



When it comes to facing up to unpleasant situations, more often than not we seem to be able to close our eyes and pretend that appalling scenarios (like the true case above) are simply not happening. It is human nature to trust, especially when our own colleagues are involved. It is also 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 rather than by active monitoring and control. And that by waiting for a tip off, we often wait far too long.

Given that fraud and corruption are possibly some of the greatest unmanaged risks to which organisations are exposed, it is interesting to speculate on how much more profitable they would be if these risks were reduced to zero.

It is a difficult question to answer because although academic research and empirical work indicates that the total direct and indirect cost of fraud and corruption is in the region of 2 – 6% of turnover for “normal” organisations, the fact is that nobody really knows the true cost.

However, the ability to significantly increase profit margins is one compelling reason to systematically manage fraud and corruption risk. As the calculation in Figure 1 below illustrates, if the cost of fraud and corruption in a company was say 3% of sales and the current operating profit margin is 5%, then totally eliminating fraud and corruption would result in a massive 60% increase in operating profits.

Figure 1: Eliminating Fraud and Corruption

The true cost of fraud and corruption...	
...and the effect on profit margins	
Sales	1000
Costs	950 920*
Operating Profit (II)	50 80*
Profit Margin	5% → 8%* !!!

* If fraud and corruption = say 3% of sales

I believe that organisations should make life simpler and treat fraud and corruption as a single problem, at least from a corporate or organisational point of view. The blurred boundaries between fraud and corruption, the 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 and simply group the two issues under one umbrella.

It is also time to accept that phrases like “one way of making money is to stop losing it”; “prevention is better than cure” and “it’s not a problem, it is an opportunity”, although they have been overused in business, in the context of fraud and corruption are indisputably true.

Developing resistance to Fraud and Corruption

The notion of developing resistance to a problem is not altogether unfamiliar. On a personal note we would all like to develop resistance to illnesses like cancer, malaria, flu and even the common cold. Similarly, in companies and organisations, internal systems to develop resistance to errors and omissions and to improve efficiency and quality have been in place for many years. From an external perspective, ratings aimed at improving resistance to corporate greed and mismanagement by measuring, benchmarking and enhancing corporate governance, corporate social responsibility, as well as environmental performance, are coming into vogue.

Organisations can also implement an internal system designed to improve the overall resistance of an organisation to fraud and corruption that would primarily be aimed at improving profitability and performance. Additional goals would be to enhance the value of the code of conduct and respond to external requirements and pressures for a well-governed and more transparent, corruption-free organisation.

The fraud and corruption resistance rating is a measure, or snapshot, of how effective any organisation is at keeping fraud and corruption at bay. When this rating is performed against a baseline standard then it is possible to identify and prioritise the improvements that need to be made.

How a Fraud and Corruption Resistance Rating System would work in practice

The Fraud and Corruption Resistance Rating System (FCRRS) is a method for measuring the resilience of an organisation, corporation or entity to the effects and impact (on profitability, long-term value, reputation and internal culture) of fraud and corruption. The

system which is described here [1] 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) and embodies the most important principles set out in the UN Global Compact Principle on Anti-Corruption, the OECD Business Approaches to Combating Corrupt Practices, Transparency International’s Business Principles for Countering Bribery as well as the COSO Internal Control Framework and the Sarbanes-Oxley Act of 2002.

The Fraud and Corruption Resistance Rating System is based on a six point cyclical strategy for managing the risk of fraud and corruption, shown in Figure 2 below, and can be applied to virtually any organisation. The darker shading within the wheel indicates where a greater investment is required in order to prevent losses to profitability, reputation and internal culture.

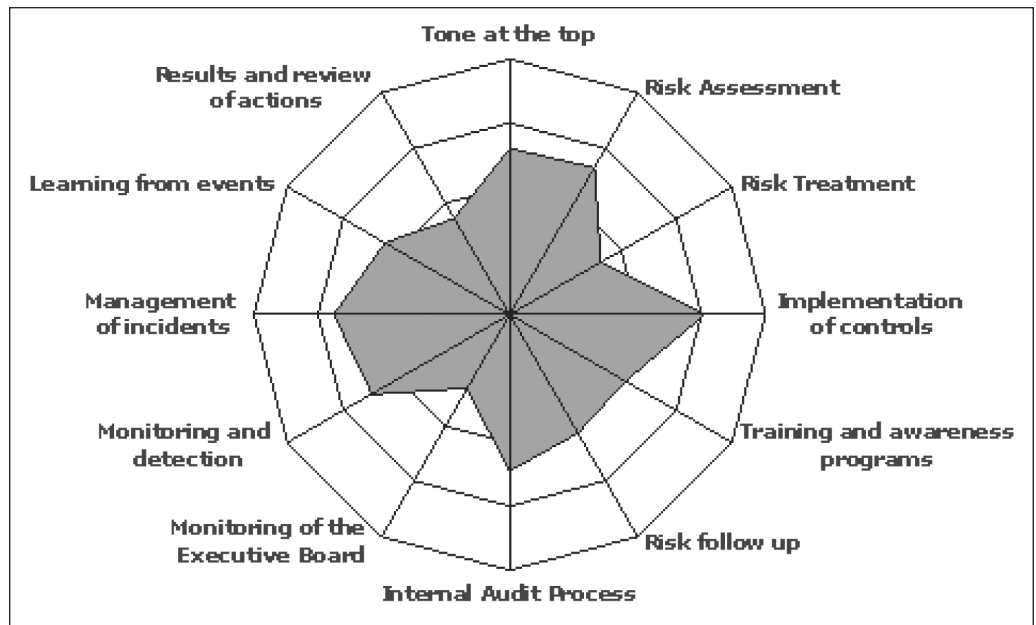
Figure 2: Fraud and Corruption Risk Management Strategy



The executive board and senior management should set a clear message, often called the ‘tone at the top’, be fully aware of and then treat the risks to which they are most vulnerable, ensure that all warning signs of fraud and corruption are detected early, establish a system for the investigation and management of incidents and finally use all experiences gained to enhance resistance.

Once the strategy has been implemented, it can be expanded to include elements that can be used to measure resistance to fraud and corruption in a consistent manner as shown in the kiviart chart [1] in Figure 3 below.

Figure 3: Fraud and Corruption Resistance



The tone at the top (1) evaluates the degree and effectiveness of senior management’s commitment to preventing fraud and corruption. The tone set at the top of an organization regarding fraud and corruption prevention has a crucial effect throughout the rest of the organization. Senior management should send a message that fraud and corruption will not be tolerated anywhere in the organization. This commitment should be visible to all employees, credible, embedded in the organizational culture and also apparent to external parties.

A thorough understanding of fraud and corruption risk (2) across the organization 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 organization at all levels. Fraud and corruption risk assessment also involves looking at how resistant the controls are to specific methods of fraud and corruption.

Once fraud and corruption risks have been understood plans can be made for their treatment (3) in a top down



manner, the implementation of effective control measures (4) and the development and launch of across the board training programmes (5).

Monitoring and the detection of red flags is one of the most difficult processes to implement and is split into four elements, namely:

- How the fraud and corruption risks already identified are continuously followed up (6) and kept up to date taking into account changes in the business and its personnel
- The effectiveness of the internal audit process (7)
- How monitoring of the executive board (8) and other senior management takes place, its effectiveness and independence
- The nature, extent and quality of proactive monitoring and detection (9) taking place within the organisation

Investigations are

often expensive and uncomfortable, and when incidents occur it may be tempting to negotiate a settlement, such as voluntary resignation or early retirement, without investigation. It is, however, through successful management of incidents (10) of suspected fraud and corruption that management gain credibility. Finally, all incidents present a wealth of learning opportunities. It is how they are used to learn from

events (11) and how management are able to measure results and review actions (12) accordingly which provides the impetus to continuously improved performance.

The “amoeba” in the centre is a unique fraud and corruption resistance profile of the particular organisation reviewed and the gaps represent the room for improvement..

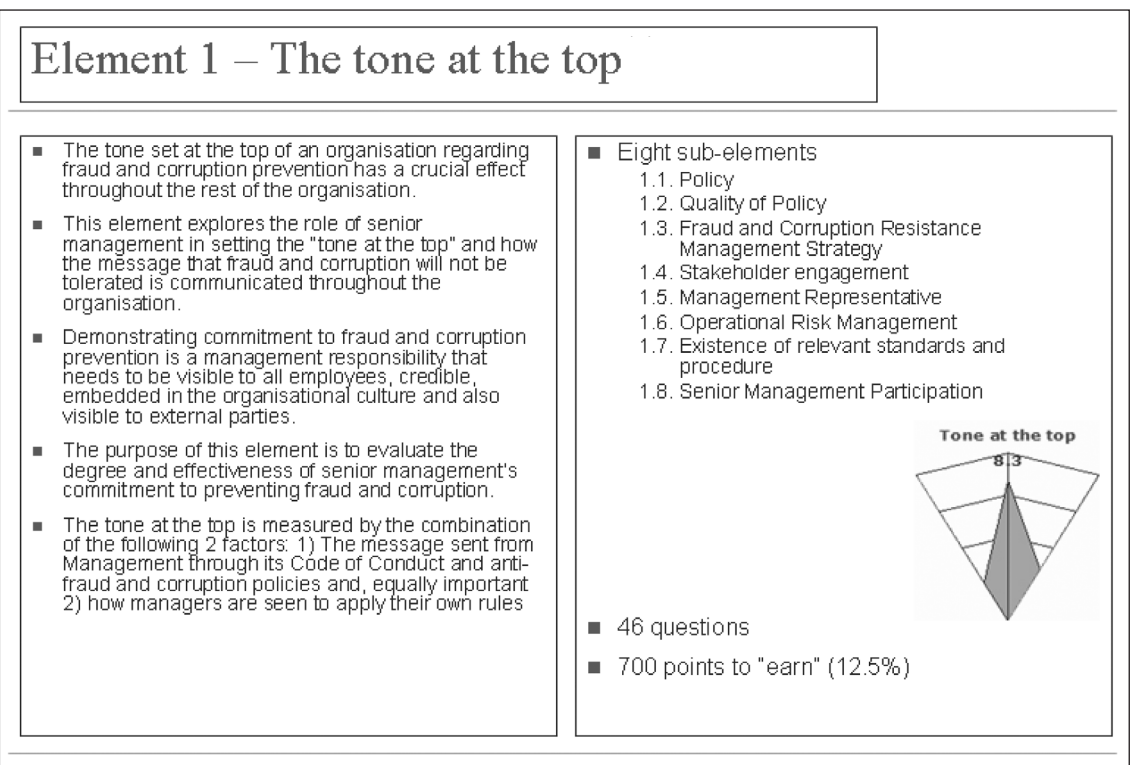
In the assessment model shown above each element is broken down into a set up sub-elements and a detailed protocol consisting of hundreds of key questions has been developed. The aim is to ensure consistency and avoid ambiguity.

Figure 4 [1] shows how Element 1, the Tone at the Top is defined and split into eight sub-elements, 46 key questions and carries a weighting equivalent to 12.5 % of the total.

A regular Fraud and Corruption Resistance Rating (FCRR) 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, provided that there was some degree of independent assessment. While the specific questions asked and weightings may differ somewhat, depending on the type of organisation assessed, an FCRR such as the one described above would be 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.

Achieving a high resistance to fraud and corruption is by no means easy. Some of the elements described above

Figure 4 – An example element in the Fraud and Corruption Resistance Rating System



present tough challenges. For example:

- the tone at the top is often reflected in a Code of Conduct, something that is becoming a legal requirement for more and more organisations. However, management often struggle with issues such as living up to their own code in the face of harsh realities and choices. Vigilantly looking for violations of any part of the code can get downplayed. Many codes of conduct necessarily include sentences such as “conducting business in an open, honest and transparent manner”. Management teams which recognise and state that this is something to aspire to are in a much better position

to improve resistance to fraud and corruption than those which blindly and falsely claim that they have already achieved transparency in every part of the organisation;

- the whole area of monitoring; from defining and looking for the red flags of fraud and corruption to monitoring the activities and behaviour of the executive board, can be a political minefield. Senior management should first recognise that whilst they are not usually the owners they have so much power and ability to override the controls that nobody within the organisation is able to monitor their behaviour without both a mandate and also very strong external support. Secondly, although the tools and techniques to look for the signs of fraud and corruption in an organisation are available, actually finding the people willing to devote time and attention to using and applying them thoroughly is not always so easy. Finding and reporting internal fraud and corruption has historically tended to be a poor career move;
- the need to learn from events is obvious but in practice this implies that incidents of fraud and corruption which are discovered need to be discussed openly and not swept under the carpet. Perceptions need changing in many organisations where any discovery of fraud and corruption is still too often seen as an indicator of management failure rather than the successful result of strong management controls.

Measuring resistance to fraud and corruption is all 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.

The concept described above is an internal rating measured against a benchmark standard. External 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 bet or go bankrupt. However, they appear to do little to measure the true resistance of an organization 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.

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

I do not believe that any organisation is ever going to be 100% fraud and corruption-proof. 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.

Increased shareholder and stakeholder pressure, improved legislation and greater awareness all round is elevating the management of fraud and corruption to the boardroom. Those senior executives who continue to dismiss fraud and corruption as an issue they do not need to deal with, or who are resigned to carry a problem they feel they can do nothing about or, worse still, who themselves are involved in fraud and corruption, will hopefully soon find that they have no place at the table.

Notes

1. Reproduced by kind permission of Det Norske Veritas (DNV), an international certification and rating agency. The author was one the main external participants in a DNV project initiated in 2005 to design, develop and pilot a Fraud and Corruption Resistance Rating System.

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