MANAGING the COST and RISK of FRAUD and CORRUPTION

Although fraud, management deception, external audit negligence, black money and the misuse of tax havens have been around for years, it may seem that after Enron, Worldcom, and the discovery of the shady funding of terrorist organisations, the world is finally waking up to fraud and corruption. Better late than never.

BY VERONICA MORINO and NIGEL IYER

This article explores the global dimension of corruption down to the local and personal level showing how it impacts on the workplace and the bottom line. The article ends with an introduction to how holistic Fraud Management can be introduced into all organisations.

The global dimension of corruption and the moral dilemma

The globalisation of markets, transactions, services and individuals has lead to the internationalisation and increase of illegal activities, transcending international boundaries. As a result, reducing the incidence of fraud and corruption has become a priority both on a national level and on an international level. In their pursuit of Corporate Social Responsibility, global corporations are faced with a number of choices, none of which are easy. Multinational and transnational companies who do business in or with countries where corruption is prevalent, face moral challenges. "Doing in Rome as the Romans do" has well-documented moral problems; acting from principle may be misconstrued as moral imperialism, and not becoming engaged, too, is a high risk alternative. Are their contributions, some of which help a corrupt government or corrupt business, balanced by the possibility of increasing the economic well-being of a particular set of people? Should multinational and other smaller businesses avoid doing business where corruption is prevalent?

In the context of global business, what is perceived as corrupt practice differs in different cultures. It is universally agreed that misuse of power, excessive greed that burdens society and the environment, favouritism, bribery and extortion are forms of corruption which need to be eradicated. Given that point of view, there are ongoing agendas by Transparency International, the Organisation for Economic Cooperation and Development (OECD), and the Council of Europe's Multidisciplinary Group on Corruption, among others, to create and enforce international codes or "Guiding Principles" that deal directly with issues of corruption worldwide.

Trying to define or to quantify corruption through our different perceptions of it, however, is difficult. Fraud and corruption is a problem that concerns and involves all of us, with the single difference that some countries have fewer problems than others in admitting it. Nigerians, Italians and Indians do not have problems admitting that there is significant corruption in their countries. Corruption is not a Russian, Afghan or Muslim monopoly; it is just as much present in all countries. However, in the parts of the world where corruption is less visible, it is often difficult to realise it is there all the same (just try to convince a Swede, a Norwegian or a Finn by saying that basically corruption follows money and that Sweden, Norway and Finland are known as rich countries…)

As a result of last year's events linked to terrorism and the funding of terrorist organisations, the world is waking up to the issue of corruption, black money and illegal transactions. Plenty of space was dedicated in the journals and periodicals to the financial backing behind terrorists' organisations and their control of a complex web of offshore companies. But what does owning an offshore company mean exactly?

According to what is considered "common knowledge", by owning a so called tax or offshore haven company such as in Cyprus, the Cayman Island, Belize, Jersey, Switzerland or Panama (just to name a few), you can:

- set up a company where nobody can tell what the company does, who the owner is and who is involved,
- hide the money away from tax authorities
- move the desired amount of money between secret bank accounts
- make undeclared payments to anyone

Although it might seem dishonest, corrupt and deceitful, becoming the owner of a tax haven company is completely legal and rather simple. Many of the international weekly business magazines, as well as some of the international airlines magazines, assign some of their back pages to advertisements for setting up accounts and offshore companies.

Example

The local managing director of a large company, ABC Corp, was suspected of giving preferential treatment to some customers and companies providing different kinds of services. Near the desk of the company lawyer, a file was found containing hundreds of documents, payment and transactions related to different offshore companies owned by the managing director and the lawyer. Deeper investigation on these companies showed that they were the hidden owners of two of the main business partners that worked with ABC Corp.

The local and personal dimensions of corruption

It is not an easy task to define and quantify the cost of corruption on a global level. Can this be done on a local or personal level? What does corruption mean to the individual? In most cases corruption involves a conflict between personal interests and the official or managerial role. Corruption occurs when someone acts with a conflict of interest for personal gain. Acts of corruption usually involve a debasement of a standard or a norm of accepted practice or behaviour. Our simple but commonly accepted definition says that it is possible to talk about fraud and corruption when an action is 1) dishonest and 2) deliberate. While it is not difficult to find an agreement on the meaning of the word "deliberate", "dishonest" is a very subjective word. Dishonesty could be interpreted as immoral, not convenient, against decency. But can we define decency, morality or convenience in a universal way?

Just try to answer, very honestly "hand on heart", to this "ethical test" with a yes or a no to the following questions.

Have you ever…:

- ☐ brought home any stationery from the company?
- ☐ lied about your previous work experiences during a job interview?
- ☐ driven after a drink or two?
- ☐ increased the days of sick leave with the help of a inaccurate medical certificate?
- ☐ taken and not declared a gift from a supplier or customer?
- ☐ taken a bus without paying the ticket?
- ☐ added things you shouldn't have to your travelling expenses?
- ☐ paid tax free cash to a builder, plumber, electrician…?
- ☐ not registered your latest extension to your home?
- ☐ stolen anything?
- ☐ used unlicensed software?

How did you score?

Whatever the score is, we usually still believe that we are honest. Probably, however, not everybody would have answered in the same way, and what might be acceptable by one individual could be considered unacceptable by another. Every individual has his own scale of values, following which he rationalises his own actions. When we do something that we consider dishonest, in order to cope with our guilty feelings, we have the need to rationalise it in such a way that our behaviour becomes acceptable. Once rationalised as acceptable, such behaviour becomes a standard practice. As time passes the guilty feeling become less and less strong and it is possible to be open towards rationalisations of gradually less honest behaviours.

Example

There were strong indications that many of the company's suppliers were giving commissions to the maintenance manager of the company in order to be selected as suppliers. Further investigations and long interviews with the suppliers revealed that only a few suppliers were not willing to pay bribes. Most of them were forced to do so by the manager (whose nickname was Mr 20%) under the threat of not working for the company anymore. After the manager's dismissal, it was discovered that most of the work provided by the suppliers was unnecessary or that the same work had been done several times. Moreover it was later revealed that Mr 20% purchased nuts and bolts for his boat through the company and took several bottles of soft drinks home every Friday evening.

The Corporate Perspective and Fraud Management

If every individual has his own personal ethical tolerance limit and his own scale of values by which to define the honesty of certain behaviours, who should define what business ethics actually means? Our experience, backed up by numerous surveys and "straw polls", shows that companies on average lose between 2% and 5% of turnover as a result of fraud. Typical frauds include theft, manipulation, conflicts of interests, industrial espionage, collusion between customers and suppliers, brokering of illegal information, bribes, payments to companies in tax havens, false qualifications and just plain and simple overcharging. Organisations are becoming more and more aware that fraud, corruption and other unethical activities represent a substantial cost to the business and an erosion of capital and resources, which damages not only the profits, but also the reputation and the culture of a company. As time goes on, some of the methods for committing fraud and corruption are getting more and more sophisticated and so make it very difficult, if not impossible, to recover any money after the event.

Fraudsters always succeed in finding the loophole which bypasses all the controls, and are often able to persuade some basically honest people to lower their ethical tolerance limits. It is not so difficult to find allies, provided that people have the opportunity, are motivated enough and are sure not to be discovered. In the end, what is one small fraud in a world of dishonest people?

To understand the true cost and impact of fraud in any organisation, it is important to implement a holistic fraud management strategy. One of the main issues is that often there is a significant difference between the level of fraud risk perceived and the actual reality. Most relatively honest employees cannot actually believe that fraud will happen. Major frauds are often not discovered because honest people are not trained to suspect other apparently honest people. As a result, risk analyses are often superficial and inaccurate when dealing with fraud and do not give the true picture of the potential for fraud in the organisation. Why is this the case and why do most people need a "shock experience" before they take fraud seriously? Why do they not wake up earlier, become cynical and suspicious, learn how to detect fraud before it happens and end up saving money?

Because of the low level of fraud awareness, the analysis of fraud needs to be given special treatment within the area of risk analysis. By creating a profile of frauds which could have an impact on the organisation, and consequently raise the awareness, detecting and preventing fraud becomes something anyone can be trained to do. This is, of course, as long as he is willing to dismiss completely from his mind the belief that fraud is not there.

Example

During an internal audit review which incorporated some fraud detection tests, a number of "red flags" or warning signs of fraud were identified. One of these tests showed that 18% of middle level and senior employees had established some form of external business after they had been employed. For example a Sales Director had his own property company and rumours about his conflicts of interest with customers and suppliers abounded.

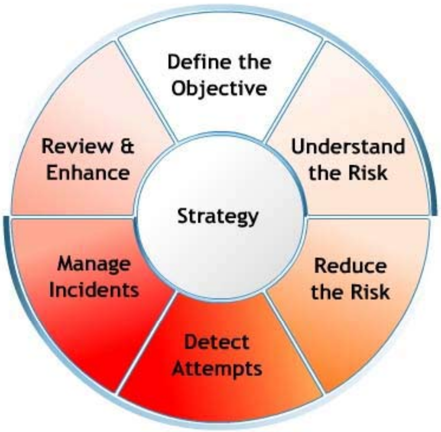
In spite of repeated and "courageous" efforts by Internal Audit, the divisional management would not accept many of these warning signs as anything more than pedantic and negative comments.

Nearly two years later, when the management team changed and Internal Audit were allowed to follow up, it was found that in just one case this Sales Director had hidden interests in suppliers, was bribing his customers and in effect running a cartel, all for his own benefit.

A Fraud Resistant Organisation—introduction to the holistic philosophy

Raising the awareness of the critical risks of fraud and corruption, learning how to detect the first signs of alarm, increasing preventive actions, managing incidents and implementing follow-up strategies are some of the possible steps of managing fraud. Instead of just focussing on the strength or completeness of the control environment, executives should also focus on improving the organisation's resistance to fraud.

A holistic Fraud Management Strategy, aimed at active prevention of fraud across an organisation, should comprise six main elements, as shown in the figure below:



The key elements in a holistic Fraud Management Strategy are:

1) Define the Objectives. Agree upon a corporate ethics policy applying to all employees including top management.
2) Understand the Risk. Identify potential fraud across all areas of the organisation (Fraud Profile).
3) Reduce the Risk. Implement preventive control for frauds to reduce generic fraud risks.
4) Detect attempts. Recognise the early warning signs (Red Flags).
5) Manage incidents. Ensure that incidents are handled in a consistent and efficient way (Fraud Response Plan).
6) Review & Enhance. Learn from incidents and earlier mistakes, increase awareness of all employees and provide training programs.

By implementing a holistic Fraud Management Strategy the intention is not to avoid every fraud, but rather to prevent high impact frauds and to design and implement procedures to follow up on those fraud that occur.

However, to create a fraud resistant organisation, the executives should always follow the principle that the holistic Fraud Management Strategy is a continuous process and not a one-time panacea. ❋

The next article ("Investigating Potential Fraud") will outline some of the most important steps to take when you identify the symptoms of fraud, as well as the mistakes to avoid.

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