

The fourth in a six-part series on Corporate Risk Mitigation looks at how companies can detect and prevent business fraud



Crack down on crooks

Every time a major corporate fraud hits the headlines the first question that inevitably springs to mind is, "How could it possibly have happened?" Then, as the details gradually emerge of the schemes, lies, sleight of hand and missed clues that enabled an Enron, Madoff, Stanford or Satyam to get away with so much for so long, that same question repeats endlessly.

After the event, as everything unravels and the world watches in disbelief, it seems that everyone from finance director to accounts clerk, chief auditor to taxman, regulator to industry analyst must either have been totally incompetent or far too trusting for their own good.

However, seasoned investigators and risk consultants know that the big cases which come to light in such public fashion are really just the tip of the iceberg. The amounts involved may raise some eyebrows, but the plain fact is that corporate fraud is going on all around us all the time.

The motivating factor is usually a combination of pure greed, perceived necessity, incentive and other pressures. These can be either commercial, causing those involved to convince themselves what they are doing is for sound business reasons, or personal.

Corporate fraud also has a multiplicity of forms. It may involve little more than a junior salesman putting in fictitious expense claims. Or there can be billions of dollars at stake with the company's top executives acting with scant regard for the law, business ethics or international financial regulations. Sometimes it is a matter of staff siphoning funds from their employer. But just as easily the crux of the case can be collusion between directors or employees and external parties, where the company is party to the fraud by falsifying records, misreporting earnings or evading tax.

Recognising that problems can arise in so many places, employers determined to mitigate this risk and deter putative criminals should establish clear ground rules for their organisations. They can set out guidelines,

EXECUTIVE INSIGHTS

Edited by John Cremer

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expectations, sanctions and more. However, they should start by stressing that constant vigilance is an essential part of every employee's job description and that any type of fraud, no matter the rank of the individuals or the sums concerned, will be regarded as serious. Turning a blind eye or implying through inaction that some breaking of the rules is permissible is the worst thing you can do. It opens the door to a corporate culture that quickly becomes rotten and encourages unscrupulous staff to get away with what they can.

In ideal circumstances, it would take nothing more than strict instructions, robust controls and regular audits to prevent any attempts at corporate fraud. Unfortunately, even when those measures all appear to be in place, people will find ways – some ingenious, others surprisingly unsophisticated – to beat the system. And, all too often, their swindles are only detected after a number of years. Companies should focus on these key areas to detect and prevent corporate fraud:

Transnational activities With the growth of international trade and the accompanying complexity of global operations, responsibilities are split between countries and continents. The aim is to improve efficiency, cut costs and boost profitability. But what companies may learn the hard way is just how difficult it is to have a complete

picture of the activities, accounts and "local practices" of subsidiaries and affiliates spread around the world.

Fraudsters may be able to exploit differences in regulatory and reporting systems or deliberately obscure what is happening with excuses related to differences in language or culture. They assume that no one from head office will query local "experts" or check every detail. And their actions become harder to trace when monies pass through multiple accounts in different jurisdictions and currencies.

As an example, we dealt with one case for a company based in the United States concerning the financial performance of its Indonesian subsidiary. We found the general manager was masterminding a scheme to divert raw materials and manufacture products, which were sold through his family firm. Subordinates doctored the books and inventory records and were threatened to ensure their co-operation. A discreet investigation also revealed that the general manager had been fired by a previous employer for irregularities and was widely believed to have gang connections.

Head offices should avoid such problems by exercising direct supervision and set the same high standards for every overseas operation.

Suspicious transactions It might be thought that companies would turn the spotlight on things like unusual cash payments to little-known suppliers, but they don't always. Executives and auditors who should know better still accept vague explanations along the lines of "we're just giving them a trial" or "we had to adjust the price on a previous contract". This is when the alarm bell should start to ring. Anything that looks abnormal in terms of the company's usual accounting, operations, sourcing, hiring, or approval procedures should be checked immediately. If the initial answers don't stand up to scrutiny, a full investigation should take place.

Clear reporting lines Many organisations believe that a matrix management structure allows for greater flexibility and reflects the way a business actually works. That may be true, but it also creates situations where there is inadequate oversight, with staff having

scope to "play off" functional and geographic bosses and dodge awkward questions indefinitely. There are plenty of high-profile examples from the finance sector of nominal superiors admitting to ignorance about their subordinates' basic job duties. That is an open invitation to fraud. The best way to fix it is to have absolutely clear lines of reporting, frequent spot checks on financial controls and regular training to counter managerial deficiencies.

Vendor verification In many cases our company handles, the root cause of the problem can be traced to a failure to conduct thorough due diligence on suppliers and vendors. This is especially so in emerging markets and can expose firms to considerable risks. In China, for example, we have seen many instances of loyal vendors replaced by others who turn out to be beneficially or otherwise controlled by the purchasing firm's management or members of their immediate family. The inherent conflicts of the situation typically lead to a fall-off in quality and paying over the odds for supplies. The way around this is to insist on a rigorous and systematic vendor verification programme and to require that any potentially sensitive links are openly declared.

Detailed background checks Employers still accept a lot at face value. They don't always do the detailed background checks that should be obligatory for key recruits and, particularly, for anyone overseeing major financial transactions. It doesn't help that former employers tend to give references that are just bland statements of fact mentioning dates worked and job titles. Sometimes missing is the important information that someone "decided to leave" because they were caught in an act of fraud or malfeasance.

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