effectiveness of controls intended to mitigate significant misconduct risk, including those that are not SOX key controls. Specifically, they should step into the shoes of the fraudster to consider whether a control, even if it is operating effectively, will actually prevent the identified risk.

Some controls are sufficient to protect against error but do not adequately guard against intentional misconduct. Early detection is the next best alternative. Monitoring and auditing procedures should be designed to detect key risk factors and indicators. Risk factors refer to changing circumstances that increase the likelihood of a risk scenario occurring. Risk indicators are red flags that suggest a fraud might be occurring.

Many front-line operations and finance personnel can be trained both on risk factors and indicators and how to search for them. Tailored data analytics and face-to-face interviews are critical. Procedures and training are also needed to provide guidance about what should be done when red flags are discovered.

TARP faces considerable oversight. The legislation requires the Government Accountability Office to report at least every 60 days on TARP’s efforts, including whether it

is meeting the intended purpose under the law and taking steps to “prevent, identify, and minimize conflicts of interest.” The GAO’s first report, issued in December, emphasized the need for the Treasury Department to develop internal controls, including policies and programs to prevent and detect fraud, waste, and abuse.

The TARP special inspector general is more independent and has greater latitude than the typical inspector general.⁶ Moreover, TARP Special Inspector General Neil M. Barofsky comes from the Department of Justice, where he prosecuted mortgage fraud and other economic crimes. TARP participants should anticipate Barofsky’s office to be proactive and creative and to apply tools ordinarily used in criminal settings.

The legislation also established a five-person congressional oversight panel appointed by both parties in the House and Senate. The panel includes two members of Congress, a law professor, the superintendent of banks in New York, and an associate general counsel of the AFL-CIO.

Expect Audits

Program participants should anticipate audits or reviews by one or more of these overseers. Barofsky has already announced a plan to conduct “formal” audits, preceded by a 30-day initial data collection.⁷ Conducting mock audits is an excellent way to anticipate scope and address deficiencies before they are discovered by a government auditor.

Contemporaneous documentation of prevention and detection efforts is essential. A company must be able to demonstrate that it acted reasonably to anticipate, prevent, and detect misconduct. Success lies in the details and with demonstrating specific instances of the company “doing the right thing.” Generic policies and procedures will not be convincing. Now is the time to start documenting the company’s efforts.

⁶ Congressional Research Service, “The Special Inspector General for the Troubled Asset Relief Program.”

⁷ Barofsky announced that the initial data collection would include a certified response from a senior executive officer consisting of (1) a narrative summarizing the use and expected use of TARP funds, (2) supporting documentation, financial or otherwise, and (3) a description of the compliance plan for executive compensation restrictions. Barofsky letter, *supra*.