DOUBLE DEALING

Hard economic times lead to increasing levels of company fraud. Make sure you avoid the obvious traps and, says Steve Vickers, know what to do if you find them

Perhaps the biggest danger that companies face today is not global competition or economic recession but employee fraud. In Hong Kong, the Independent Commission Against Corruption has seen a large surge in complaints in the past couple of years.

Much of the corporate corruption that takes place today is carried out inside by company employees, often in collusion with colleagues or outsiders. Their activities can go undetected for months or years because firms have neglected to establish basic fraud prevention and risk mitigation measures.

Companies, and especially foreign multinationals that have transplanted their business models to Asia, are more likely to suffer from fraud if their business operations display three or more of the following characteristics:

- Internal controls are insufficient or inappropriate for Asian business practices
- Where present, sophisticated controls or "fire-walls" fail and allow for collusion among staff in different departments
- Insufficient pre-employment screening of recently hired executives, who also brought personnel from their previous companies
- Internal accounting procedures are weak and internal audit staff are reluctant to confront local management
- Early warnings or minor fraud incidents have been covered up
- Morale is low because of down-sizing or cost-cutting
- Multinationals employing a matrix management system that leaves major gaps in oversight between managers responsible for geographic regions and those in charge of product divisions
- Firms have recently undergone significant restructuring
- Expatriate management are rotated every two to three years and do not have sufficient time to get to understand their workplace
- Local staff turnover is high

Companies are often unwilling to accept that they have a problem with fraud even if there are clear indicators. Anonymous letters are filed away or are not followed up. If a company does decide to launch an internal investigation, the assigned staff, usually from the human resources or legal departments, may lack the experience, political clout or resources to carry out a thorough review. A poorly conducted internal investigation can often create bigger headaches as the suspects are let off the hook.

When companies do take action to halt internal fraudulent malpractices, they often believe that dismissing the offenders will solve the problem. However, this is only a short term solution as the causes for the internal corruption may be more systemic and widespread.

In the event that you suspect that there is fraudulent activity being committed by staff or connected parties, you should contain knowledge of the fraud and any investigation to a small number of staff. If after evaluating any complaints (clarifying terms of reference of the inquiry) you need to conduct an internal probe, manage it through an integrated crisis management team or call in outside consultants if necessary. Evaluate any potential legal and public relations damage if the alleged fraud becomes public.

If you unfortunately find that the fraud is significant, inform senior management. It is best not to involve them heavily in the investigation. Especially at such times, management's primary role should be to run the firm.

Remember to protect the company: ensure that steps to protect potential claims under Fidelity policies or Bankers Blanket Bonds are immediately put into place and documented. Once suspicions are confirmed, you also need to file a detailed report to the authorities, provide evidence, and deliver it to appropriate senior level law enforcement authorities. Be warned: if the fraud takes place in China or other countries with less transparent political, legal and law enforcement systems, carefully evaluate the risks of corrupt company employees who may be colluding or bribing officials.

> Companies are often unwilling to accept that they may have a problem with fraud even if there are contributors such as high turnover, low morale or restructuring

While the vast majority of companies and their employees are honest, fraud is clearly on the rise in the workplace and company management at all levels should increase their awareness of such malpractices. As fraud is financially costly and potentially damaging to morale and corporate reputations, prevention is always the best strategy.

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FORMS OF FRAUD

Manufacturing Fraud

Companies subcontract production to manufacturers who in turn subcontract to smaller manufacturers who start selling the product themselves.

Distribution Fraud

Local staff set up a distribution network, for example, in which they directly or indirectly own the distributors. This often leads to high levels of unrecoverable receivables, low profit margins and strong initial sales that turn out to have been non-existent. This type of fraud is widespread in developing markets such as China and India.

Capital Market Fraud

Fast growing corporations suffering from cash-flow problems seek to raise funds through carefully thought-out scams such as the "self-collateralization" of bank loans or the issue of "prime bank notes".

Share Market Fraud

Struggling listed companies or those owned by families strip out the assets of their firms or illegally allocate shares without informing minority shareholders, company boards or the regulatory authorities.

Third Party Conspiracies

Dishonest staff collude with outside parties such as clients or suppliers to defraud companies. This has been a particular headache for Hong Kong insurance industry, with insurance staff working with insurance agents from rival firms to poach clients and inside information and thereafter to "twist" or transfer policies.

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