Tackling Fraud and Corruption

Despite significant investment in governance frameworks, fraud and corruption management rarely gets beyond compliance requirements.

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Over the past few years, most large organisations have expended a great deal of effort in complying with new legislation which has been introduced in response to a spate of corporate collapses resulting from fraudulent and corrupt behaviour. This has included significant investment in corporate governance, operational risk management and corporate responsibility frameworks.

The result is that there is a greater understanding of the processes and controls which mitigate fraud and corruption.

However, once the regulatory requirements have been satisfied, that has usually been the extent of the fraud and corruption prevention strategy, particularly if the organisation has not suffered any prior large frauds.

As a number of organisations have recently discovered, focussing purely on processes and controls is not enough to prevent fraud. Even after expending all the effort to comply with the legislation, fraudsters have still been able to work undetected over long periods of time. Those organisations have found that there are other elements of a strategy which need to be in place if they are to avoid the unpleasant effects of fraud and corruption.

They have realised that they have not invested enough time and effort in developing one of the most potent anti-fraud and corruption weapons; their own employees. To implement an effective strategy, the organisation needs to empower employees to prevent fraud and corruption.

The first step in this process is to make senior management aware that investing in an anti-fraud and corruption culture can help to avoid the unpleasant after effects.

The Effects of Fraud and Corruption

Discovery of fraud and corruption in an organisation has a number of effects. The first is the dramatic and damaging effect on innocent employees and third parties—loss of morale and shattered confidence, high stress from investigations and being under suspicion.

There is also a realisation by senior management that because fraud and corruption losses eventually come off the bottom line, every dollar lost reduces net income by the same amount. If the profit margin of the organisation is say 10%, then to recover the lost income requires 10 times the revenue to be generated. Hence to recover a $10 million loss requires $100 million dollars of extra revenue.

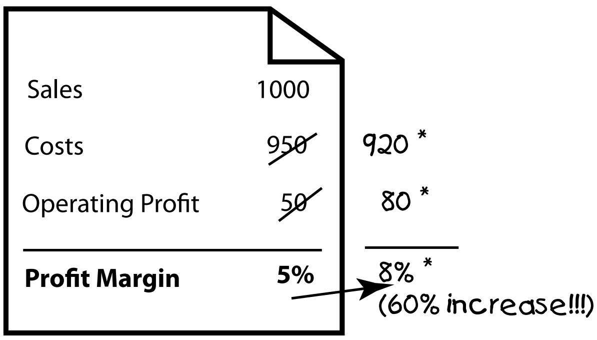
Additionally, in most cases, the hidden indirect cost such as constraints on expansion and development, damage to reputation and employee morale greatly outweigh the direct costs.

Senior managers quickly realise that the costs of investigation are not to be taken lightly. If a case is complicated and involves the international movement of funds, then the investigation costs can be very complex. It is not unusual to spend $1 million or more on investigating a $10 million fraud. When cross border money transfers and offshore tax havens are involved, this can cost more than the amount lost.

Probably the single most important (and often the most ignored) realisation by senior management is that the organisation may be carrying other on-going frauds. There is a wealth of evidence to support this message.

For example, research by the Association of Certified Fraud Examiners in the US across a wide range of industries has repeatedly indicated that the typical organisation loses around 5% of its annual revenues to fraud and corruption. (Report to the Nation 2002, 2004, 2006 available at www.acfe.com/fraud/report.asp)

Clearly, investing in preventing fraud and corruption, and hence removing hidden costs, is far better than investigating and cleaning up post event. It can lead to large increases in profit margin as shown in Figure 1 below.



* If fraud and corruption = say 3% of sales

FIGURE 1 Hidden costs of fraud

Once this is acknowledged, then there are a number of steps which can be taken to enhance a fraud and corruption risk management strategy.

Tone at the Top

The first step is to set the correct tone at the top. A healthy and ethical organisational culture from the top down is a cornerstone of effective fraud and corruption prevention. However, there is a big difference in a Board of Directors simply issuing a Code of Conduct and Fraud and Corruption Policy and then only paying lip service to it, and in empowering employees to prevent dishonest or corrupt business practices.

For example, some Chief Executive Officers are hired because they achieve results by being ruthless, decisive, aggressive risk takers who are totally fixated on the bottom line profit. There is nothing intrinsically wrong with this because improved profit is still what the shareholders and stock markets want to see. However, when these CEOs are surrounded by weak fellow directors and managers, they may begin to treat the company and its assets as their own. They run up large personal expenses which the company pays for, or have work done on their homes by company contractors, or treat their employees as personal servants. They also pressure employees to indulge in business practices which are may be fraudulent and corrupt, but are acceptable, as long as they are making large profits for the company.

Alternately, the CEO may be 'honest' but tolerates dishonest practises because the perpetrators are making huge profits.

At the extreme end of the scale, and the most difficult for employees to deal with, is the personality type known as the corporate psychopath.

Corporate psychopaths have an overwhelming urge to obtain power and the status that having a lot of money brings. They desire influence and power over their colleagues and make plans over long periods of time and lie, deceive and manipulate as necessary to commit their frauds without feeling any remorse. They enjoy humiliating staff without making it obvious that they are behind it and can change their stories so skilfully that it can leave employees confused and wondering if they have stumbled into a room full of smoke and mirrors. There is very little to distinguish this type of person from those in the upper echelons of organised crime.

Very few people actually see the real persona. Only those few who are on the receiving end of the psychopath's attention catch a glimpse of what is lurking below the surface.

The pressure exerted by such a dishonest CEO, director or senior manager can motivate other managers and employees to participate in a major fraud. Such frauds can have catastrophic effects and, once started, are hard to stop.

Management initiated frauds can spread rapidly through an organisation. This leads to a lack of interest in controlling the business and an increasing temptation to join in with similar, albeit smaller frauds.

Honest employees may be powerless because they have not been provided with any awareness training as to what constitutes fraudulent or corrupt behaviour, nor a practical means of reporting concerns. Employees need to see that dishonest or corrupt business practices are not tolerated anywhere in the organisation, even at the top.

Fraud and Corruption Awareness Training

Practical awareness training is essential to assist employees to identify when they may be dealing with fraudulent or corrupt individuals, particularly those who may be senior to them, and to train them how to respond.

It is common to find that very few employees have previously received any form of practical instructions. However, after training, all employees, whatever their position or level, have found the subject engaging, interesting and as a result have been much more prepared to do something about the problem of fraud and corruption.

The most effective programs are those which are:

- realistic, enjoyable and interactive where feedback from the participants is an integral part of the program. Practical, engaging training scenarios and case examples should be used
- a mandatory part of training for all employees. The content and examples used should be regularly reviewed and updated
- stand-alone, well co-ordinated and planned, to avoid confusion and duplication of effort.

It is very important, before developing and launching a Fraud and Corruption Awareness Program to identify a sponsor who will support it and ensure that it has received sufficient management attention. Sponsors can include Corporate Security, Human Resources, the CFO, Legal and Compliance, Corporate Responsibility and if possible, the CEO.

Not having a sponsor can lead to the program not being taken seriously and people being too scared to report potential problems for fear of retribution. Often a joint sponsorship team involving one or more Executive Board members is the preferred and stronger solution.

The training program should demystify fraud and corruption for the participants, help their understanding of the methods used against the company by different opponents as well as teach them how to defend against fraud, and how to spot and deal with the red flags.

Participants should be encouraged to recognise the loopholes from the perspective of a potential criminal, and the way that psychology may be used to fool an honest person.

Example

An employee with a severe gambling problem used a ballpoint pen containing erasable ink to make out a spurious cheque to a genuine payee. He waited until his manager had an office full of people before knocking on the door and requesting an 'urgent' signature. The manager, whose mind was on other urgent issues, verified that the cheque was made out to the expected payee and signed it without querying the supporting documentation. After this the employee rubbed out the payee name, inserted his own name and cashed the cheque. He used this technique to raise dozens of cheques over a number of years and obtained more than $5 million. The fraud only came to light when he went on holiday and a colleague discovered how he had been hiding discrepancies in the books.

Equally important is to train managers to detect when employees may have problems that could potentially lead to fraud. For example, several recent frauds have involved employees who had developed gambling addictions as a result of depression. Too feed their addiction, they had resorted to stealing from their employer. In each case, the employees had displayed changes to their behaviour and other red flags which colleagues had either ignored or had not recognised their significance.

Specific training should be provided on how to identify and deal with employees who may be suffering from depression. The organisation Beyond Blue (www.beyondblue.org.au) can provide advice.

Empowering Employees to Report Concerns

Having trained employees to spot the red flags or fraud and corruption, it is then essential to empower employees to report concerns. Usually, the first reporting line is to their direct line manager. If that is not feasible, for example, when they have suspicions about their line manager, the organisation should implement a whistle blowing procedure to provide a confidential and an anonymous route for employees. There is a legal requirement in some countries which have adopted whistle blowing legislation, for the whistleblower to be protected from any adverse reaction by the company or directors following their disclosure, providing that the disclosure was not malicious. (A few countries have adopted legislation which says that employees should not be encouraged to blow the whistle on colleagues, but even in these countries it should still be possible to provide a safe reporting route.)

However, in spite of improvements in legislation, it is still a brave employee who raises issues involving the CEO or other executive director. Employees working for an executive who is a corporate psychopath may find it very difficult to come up with solid proof even if suspicions are raised about behaviour or lifestyle, or if there is evidence in transactions or documents. The corporate psychopath is an expert at manipulating situations, evidence and people and will have built up a powerful network of supporters, both executive and non-executive. The employee who raises concerns can be sidelined, but not in a manner where they could successfully argue that they had been unfairly discriminated against as a result of them blowing the whistle.

When designed and implementing a whistle-blowing reporting line, the sponsors together with independent executives for example, on the Audit Committee, should include a procedure for dealing with those extreme cases where an employee or external party may raise issues implicating the CEO or other director. Employees are then empowered to report concerns at every level of the organisation without the fear of retribution.

Measuring Fraud and Corruption Resistance

An increasing number of organisations are realising that even though they may be able to certify that they comply with relevant legislation, they still do not have any effective way of measuring how resistant they are to fraudsters or corrupt individuals, or of benchmarking against other organisations, nor of testing the level of understanding by employees about fraud and corruption.

Recognising this need, one of the world's largest independent third party certification and assessment agencies, Det Norske Veritas ('DNV'), has developed a prototype Fraud and Corruption Resistance Assessment protocol, which comprises 12 main elements as shown in Figure 2 below:

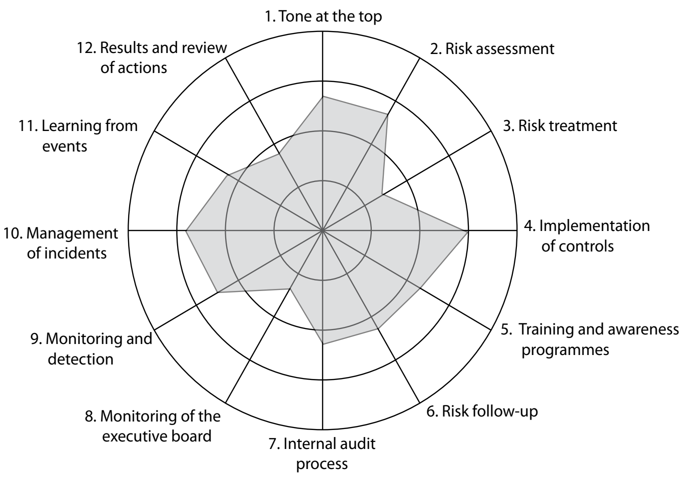


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FIGURE 2 Prototype Fraud and Corruption Resistance Assessment protocol.

The objective is to test in practical terms how effective has been the implementation of the fraud and corruption strategy. The amoeba in the centre is a unique fraud and corruption resistance profile of the particular organisation and the gaps represent where there is room for improvement.

Behind the assessment model shown above, a detailed protocol consisting of over 500 questions has been developed in an attempt to ensure consistency and avoid ambiguity. Also a weighting and scoring system for each of the twelve elements is applied.

For example, element 1, (Tone at the Top) explores the role of senior management in setting the 'tone at the top' and how the message that fraud and corruption will not be tolerated is communicated throughout the organisation. It is then further divided into eight sub-elements:

1.1. Policy
1.2. Quality of Policy
1.3. Fraud and Corruption Resistance Management Strategy
1.4. Stakeholder engagement
1.5. Management Representative
1.6. Operational Risk Management
1.7. Existence of relevant standards and procedure
1.8. Senior Management Participation

with a total of 46 key questions which carry a weighting equivalent to 12.5 % of the total. The end result is a rating as shown in Figure 3 below:

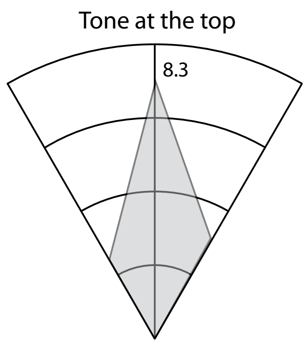

FIGURE 3 One of the elements of the protocol examined in more detail

A regular Fraud and Corruption Resistance Assessment would typically be requested by either a non-executive board member or the Audit Committee, but it could equally well be initiated from within the company, provided that there was some degree of independent assessment.

It is unlikely 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 empower their employees can build an organisation with a much higher resistance to fraud and corruption, thereby adding significant value for shareholders and stakeholders alike. ⁜

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