Fraud Intelligence

For the prevention, detection and control of fraud in all its guises

Pre-emptive strike

"An ounce of prevention is worth a pound of cure." Benjamin Franklin was referring to fire prevention and as the founder of Philadelphia's first fire brigade, he acted on his conviction and undoubtedly saved many lives and much property. **Richard Minogue** and **Nigel Iyer** believe the Franklin maxim applies equally to fraud and corruption.

When it comes to our own health people sometimes put off a visit to the doctor or dentist until it is too late for fear of being labelled a hypochondriac, or simply because it doesn't seem urgent. Going to the doctor takes time and costs money but could make the difference between life and death. Similarly, the cost of a single case of fraud or corruption is likely to be many times greater than the cost of an early health check.

In last month's issue [1], we took a look at how companies are investing in integrity and ethics. As the recession bites and more and more organisations wake up to the sting of greed, fraud and corruption, the relationship between ethics and profits becomes increasingly clear. Today, it is really worth making sure that the defences are up and running.

The first line of defence is a robust Integrity programme and an effective system of internal controls. However, for this to be effective, resources also need to be devoted to monitoring and rooting out the red flags of non-compliance, something we call the Integrity Health Check.

There are a number of analytical tools and methods available to organisations, designed to detect suspicious characteristics or transaction patterns. By proactively searching for these red flags, the rationale goes, organisations are able to identify inappropriate relationships or business behaviour before too much harm is done. It is the equivalent of going to the doctor for a check-up even though you feel perfectly well. [2]

Just like our own excuses for not going for regular checkups to the doctor or dentist, in the business world, health checks are not always that popular. They cost time and money. And besides, internal controls are strong or at least adequate. Any major exceptions will be detected by the auditors. We trust our employees. We are looking forward to the future, not worrying about transactions that have already been approved, accounted for, paid and archived. If it's not broken, don't fix it. The list goes on.

Other priorities...

In an international energy company, the Security department routinely analysed supplier transaction and supplier master data for regional divisions in order to identify inappropriate vendors and conflicts of interest. During two years, a number of inappropriate situations were detected and addressed. The internal audit department, who had not been involved, heard about the projects and complained to management that security was exceeding its mandate and performing internal audit work. All such projects by security were stopped. Internal audit, however, did not perform its own health check projects, due to other priorities.

The aim of Integrity Health Checks

Integrity Health Checks contribute to prevention in two basic ways. Firstly, by identifying unusual circumstances or transactions at an early stage, inappropriate activities can be addressed before major costs have occurred. Costly investigations are avoided. Secondly, in an environment where health checks are routinely performed, the likelihood of detection is apparent, creating a strong deterrent to potential fraudsters.

Before starting any project, it is worthwhile defining exactly what you want to accomplish. The objectives of a health check will vary, depending on the scope of the

project, who is conducting it and the nature of the transactions reviewed.

> ## Objectives of an Integrity Health Check
> - Evaluate how the organisation's Code of Conduct is working in practice.
> - Determine whether previously identified integrity risks are occurring in practice.
> - Identify areas of interest for upcoming internal audit or security reviews.
> - Identify unusual customer discounts or pricing.
> - Identify unusual supplier payments or overbillings.
> - Identify suspicious or inappropriate counterparties.
> - Evaluate the effectiveness of internal controls.

In our experience, a health check will always identify areas of interest – nobody is perfectly healthy! But a well-conducted project that produces only minor exceptions cannot be considered a failure; on the contrary it is the desired result. It is a confirmation that, after careful analysis, nothing appears seriously wrong. This bill of health supports management's and the board's representations on internal control and their confidence that their integrity programme is effective.

An Integrity Health Check project will normally pay for itself in any large organisation, by identifying costly exceptions and permitting timely counter measures. In the longer term, management is not only interested in finding the exceptions but in preventing them altogether. Integrity, in an organisational ethics context, is about consistency between business principles and conducting business, between policy and practice. A successful integrity programme is the way to identify and eliminate the inconsistencies. It is important. It is the key to compliance.

Establishing policies that are both realistic and sincere, training employees and establishing communication channels so that they will apply the code and help identify risk areas, and periodic integrity health checks to verify compliance – these are the basic elements of an effective integrity programme.

How to know what to look for

An "Integrity Incident" can be defined as the occurrence of fraud, corruption, or breaches of the organisation's Code of Conduct and ethical policies. The perpetrator of an integrity incident might be an employee, a business partner, or even an unrelated party such as a hacker or the issuer of a hoax invoice. "Integrity Risk" is the product of an integrity incident's probability and the damage that it might cause. One needs to consider both the short and long term damage. Paying a bribe might bring in more business and increase profit in the short term but damage company culture and image in the long term.

Assessing integrity risks is a tricky business but fortunately large organisations have access to a wealth of knowledge: their employees. Risk experts and high level managers cannot match the detailed knowledge of employees working within the organisation's processes. They know where the potential faults lie even if they are not trained to think of them as "risks". With a little training and motivation, the detailed risk knowledge that employees possess can be collected and analysed. Just ask an employee or manager to put themselves in the shoes or a dishonest person, or fraudster - think of the damage they could do by finding and exploiting loopholes.

> A world class manufacturing and sales company performed a risk awareness and brainstorming session for employees in the purchasing function. Participants mentioned that certain departments had a tendency to bypass the purchasing function. In further discussion, it became apparent that the sales promotion department was particularly recalcitrant. During the integrity health check performed the following month, special attention was given to transactions authorised by the sales promotion department and as a result several unapproved conflict of interest situations were uncovered. The purchasing employees knew there was a problem but before the training and brainstorming they saw it as an internal political problem, not as an integrity risk.

Rather than shutting our eyes to what is going on in the world around us, we would use the Integrity Health Check to proactively look for the symptoms of what we could realistically expect to be happening in the organisation. Once the symptoms, or red flags, are visible, we can examine them. In some cases, no action will be necessary. In other cases, we may choose to investigate and prove or disprove that fraud has occurred. But in most cases, we can resolve undesirable situations quickly and quietly before major damage is done. By recognising and reacting to the early symptoms, we prevent small problems from turning into big headaches. And we can use our knowledge to

identify "leading indicators" to help heighten awareness of the risks, improve defences and prevent future frauds.

Getting started

A few years ago, the term "monitoring" conjured up, in some people's minds, images of "The Stasi" and a belief that management does not trust its people. "Internal Control" was misunderstood and out of fashion.

Enron, Worldcom and the Sarbanes-Oxley legislation that followed certainly led to a better understanding of the purpose of internal control and more open attitudes to monitoring. But when proposing an Integrity Health Check, there is still likely to be a wide variety of opinions. Before starting it is worth building a degree of consensus about the benefits of actually knowing whether the Integrity Programme is working or not. We have seen integrity health check projects initiated in many different ways, including:

The internal audit-led project

Using internal and/or external resources, internal auditors include a health check project in their annual audit plan, approved by the board. The results of the health check are summarised in an audit report. Suspicious transactions or counterparties are followed up by internal audit or reported to the operating division for follow-up, depending on the circumstances.

The security department-led project

The Security department arrange with an external service provider to perform a health check. Data is obtained using the Security department's authority, directly from IT. Suspicious transactions are investigated directly by the security department.

The service-led project

The shared services department develops a health check process, with or without external resources, and offers it as an additional service to its internal customers.

Top down project

Top management, or management of a local company, sponsor a health check project using an external consultant. The project is usually under the authority of the CFO or another senior executive.

The best way to organise and approve a health check project differs from one company to another. Top management support is clearly an advantage as it reduces the possibility of political infighting. However, support and consensus from all of the areas that share monitoring

responsibility will greatly contribute to the success of an integrity health check project.

Integrity Health Checks in practice – 3 case studies

Case 1 – Chopping large unwarranted and unnecessary costs

It was clear to all that the supplier of marketing services had overbilled for years to the tune of hundreds of millions of euros. The red flags collected by an Integrity Health Check were numerous: the supplier had only one customer; their invoices were vague and clearly inflated; some of the mark-ups applied were outrageous; other well-qualified competitors were not allowed to tender; the procurement department was bypassed. The supplier had effectively become an internal department with a virtual 'licence to print money'. All the signs pointed to insiders receiving kickbacks. The only question was how much investigation work was needed to apportion blame between our own employees and the supplier's.

The pragmatic Financial Director decided that a long and drawn out investigation would be painful and would probably not achieve the desired result. His simple and effective solution was to strengthen internal controls, allowing the professional procurement department to actually do their job and re-tender the contract. Annual costs were halved and, according to nearly everyone, the quality of service improved dramatically.

Case 2 – Fostering the open and ethical culture

An Integrity Health Check of sales transactions identified several customers and agents, which were in fact offshore or front companies, operating from so-called tax havens. A single customer relationship accounted for around 10% of the total turnover of our largest international business unit. The sales director's plausible explanations ranged from "this is an old relationship with our largest Russian customer and the deal was set up many years ago before new controls and rules were introduced" to "this business is very profitable and should not be disturbed." Nobody wanted to address the uncomfortable fact that tens of million dollars in sales rebates had been paid to offshore accounts and that the money could have gone to, frankly, anybody.

The case was examined thoroughly by a joint team, led by Corporate Audit and the Head of the Business Unit. Remedial action taken included ceasing all business of that nature, disciplining the worst offenders

and fully disclosing the corrupt payments that had been made. Most significantly, these real examples were used as learning experience in senior management training. The Code of Ethics was here to stay.

Case 3 - Rooting out dysfunction

In a medium sized company the red flags were everywhere but nobody had wanted to notice them. However, when a whistleblower copied a senior manager's expense report with a receipt from a fancy restaurant and a handwritten comment "strategy meeting with myself," the board sat up and took notice. All the other red flags that had been raised previously in audit and security reports suddenly took on a new meaning. These included gross supplier overcharging, harassment of staff who did not toe the party line by a subgroup of managers, diversion of sales receipts and conflicts of interest. This "help yourself culture" was all taking place under the umbrella of what was thought to be a strong and clear set of policies and internal controls.

The solution to a cultural problem was, of course, a cultural one. The worst offenders had already left and the task of bringing realism to the company culture and cleaning-up and was left to the newly appointed board and managing director. They started with awareness training and internal controls specifically aimed at curtailing unwanted and unnecessary costs.

Summary

Inside every major problem is an opportunity waiting to be grasped. The examples above [3] show how some companies refused to accept inappropriate situations and, by meeting their problems head-on, achieved both ethical improvement and financial success. In each case, whilst some investigation work was required following an Integrity Health Check, the primary goal was always forward looking: to ensure a healthier, more ethical and more efficient and valuable organisation at the end.

Notes

1. 'Going the right way: the ethics and integrity trend,' Minogue and Iyer, *Fraud Intelligence* February/March 2009.
2. 'Fraud and Corruption Prevention and Detection,' Iyer & Samociuk, Gower.
3. These three examples are taken from real cases in which the authors were involved.

Richard Minogue and *Nigel Iyer* have over 40 years' combined experience dealing with corporate ethics including a long stretch investigating and detecting incidents of fraud and corruption. For the past 5 years they have focused their efforts on making sure that corporate Codes of Conduct really live in practice and that there is consistency between principles and actions.
They welcome comments and criticisms on richard.minogue@ septiagroup.com and nigel.iyer@septiagroup.com. This is the second of a series of two articles.

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