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TOOLS AND RULES TO COMBAT FRAUD

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TOOLS AND RULES TO COMBAT FRAUD

“ Fraud – A practically conclusive test as to the fraudulent character of a deception for criminal purposes is this:

Did the author of the deceit derive any advantage from it which he could have had if the truth had been known?”

- Stephen’s “ History of the Criminal Law of England”

Thus in a way we can define fraud as a deliberate **deceit** which is planned and executed to **deprive** an individual of property money or other valuable security. Fraud must be committed with **intent** and includes **actions** of misrepresentations and / or acts of **omission**.

Combating Fraud

Managing the risk of fraud is essentially no different to managing any other type of business risk.

For the purpose of combating fraud it is utmost essential that we are bale to identify red flags. Red flags basically imply that individual discrepancies may not seem significant but an accumulation of small differences may indicate material fraud. Some of the salient signs of red flags are:

- Infighting among top management
- Low morale and motivation among employees
- Understaffed accounting departments
- A high level of complaints against the organisation from customers, suppliers or regulatory authorities
- Inconsistent and surprising cash flow deficiencies
- An employee with a lavish lifestyle beyond his salary

In the annual fraud survey we had conducted the following were highlighted by the respondents as the main tools that were being used to ensure avoidance of fraud:

- Review and improve internal controls
- Establishment of corporate code of conduct
- Background check on new employees
- Increased role of audit committee
- Staff rotation policy
- Increased budget for internal audit
- Code of sanctions against suppliers contractors
- Establish a fraud policy
- Training courses in fraud prevention and detection
- Comprehensive fraud diagnostic review
- Increased budget for security department

Internal Controls

An effective control system within the organisation is the first deterrent to the occurrence of Fraud within the organisation.

Internal controls are necessary to be built into the system which reduce the possibility of a loss occurring, such as restriction of access to premises or assets, increasing awareness of existence if controls for

instance segregation of duties, management supervision, physical security, dual cheque signing authority etc. Detective controls which highlight irregularities or errors after they have occurred should be put in place for instance bank reconciliations, inventory counts, regular account reviews, audits etc. Reconstructive controls which reduce the impact of any loss through effective backup or disaster recovery plans such as adequate amount of insurance, off site storage of duplicate records and computer disks, regular computer backup should be in place too.

Examples of fraud indicators – override of controls, unexplained pricing expectations, personal characteristics and motivations of management.

Fraud Risk Management

Modern risk management principles contemplate a three-part cycle for managing all kinds of business risk:

- identify the specific inherent fraud risks that may be present within each operational management unit; assess the effectiveness of internal controls in force that would tend to impact on the risks identified;
- determine an overall risk rating for each inherent risk identified; and
- develop strategic measures to counter the impact of each inherent risk in light of the individual risk ratings. identification of each inherent risk
- consideration of the internal controls currently in place that would tend to impact on each inherent risk
- rating each risk against six criteria on a scale of 1 to 5
 - ⇒ volume of transactions associated the process giving rise to the risk
 - ⇒ internal control risk
 - ⇒ nature of the potential loss
 - ⇒ potential quantum of loss
 - ⇒ past incidence of fraud of that type within the company
 - ⇒ the impact on public opinion that would result from knowledge that a fraud of that type had occurred.

Fraud Control Planning

The organisation looking to combat and prevent fraud should have a laid down fraud control plan which should have the following incorporated:

- Definition of Fraud / Statement of attitude with specific relevance to the company
- With who all would the fraud control responsibilities lie
- Fraud risk assessment
- Documentation of all policies and procedures relating to the same\
- Pro active fraud detection by line management
- Internal audit strategy
- Reporting Protocols
- Fraud prevention / Internal Control training

Reference articles:

- 1 [Seven Deadly Sins](#)
- 2 [Lethal Cocktail](#)
- 3 [Window Dressing](#)

Seven deadly sins

Doing business in a new environment always poses additional problems. Unfortunately, not enough attention is paid to controlling the inherent fraud risk in any new enterprise. The hurry to set up operations or buy out an existing enterprise and sometimes, the reluctance to say NO to a possible merger/ acquisition deal makes management ignore some basic rules. If the 7 deadly sins highlighted below are not committed, the decisions taken will be far more reliable and helpful to the organisation.

1st deadly sin - Poor research into new markets

It is perhaps not surprising, given the business opportunities that new markets present, that the fraud risk can be low on the risk profile rankings. Management often includes fraud risk in the country risk. However, separate identification of fraud risks enables counter measures such as close supervision of procurement and commission payments.

2nd deadly sin - Inconsistency in control and ethical conduct

Empowering local management to lead the business has many positive aspects. The potential downside is loss of control. In some less developed countries, it is quite common for the managing director to rule in an autocratic fashion. A clear hierarchy forms and an unquestioning, accepting culture results. The example below illustrates that good habits should be maintained.

A large company had made a number of acquisitions. The Managing Director of one the acquired companies was allowed to continue. He was an autocrat, dismissive of Head office interference but producing significant profits. To placate the Managing Director, who was always threatening to leave, various compromises were made. Subsequently, a competitor complained to Head Office about his behaviour and subsequent investigations supported allegations of fraudulent and unethical behaviour.

3rd deadly sin - Commissions and kickbacks

Businesses often encounter the dilemma, of whether to pay commissions and kickbacks to do business especially if it appears to be a locally accepted practice. The attitude towards commissions and kickbacks include:

- 'We don't like them, but we pay them';
- 'We might pay them but I don't want to know about them';
- 'We use agents and don't handle the payments directly'.

All these attitudes create risk in that commissions, cumulatively significant, are not controlled. If they have to be paid, at the bare minimum, they require justification, authorisation and adequate control.

4th deadly sin - Inadequate audit and control procedures

A number of people subscribe to the view that long distance control is enough to protect their business interests. However, as any reader of the book 'Rogue trader' will note that Leeson's concern that his fraud might be discovered rose in line with the expectation of a thorough audit. Telephone queries proved relatively easy to satisfy. Face to face control is the key to good management and effective control.

5th deadly sin - Inadequate understanding of local legislation

There are many legal angles, which need to be covered in a due diligence exercise. Opinions from local lawyers will often be the starting point. Many questions need to be addressed to ascertain whether the law deters fraud or assists the defrauded.

6th deadly sin - Limited awareness of local scams

Often, a particular scam is more prevalent in certain areas. Prevention in large part lies in the knowledge of these scams, especially those that target MNCs. Awareness of scams is as essential as a clear process for determining the legitimacy of local business, proposals and partners.

7th deadly sin - Inadequate control over Joint venture partners

Businesses may be set up in collaboration with a local sponsoring partner. Due diligence of local partners can be more complicated, but not doing so can have disastrous consequences. This example illustrates some typical risks.

A large company entered into a joint venture with a local family-run company to build a large processing plant. The project was in effect run by the company's joint venture partner. During a subsequent investigation it was discovered that:

- Some local managers were in collusion with suppliers;
- A contract for pipe construction was awarded without tendering;
- Payment of commissions was not being properly managed.

To conclude, the strategy for addressing fraud risk should include:

- Full research of local environment;
- Proper assessment of and control over potential joint venture partners;
- Analysis of fraud risk inherent in the business venture;
- Control and ethical standards comparable with the rest of the business

The companies, which strive to achieve these basic steps, will limit their exposure to fraud in their new ventures. As they say, a stitch in time.....

The lethal cocktail

Fraud hits businesses where it hurts the most - in the pocket. Major fraud can put the entire business at risk and damage its reputation. It could create an unhealthy working environment where honest employees get the impression that one way to be rewarded is to defraud the company. Of course there is always a 'rogue' at the centre of every fraud and there is some form of direct control weakness. But usually there are several factors (a lethal cocktail) which enable the fraud to happen. The factors relate not only to risk management and control, but also to wider business environment issues like the organisation structure, culture, ethics, personal profile, reward arrangements and communications in the business.

Replies to KPMG India Fraud surveys show that organisations are increasingly facing fraud-related problems. The main reasons repeatedly identified by respondents for the increase in fraud have been:

- Weakening of society's values;
- Lack of emphasis on fraud prevention and detection;
- Increasing economic pressures; and
- Increasing sophistication of criminals.

Very often in an investigation, many factors that combine to make the cocktail are overlooked and the result is a report with circumstantial situations rather than a clear case. For example, over emphasis on books of account or documentary records can provide a misleading picture. Not only that, it can warn the alleged suspect of an investigation under progress or make innocent employees uncomfortable with the line of questioning. While all this is necessary, to do it in a planned manner as part of an overall strategy designed to find out all the ingredients of the cocktail is better and more fruitful. Review of documents has to be supplemented by field work to gather information from the market. This could involve background checks, meetings with the suppliers or customers, benchmarking against other industry players, etc. – the list could go on and on. In short, one needs to dig out all the facts, wherever or whatever they may be.

In one of our recent case files, we faced a similar situation where if the investigation had not gone beyond the basics, the suspect would not have been nailed. In this case, the Chief Accountant was allegedly misappropriating funds. The tip-off was an anonymous letter from one of the stationery suppliers. Our interviews with the Chief Accountant's office colleagues did not provide any substantial leads. On the contrary, they were full of praise for the dedication with which he worked. Various examples were cited to demonstrate how overheads had been brought down in the past 3 years. A review of the payments approved by the Chief Accountant and his personal expense reports also did not provide any indication of misappropriation of funds. In short, on paper, everything was fine. On facing a dead end on a review of documentation and interviews with Company staff, it was decided to look at the other factors that could provide an insight into the allegation made. These factors revolved around lifestyle and background of the Chief Accountant. When collecting information with this objective, it was found that the Chief Accountant's father had retired a short while ago and he had to meet the hospitalisation expenses for his father. With this important clue, we found out the estimated expenditure made at the hospital for the treatment. Simultaneously, as the Chief Accountant was fairly confident, he showed us his bank statements and confirmed that his salary was the family's only source of income. On correlating the two, it was clear that the payment made to the hospital were not withdrawn from the bank. When confronted with this evidence, the Chief Accountant confessed that a kickback had indeed been taken.

It is important for organisations to work on these non tangible aspects of the cocktail when conducting risk assessments. One way of looking at fraud is to see fraud risk as a 'shadow' of the business risk profile. The shadow profile makes the opposite assumption that from time to time people may be

dishonest. For each category of risk in the business profile, there is an equivalent in the fraud risk profile. So, for example, if 'quality' is an issue and the organization has quality controls and quality inspectors, the 'shadow profile' includes frauds such as bribery of quality inspectors, the substandard product frauds and forged product certifications. Similarly, companies will be concerned to secure the 'best purchase price' in the market place. The shadow profile includes frauds such as bid rigging and bid fixing. Plotting the fraud risks in a systematic way against the business risk profile is a good way to avoid the lethal cocktail.

Window dressing – Is it Fraud?

Recently, the CFO of a Company discovered that the excellent results being posted by one of his divisions was not because of higher revenues or effective cost control, but as a consequence of some smart bookkeeping by the Financial Controller. A closer look revealed that the principle of conservatism had no place in the Controller's arsenal. The Company, fearing existence of more skeletons asked a team of investigators to go in and flush them out.

The preliminary interviews with some of the senior personnel, both at the Head office and the Division, suggested that many of them did not see this as Fraud. To them, Fraud would have existed if the Controller had profited personally. One of interviewees even commented that the Controller was trying to do his job by helping the Company show better results. On hearing this, all that the investigator could think was whether the Controller was trying to 'do' his job or 'keep' his job. Taking the discussion further, the investigator tried to determine what kind of action should be taken and what message should be sent within the organisation that would clarify the Company's stand on such matters. Again, the investigator was shocked to hear that as the matter had been resolved, no further action was required. Effectively, what was being said was, "Window dressing is a part of life and people should not be punished for it".

On concluding the investigation, it was determined that although the practice of aggressive accounting was being followed in all Divisions, but it had not reached a point where the rationale for various positions taken had become absurd. However, it was also found that our Controller friend had gone a step further and recorded a fictitious transaction to boost profits. The investigator was a man who liked to go by consensus and decided to take the viewpoint of senior management again. This time, however, all were unanimous in terming this transaction as wrong and something that was not acceptable. But, on the question of action against the Controller, the vote was split, as, according to some of them, there was no personal profit.

The Company eventually decided to terminate the services of the Financial Controller not only because of the existence of the fictitious transaction, but to send a message that a deviation from Company's accounting policies will be dealt with strictly. The CFO knew that a lenient action at this stage would only increase this menace and window dressing will become an acceptable way of life.

The above situation is something we all face in our office trying to meet aggressive targets. The fear of retrenchment in case of non-performance has heightened the likelihood of window dressing. It invariably starts small and if not curbed, it has a snowballing effect. In a few years, it becomes a part of the organisation's culture. The downfall comes when Business Managers forget the window dressing done in the past and start believing the numbers themselves. Sooner or later, the lenders and other stakeholders become wise and the Company goes bust. There are umpteen examples of companies in India that have become victims of window dressing.

In my view, window dressing is Fraud and the argument is simple. On a Company level, one window dresses the financial statements to show a better picture than what it actually is. It is done with a singular

objective, i.e. to deceive one or more stakeholders into believing something that is not true. For example, to deceive the lenders and get additional credit facilities or to impact the share price to enable oneself to unload stock or to hide diversion of funds by the top management. At a division level, it is done to meet budgets as a variance would result in lower bonuses or delayed promotions.

Large parts of NPAs pertaining to the corporate sector are a direct or indirect result of window dressing. The lending institutions did not take timely remedial measures and in some cases, even when they heard the corporate grapevine, chose to look the other way as they believed this to be a temporary phenomenon. But alas! It never happens that way.