Measuring resistance to fraud and corruption

Peter Wieland[1], Knut Anderssen[2], Nigel Iyer[3], Veronica Morino[4]

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Abstract

The fact that corruption constitutes a major obstacle to democracy and the rule of law has been known for some time. Empirical research estimates that an average organisation loses about 5% of its total annual revenue to fraud and abuse committed by its own employees. Thus, fraud and corruption are major risks for all organisations. Recent cases of organisations involved in fraud and corruption show a substantial financial loss, both directly due to the fraud and subsequent investigation expenses and fines as well as indirectly due to reputation damage. No surprise that the fight against fraud and corruption has become a popular and focal topic within Corporate Social Responsibility (CSR) these days and this has been supported by both sides, the corporations and society at large. Anti-corruption has been integrated as 10th principle into the UN Global Compact. Anti-fraud measures are being strengthened in many organisations following major corporate financial fraud scandals mainly in the US and the subsequent Sarbanes-Oxley Act of 2002. As more and more organisations put in place systems to assess and manage risks of fraud and corruption, one question remains: how can we measure the effectiveness of these systems to prevent fraud and corruption, and how can we rate how resistant an organisation actually is? This paper explains how organisations typically integrate and implement guidelines and best practices on how to fight fraud and corruption (e.g. the OECD Business Approaches to Combating Corrupt Practices or Transparency International's Business Principles for Countering Bribery) throughout their business processes. It also introduces a rating system to measure the resistance of organisations to fraud and corruption and a benchmark against the initiatives mentioned above.

[1] Det Norske Veritas (DNV).
[2] Det Norske Veritas (DNV).
[3] Hibis Scandinavia A/S & Hibis Europe Ltd
[4] Hibis Scandinavia.

Introduction

Fraud and corruption are possibly some of the greatest unmanaged risks to which organisations are exposed to. This hypothesis tempts to speculate on how much fraud and corruption cost a typical organisation. This is a difficult question to answer. Empirical work indicates that the total direct and indirect cost of fraud is in the region of 5% of annual revenue for "normal" organisations [1]. Corruption is recognized to be one of the world's greatest challenges. It is a major hindrance to sustainable development, with a disproportionate impact on poor communities and is corrosive on the very fabric of society. The impact on the private sector is also considerable - it impedes economic growth, distorts competition and represents serious legal and reputation risks. Corruption is very costly for business, with the extra financial burden estimated to add 10% or more to the costs of doing business in many parts of the world [2].

Fraud and corruption are often intertwined and have impact on the entire risk landscape organisations are facing. On the political front, corruption constitutes a major obstacle to democracy and the rule of law. In a democratic system, offices and institutions lose their legitimacy when they are misused for private advantage. Though this is harmful in the established democracies, it is even more so in newly emerging ones. Accountable political leadership can not develop in a corrupt climate. Economically, corruption leads to the depletion of national wealth. It is often responsible for the funnelling of scarce public resources to uneconomic high-profile projects, such as dams, power plants, pipelines and refineries, at the expense of less spectacular but more necessary infrastructure projects, such as schools, hospitals and roads, or the supply of power and water to rural areas. Furthermore, it hinders the development of fair market structures and distorts competition, thereby deterring investment. The effect of corruption on the social fabric of society is the most damaging of all. It undermines people's trust in the political system, in its institutions, and its leadership. Frustration and general apathy among a disillusioned public result in a weak civil society. That in turn clears the way for despots as well as democratically elected yet unscrupulous leaders to turn national assets into personal wealth. Demanding and paying bribes become the norm. Those unwilling to comply often emigrate, leaving the country drained of its most able and most honest citizens. Environmental degradation is yet another consequence of corrupt systems [3].

Thus, no organisation with the intention to exercise Corporate Social Responsibility as a contribution to sustainable development can ignore the risk of fraud and corruption. The ability to significantly increase profit margins is another compelling reason to systematically manage fraud and corruption risk. The rapid development of rules of corporate governance around the world is prompting companies to focus on anti-fraud and anti-corruption measures as part of their mechanisms to protect their reputations and the interests of their shareholders. Their internal controls are increasingly being extended to a range of ethics and integrity issues and a growing number of investment managers are looking to these controls as evidence that the companies undertake good business practice and are well managed.

This paper explains how organisations typically implement fraud and corruption countermeasures throughout their business processes, and how to assess the efficiency of this implementation. The Fraud and Corruption Resistance Profile introduced below provides a snapshot of how resistant an organisation, corporation or entity is to the effects and impact (on profitability, long-term value, reputation and internal culture) of fraud and corruption. The assessment is equally applicable to financial institutions, global corporations, small and medium sized businesses, public sector bodies, in fact any organisation that is exposed to fraud or corruption. A Fraud and Corruption Resistance Profile would typically be requested by either a non-executive board or an audit committee but it could equally well be initiated from within the company.

The boundaries between fraud and corruption are blurred. The existence of many definitions of fraud which already include the words corruption and bribery, and the numerous other vague and varied definitions of corruption which exist suggest that it is time to stop quibbling over definitions. We believe that organisations should treat fraud and corruption as a single problem, at least from a corporate or organisational point of view. The system which is described here has been developed based on the following definitions:

- **Fraud**: "An intentional act by one or more individuals amongst management, those charged with governance, employees, or third parties involving the use of deception to obtain an unjust or illegal advantage." (International Standards on Auditing ISA 240)

- **Corruption**: "the abuse of public or corporate office for private gain"(OECD / World Bank working definition)

The concept of resistance

For most organisations the notion of developing resistance to a problem is quite familiar. Management systems to optimize performance with focus on e.g. quality, environmental issues, and occupational health and safety are frequently implemented in organisations. Reducing risks through systematic assessments is an integrated part of a management system. If an organisation claims to fight fraud and corruption, it should integrate effective measures in the management system to manage fraud and corruption related risks.

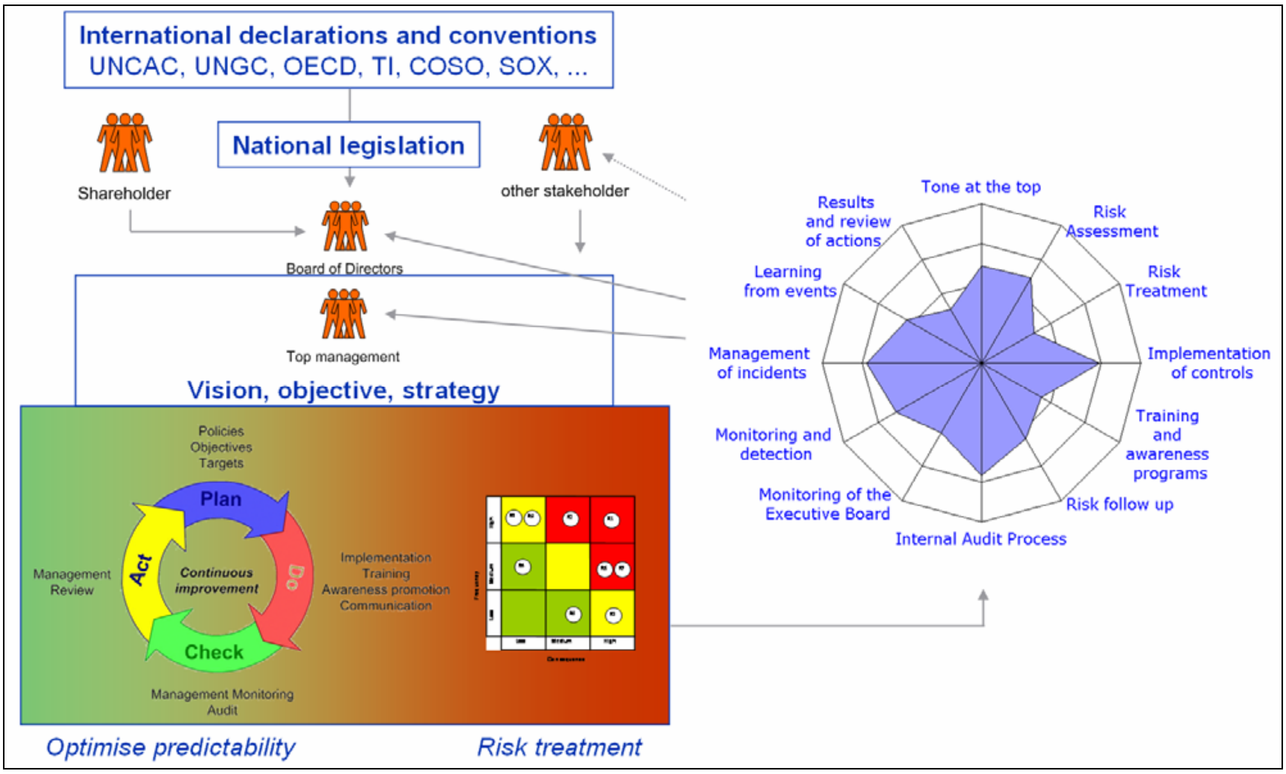

Figure 1: Implementation and assessment of fraud & corruption resistance

Figure 1 illustrates the core concept of how resistance to fraud and corruption is build into an organisation's management systems and how it can be assessed. For the organisation – in this case a listed company - the top management defines a vision, objectives and a strategy for the organisation. It is the responsibility of the Board of Directors to endorse the organisation's strategy, develop directional policy, appoint, supervise and remunerate senior executives and to ensure accountability of the organisation to its owners and authorities. In most legal systems, the Board of Directors is elected by the shareholders in general meeting and has fiduciary responsibility on behalf of the shareholders. Management systems help organisations

(a) to optimise their operations (processes, etc.) in respect to the defined objectives; (b) to comply with applicable laws, regulations, and relevant requirements, and (c) to continually improve in the above.

Management systems often follow the Plan-Do-Check-Act (PDCA or Deming) cycle [4].
One way to assess the potential ability of an organisation to meet challenges like fraud and corruption is to measure the way focus on the prevention is integrated in different elements of the management systems. When a rating is performed against a baseline standard then it is possible to identify and prioritise the improvements that need to be made.

As illustrated in Figure 1, the Board of Directors are responsible for the accountability of the organisation to comply with applicable laws and regulations. Due to peer or stakeholder pressure, the organisation might also chooses to adopt and comply with the other relevant requirements or best practise, even if they are not legally binding.

Framework of requirements

Legislation and guidelines on how to prevent fraud and corruption have been improved substantially during the last decade. Rather than introducing new requirements, our rating system is build on the following framework of widely accepted conventions, principles, and guidelines in the field of preventing fraud and corruption:

- **United Nations Convention against Corruption** that was adopted by the United Nations General Assembly in 2003. To combat corruption, it includes measures on prevention, criminalisation, international cooperation, and asset recovery [5].

- **UN Global Compact Principle on Anti-Corruption**: The Global Compact, established in 2000, seeks to promote responsible corporate citizenship so that business can be part of the solution to the challenges of globalisation. In this way, the private sector – in partnership with other social actors – can help realise the Secretary-General's vision: a more sustainable and inclusive global economy. The 10^{th} principle is on anti-corruption [2]

- **OECD Business Approaches to Combating Corrupt Practices**, anti-corruption material published on the websites of companies in UNCTAD's list of top 100 non-financial multinational enterprises which seeks to understand these companies' views of corrupt business practices, as well as their anti-corruption management and reporting practices [6].

- **Transparency International's Business Principles for Countering Bribery** which were published by Transparency International, the global civil society organisation leading the fight against corruption. The Business Principles aim to provide a practical tool to which companies can look for a comprehensive reference to good practice to counter bribery [7]

- **the COSO Internal Control Framework**, a model for evaluating internal controls developed by the Committee of Sponsoring Organisations of the Treadway Commission (COSO). This model has been adopted as the generally accepted framework for internal control and is widely recognised as the definitive standard against which organisations measure the effectiveness of their systems of internal control [8].

- **Sarbanes-Oxley Act of 2002, Section 404** introduced highly significant legislative changes to financial practice and corporate governance regulation. It introduced stringent new rules with the stated objective: "To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws"[9].

- **U.S. Foreign Corrupt Practices Act** of 1977 (FCPA) which prohibits U.S. companies, their subsidiaries, as well as their officers, directors, employees, and agents from bribing "foreign officials" and also requires U.S. companies that issue debt or equity to maintain internal accounting controls and to keep books and records that accurately reflect all transactions [10]. Even if somewhat dormant for many years, the FCPA is enjoying a renaissance in the wake of the UN Global Compact and Sarbanes Oxley.

It is natural to believe that as a result of all the additional new laws, regulations and internal controls which have sprung up recently, fraud and corruption on this scale is a thing of the past. The sad fact is that in spite of tougher legislation in the past 20 years, far too little has changed in terms of fraud and corruption. Despite improvements in reporting requirements, a greater awareness and stronger penalties, how much really has been done to effectively prevent fraud and corruption from occurring in the first place? Too little it seems - empirical data still shows that far too many incidents are detected by a tip off (34%) or by accident (25%) rather than by active monitoring through Internal Audit (20%) or Internal Controls (19%) [1].

However, few practical management tools [11, 12] help organisations to actually implement changes in legislation, guidelines, principles, and other relevant recommendations.

Assessment elements

Building effective resistance of fraud and corruption requires teamwork, across the typical functions of a company. Involved parties are the CEO, Financial Department, Legal Department, Human Resources, Internal Audit and Security, Corporate Communication and Investors Relations. Each party has its role and responsibility. In order to assess organisational preparedness, these roles and responsibilities within different areas of an organisation were linked to 12 elements. The motivation for each of the 12 elements of the introduced Fraud & Corruption Resistance is given below:

1. Tone at the Top

The tone at the top evaluates the degree and effectiveness of senior management's commitment to preventing fraud and corruption. The tone set at the top of an organisation regarding fraud and corruption prevention has a crucial effect throughout the rest of the organisation. Senior management should send a message that fraud and corruption will not be tolerated anywhere in the organisation. This commitment should be visible to all employees, credible, embedded in the organisational culture and also apparent to external parties.

2. Fraud and Corruption Risk Assessment

A thorough understanding of fraud and corruption risk across the organisation is a prerequisite for effective prevention. The assessment would involve systematic identification and ranking of those fraud and corruption risks which can and do affect the organisation at all levels. Fraud and corruption risk assessment also involves looking at how resistant the controls are to specific methods of fraud and corruption.

3. Fraud and Corruption Risk Treatment

Once fraud and corruption opportunities have been assessed, effective and mitigating measures have to be put in place by all levels of management, from the top down. Treatment in the form of a strategic plan, and management responses will lead to a reduced risk of fraud and corruption as well as a significantly increased chance of early detection. The purpose of this element is to measure the degree and effectiveness of mitigating measures.

4. Implementation of controls

The implementation of internal control measures should correspond to the specific fraud and corruption risks which have been identified and documented. In addition certain fundamental controls such as screening of employees, channels for reporting of malpractice and protection of assets need to be working effectively. Unnecessary or redundant controls should be identified and eliminated. The nature and purpose behind corporate governance regulations needs to be recognised by management and properly embedded within the organisation. The purpose of this element is to measure the degree and evaluate the effectiveness of how the anti-fraud and corruption controls have been implemented.

5. Training and awareness programs

Training programs should be practical in nature, cover a wide spectrum of risks and apply to all employees. Training should be assured for third parties, when their activities are closely integrated. The training should be held at regular intervals and structured to encourage feedback and sharing of information and best practices. The purpose of this element is to measure the degree and evaluate the effectiveness of the organisation's fraud and corruption training and awareness programs.

6. Risk follow-up

A system ensuring the follow-up of fraud and corruption risks should be in place. Risks should be reviewed regularly, and at a management level appropriate to the risk level. Fraud risks should be re-evaluated whenever major changes to underlying products or processes occur. The system also should include a mechanism allowing line managers to report their concerns when changes or other circumstances increase fraud risks dangerously.

7. Internal Audit Process

Large organisations should include an internal audit function that continuously evaluates the effectiveness of the organisation's system of internal controls. (In small organisations this function might be performed by top management.) The internal audit function should report to the Board or to top management, in order to ensure its independence from the areas under review. Internal audit should have clear mandate, be staffed by appropriately experienced and qualified personnel, and spend a proportion of its time evaluating measures taken to reduce the risk of fraud and corruption.

8. Monitoring of the Executive Board

The Board of Directors has primary responsibility for setting the fraud and corruption risk management strategy. The Board may assign an Audit Committee to be responsible for actively overseeing the effectiveness of implementation of that strategy. The Audit Committee or the full Board should also arrange and review an annual fraud and corruption risk assessment covering the Board of Directors and senior management. The purpose of this element is to measure and evaluate the degree of monitoring of the executive board and senior management.

9. Monitoring and detection

Proactive fraud and corruption detection is a key element in the risk management strategy, either to prevent illicit activity succeeding in the first place or to catch it in its infancy. Tests and triggers, which assist in the early detection of the symptoms of fraud and corruption, should be embedded into the organisation's communication policies as well as procedures and systems. The purpose of this element is to measure the degree and effectiveness of the monitoring and detection processes.

10. Management of incidents

Management of incidents involves the methodical investigation and examination of incidents of potential fraud and corruption as well as the actions taken to remedy the problems observed. This should also include identifying and treating the root causes of problems and not just the symptoms. The purpose of this element is to measure and evaluate the degree and effectiveness of managements systems and practices for managing incidents of potential fraud and corruption.

11. Learning from events

All recognised incidents of fraud and corruption provide the organisation and its management with opportunities for improving controls. By evaluating how and why incidents of fraud and corruption occurred the organisation can learn what controls are required to prevent them recurring. The purpose of this element is to assess the extent and effectiveness of the systems for recording and follow-up of incidents, feedback to key support functions as well as the methods of dissemination of information and experiences.

12. Results and Review of Action

All stakeholders including owners, audit committees, non-executive directors, regulators, financial institutions, governments and non-governmental organisations have different requirements and interest in respect of the prevention, management, and reporting of fraud and corruption. The purpose of this element is to measure the quality, extent, effectiveness and consistency of the reporting of fraud and corruption related risks, incidents and follow up actions to the stakeholders.

Assessment process

To assess organisation's resistance to fraud and corruption is important yet difficult.
Each of the assessment element introduced above is broken down into a set up sub-elements and a detailed protocol consisting of hundreds of key questions has been developed.
Each question has a unique score related to it. Scores for all questions add up to the maximum score of 5000. Elements are weighted differently, with "Tone of the Top" being the most important element, making up 12.5% of the total score. Each question is of one of the following types:

Yes/No	When a question has a yes or no answer, points are awarded on an "all or nothing" basis. Any activity should be at least "90%-in-place" in order to be scored. In any other case, zero points are awarded.
Part/Whole i.e. '5/45'	When a question has several component answers, partial scores can be awarded. These questions are marked for example "part/whole 5/45", indicating 5 points for the component boxes for each sub question, with a total of 45 points possible. Any activity should be at least "90%-in-place" in order to be scored. In any other case, zero points are awarded.
Professional Judgement	Some questions are scored based on "Professional Judgement', where the auditor must judge the degree of compliance or quality of the system with reference to the scoring guidance. The auditor can award from zero to the full points indicated, based on their judgement.
Percentage	When the degree of compliance could be partial, the score is based on percentage of compliance. This is indicated by a "%" symbol followed by the total value, such as "% x 30" i.e. 100% score earns 30 points
Frequency	Some questions evaluate how often a certain activity is done. In these cases, points should be awarded as indicated by the designated frequencies, e.g. Yearly (45) or Monthly (15)

This concept described is an internal rating measured against a benchmark standard.

It is based on interviews with champions or experts of the elements and sub-elements within the organisation. The aim is to ensure consistency and ambiguity. Figure 2 is a fraud and corruption resistance profile summary of a particular organisation reviewed. The gaps represent the focus areas for improvement.

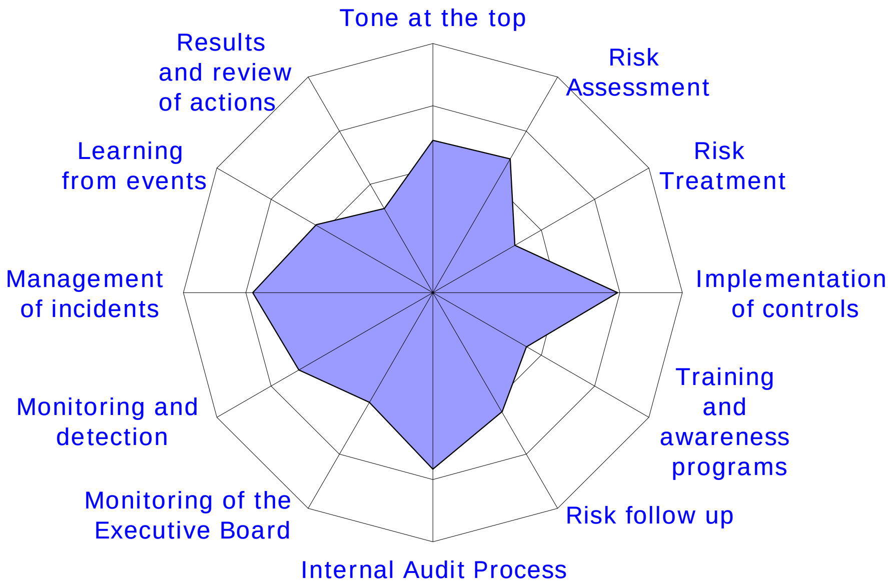

Figure 2: A typical Fraud & Corruption Resistance Profile Summary

The rating of characteristics selected above is an assessment to describe an objective (resistance to fraud & corruption) *against* a set of equal characteristics of peer objectives (the framework of requirements introduced above). As with all assessments there are a few standard properties that must be assessed and monitored to validate the results from the rating. When these properties are out of control, the rating can have no confidence and may be considered subjective. Obviously, this type of rating has many characteristic in common with surveys, and precise figures related to these properties cannot be obtained.

The most relevant properties to watch are:

1. Accuracy and bias: This property tells the variation of a given rating against an imagined peer master. The more focused the rating process, the better the process is managed, the better the accuracy. When peers are from a different industry, we may have a systematic bias on top of the variation from imperfect accuracy.
2. Repeatability: Repeatability is better the more essential factors are kept the same: Same auditor (team), same processes and functions assessed, same time budgets, same time of the year, etc. The accuracy under such conditions will be the best possible.
3. Reproducibility: Reproducibility is linked to adverse conditions, real life conditions when many of the above conditions are changing from time to time. The accuracy suffers. Ultimately, the accuracy can be so low, uncertainty so high that it could be impossible to make any safe conclusions.
4. Confidence intervals: We may express confidence in terms of intervals, such as between 2 given levels of score: 150 – 100, reflecting a safe consensus from the assessors. This could further be assumed to be close to 80-90% accuracy.

Related assessments

Unsolicited ratings, such as the well known credit ratings, may implicitly take into account fraud and corruption when attempting to identify the risk that a company may be a poor investment or even collapse. However, they appear to do little to measure the true resistance of an organisation to fraud and corruption. This is in spite of the fact that several recent corporate collapses have been triggered by fraud and corruption, the dishonesty of senior management, or in many cases, both.

Some research organisations focus more on fraud and corruption topics but assessments are still performed unsolicited. Latest effort is from FTSE, an independent company owned by The Financial Times and the London Stock Exchange. Their FTSE4Good Index [13] has been designed to measure the performance of companies that meet globally recognised corporate responsibility standards, and has lately integrated a countering bribery part as shown in Figure 3.

Some research institutes or organisations try to evaluate the resistance of an organisation with a series of questions like:

- Did the organisation have a case in the last couple of years?
- Did the case represent an isolated event?
- Did the case appear to be systematic, i.e. is the company doing it on purpose?
- Is the case sufficient to represent a material violation?
- Has the company been convicted of the offence?

Such consequence-related measures of an organisation's resistance have several weaknesses:

- It's hard to argue that fraud or corruption happen coincidently rather than on purpose. But it's an individual, not an organisation, that commits fraud or corruption. Thus it is hard to believe that any organisation will ever be 100% fraud and corruption-free. Just being in business carries an inherent risk of fraud and corruption, and fraudsters are very adept at identifying and exploiting new opportunities. However, executives who can build an organisation with a high resistance to fraud and corruption will be able to bridge some of the most significant gaps between theory and practice which still exist today, thereby adding very significant value for shareholders and stakeholders alike.
- Many incidents never reach the public room. If an incident is detected within an organisation, it is not necessarily reported externally. The reason for not disclosing incidents might be the fear of reputation damage by the incident itself or the resulting court case, and the low chance of recovering the loss [13]. If an incident is reported, it is not necessarily prosecuted and of those incidents prosecuted, not all are convicted. The huge majority of incidents are probably never detected of first many years after they have been committed.
- There is a delay between the incident and eventual disclosure of information [1]. The organisation may have reacted appropriately during this time, offenders may have been dismissed, effective investigations and cause finding efforts may have been performed, training programs may have been updated, etc.

Policy

- **Board Level** Commitment made public;
- **Transparency of any political donations,** and an approvals and disclosure process for such donations;
- **Policy applies to business partners** (including agents, suppliers and contractors) i.e. they must not promise, solicit, give or accept bribes as part of their business relationship with or on behalf of the company.

Systems

- **Sanctions process** for breaches of policy;
- **Risk based assessment** or risk led prioritisation/implementation (simple and high level to identify the vulnerability of the company);
- **Communicate policy to business partners** (including agents, suppliers and contractors);
- **Appropriate systems for appointment and remuneration of business partners and intermediaries** (e.g. due diligence and vetting of agents' anti-bribery policy, or that partner or intermediary payment is not above market rates, which could indicate that the partner or intermediary intended to facilitate bribery).

Figure 3: FTSE4Good criteria for countering bribery

Outlook

In the future we envisage that external credit and other ratings will also include a much more significant element capturing an organisation's resistance to fraud and corruption. This will help actual and potential investors, as well as other stakeholders (such as insurers, officers and employees) to make more informed decisions. As the concept develops, fraud and corruption resistance indices could be created for different industry types.

Increased shareholder and stakeholder pressure, improved legislation and greater awareness all round has in many leading organisations, elevated the management of fraud and corruption to the boardroom. This trend is likely to continue and those senior executives who continue to dismiss fraud and corruption as an issue will hopefully soon find that they have no place at the table.

In the near future simply talking about the topic will hardly be enough. A fundamental understanding of the risk concept is at the heart of resistance. Risk in itself is not bad, and failure is a part of learning. Advancement cannot be achieved without taking risks, but organisations must balance risks against opportunities; control their appetite. There is a wealth of reference standards for risk management, and there are numerous useful tools for risk assessment. The best risk management practice for the organisation and processes at hand is to strike a healthy balance between simplicity, capability and effectiveness.

However, organisations need to assess their ability to cover fraud and corruption in their risk management. This will enable them to focus resources and improve over time. The aim is to ensure consistency and ambiguity. The presented model is one way of assessing organisation's resistance to fraud and corruption and as such a valuable tool for management.

Assessing resistance to fraud and corruption is about measuring how good an organisation is at doing things in practice, not just fulfilling legal and other requirements on paper. As organisations start applying fraud and corruption management techniques with the objective of pushing these hidden costs out of the business, the effects may be so dramatic that their competitors may have to follow suit in order to stay in business.

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About the authors

Peter Wieland is Global Business Development Manager for Corporate Social Responsibility (CSR) in DNV (www.dnv.com) . He has worked 6 years experience in the field of Corporate Social Responsibility (CSR) and Sustainable Development, 3 of them as Research Programme Director for DNV's Strategic Research Program "Organisations of the Future". Main work areas are social and environmental audits, financial value of intangible assets, risk management, ethical supply chain management, verification of sustainability reporting, corporate governance, as well as fraud and corruption resistance. He has several years of lecturing experience in numerous countries within CSR, report verification, and ethical supply chain management. Peter is a member of DNV's CSR board and holds a PhD from the University of Karlsruhe, Germany.

Knut Andersson is a senior management system auditor covering several standards affecting resistance to fraud and corruption. He has been a party to the development of several DNV rating systems including the system on Fraud and Corruption Resistance. His experience spans a range of industries and business areas for more than 25 years. He holds a Dr. Ing. degree in Mechanical Technology from NTH Trondheim, Norwegian University of Science and Technology, Norway. He lectures courses on risk management and process control.

Nigel Iyer is a Director and founder member of Hibis Scandinavia A/S and a Director of Hibis Europe Ltd. He has performed numerous fraud and corruption risk reviews for multinational companies, uncovered major frauds and assisted senior management in the investigation of their incidents of fraud including cases of bribery, money laundering, theft of intellectual property and procurement fraud. Nigel has published several books on the topic including "Fraud Resistance – a practical guide" co-authored with Martin Samociuk, and a new publication named "Preventing Fraud and Corruption" which will be published by Gower in November 2006. Nigel is a popular lecturer and holds regular training sessions on fraud for Business Schools, Institutes of Internal Auditors and Security Professionals, various State Authorised Auditors Associations and major corporations.

Veronica Morino is a Senior Consultant and investigator at Hibis Scandinavia A/S. She has taken part in several investigations of corruption and has successfully managed major cases of fraud in large multinational companies. Moreover, she leads Hibis' Worldwide Investigative Research team. She is responsible for the development of Hibis' learning tools which aim to increase awareness and prevent and detect fraud and corruption, and is currently managing the latest release of Hibis' Fraud-i Online training package. Veronica has a degree in Sociology of Economics and Labour from the University of Rome, and a Masters degree in Organisational Science.