



Managing Fraud Risk in Today's Economy

Industry Spotlight

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The global recession has not only wreaked havoc on companies' bottom lines but has also increased the risk of fraud to organizations worldwide. According to a 2009 global economic crime survey¹, an average of 43% of organizations across all sectors reported an increase in fraud during the depths of the recession. While the number of reported cases varied by geography, industry and organizational size, the one true constant that remains is that all organizations are susceptible to economic crime. Whether this increase is due to more occurrences or simply better detection, companies need to be proactive in identifying their greatest risks, and implement the appropriate anti-fraud measures and controls to combat this growing issue.

Not surprisingly, the most common type of fraud committed during tough times is asset misappropriation where directors and employees will steal company assets for their own personal gain.² According to **Mike Savage**, a partner with **Ernst & Young LLP (Canada)** and practice leader for their **Fraud Investigation & Dispute Services**, employees are more easily tempted during a recession because they are struggling financially and are more predisposed to take for themselves.

While fraud can take on many forms i.e. asset misappropriation, accounting fraud, corruption and bribery or some other type of fraud, the "**fraud triangle**" points to three elements present in every fraud situation – **motive or pressure**, **rationalization** and **opportunity**.

"For instance, if an employee of a company has a cottage and he doesn't want to sell it and he knows that he isn't going to get a good bonus this year, he will feel pressured to do something about it. In his mind, he rationalizes that this is okay because he put in the long hours and did everything the company told him to do. He sees an opportunity through the internal control system to be able to get the assets and to conceal the fact that they are stolen," explains Savage.

By understanding the causal factors of fraud, companies can better manage fraud risk by removing or reducing these factors. According to Savage, managing fraud is a lot like managing a fire – "If you take away any one of those three elements [heat, oxygen or fuel], the fire goes away. It's the same with fraud. You take away any one of those three [the motivation, rationalization or opportunity], the fraud goes away."

Risk Factors

In contrast, increasing any of these **three risk factors** will increase the likelihood of fraud. For example, operating in a leaner economy often means a reduced staff where employees are assigned to perform additional tasks that they might not be qualified to do; and with a reduced head count, there are even more opportunities for employees to commit fraud that goes undetected.

"Before we might have had many people and we were able to say to one person, you do the recording of the transaction; and to another person, you do the authorization; and to a third

^{1,2} PricewaterhouseCoopers – *"The Global Economic Crime Survey"*, November 2009.

person, you control the assets. You've got these checks and balances built into your system and if we were to layoff one or two of these people, then suddenly all the eggs are in one basket and the checks and balances are gone," says Savage.

Once layoffs have taken effect, he recommends that managers **re-evaluate** who is doing what to see whether or not some of the tasks need to be reassigned to improve **the segregation of duties**. This can provide additional comfort to companies knowing that there are checks and balances back in the workplace. However, if a good segregation of duties cannot be achieved with a reduced staff, companies should look at providing **more effective management and supervision** to their employees to help mitigate fraud risk. With more employees reporting to fewer managers, the capacity for good supervision becomes very difficult. Savage suggests that to overcome this, companies should hire employees who have the ability to supervise effectively and to remind their current managers to provide good coaching and guidance to their staff to encourage ethical behaviour.

Effect of Fraud

While fraud is costly for companies, the **mistrust** that pervades as a result of fraud can prove to be very damaging to their reputations. Once an organization announces that they have had an issue, the marketplace reacts strongly and starts to question everything about the perpetrator and the company.

"If a chief executive commits a fraud by increasing his expense plans; we understand that it's not necessarily enough money to really damage the organization as a whole. But the question on everyone's mind becomes, if he's been lying about his expense plans, what else is he lying about? Why did the company not catch this earlier? So trust goes out of the system," explains Savage.

With all the negative press surrounding the fraud within the organization, it can really put off investors, suppliers and customers from doing business with that company. Even worse, it can reduce employee morale and turn off potential recruits from wanting to work for the company.

Anti-Fraud Culture and Controls

While legislation is helpful in deterring fraud, companies can do a lot more to help themselves by building **an anti-fraud culture**. Sending an appropriate and clear message from the top about **zero-tolerance for wrongdoing** makes it difficult for employees to rationalize inappropriate behaviour.

"There is an opportunity with some very simple messages from the Chair of the Board, the CEO or the CFO to send messages down the organization that are set in an appropriate tone which say 'it is not okay to do these things; we're a good company, a responsible employer and we don't tolerate wrongdoing.' This makes it a lot harder for employees to rationalize doing bad things," says Savage.

Companies can also reduce incidences of fraud through **open communication** with their employees. For instance, companies who have just gone through a round of layoffs can reassure and communicate to their staff that going forward there will unlikely be more layoffs so that the remaining employees do not feel pressured or driven to commit fraud; in addition, companies can also offer their staff counseling support to help them better cope with their current circumstances.

In most large organizations, there is a **written code of conduct** that employees are expected to follow. While this is a step in the right direction, companies also need to communicate these codes or policies to their employees. According to Savage, policy manuals are often so thick that it is not realistic to expect employees to spend their whole day reading them or even remember what they have read. Instead,

he recommends that companies communicate these policies to their employees on an ongoing basis; refresh them from time to time; raise awareness about fraud in their companies and encourage employees to report any unethical behaviour that they are aware of.

To create an effective **anti-fraud program**, companies need to conduct a **full risk assessment** to identify their biggest risks and to implement the necessary **anti-fraud controls** to mitigate them. More specifically, “management needs to look at its own facts and circumstances in light of its own experience; look at what is happening in the industry and the way they are operating and figure out where their greatest risks are and focus on them,” advises Savage. In addition, companies should be **consistent in their responses** when investigating any allegation, whether it is against the chief executive or against an administrative assistant. A fair and consistent response procedure will encourage employees to trust the system and to report incidences that occur.

According to Savage, companies can really help themselves by recognizing when there is an issue; working through the negative emotions of the situation; and being proactive and focused on what the company wants out of the incident - whether it is to recover the stolen assets or to punish the perpetrator or to deter someone else from doing it, it can often lead to quicker and better results.

Reporting Fraud

No company is immune to fraud despite the anti-fraud measures put in place; so if and when an incident does occur, the best way to handle the situation is to **escalate it** through the **chain of command**. “This is always going to be the quickest and the best and most effective solution to any issue that any employee raises,” says Savage. However, if it is a situation where the employee is questioning the actions of his or her superior, he recommends that the employee reports it to one of the “**dotted line relationships**” in the organization i.e. the general counsel’s office, the human resources office or the internal audit department who often deal with sensitive and confidential issues. Should the employee feel uncomfortable reporting the fraud to anyone directly, companies should have a **whistleblower channel** available to their employees and encourage them to use it only as a final option.

Based on the growing number of economic crimes, there is no denying that fraud is a very real and serious issue for companies in today’s economic environment. It is not only financially draining but can often be severely damaging to a company’s reputation. Companies must do more with less as cutbacks affect the checks and balances that were once in place. Without incurring significant costs, companies can build an anti-fraud culture in their organizations by setting a zero-tolerance for wrongdoing; and performing a full risk assessment to identify their biggest risks in order to implement the appropriate anti-fraud controls. To manage fraud when it occurs, companies should encourage their employees to escalate incidences through the chain of command; or report them to a dotted line relationship in the organization if the perpetrators are at a senior level. While legislation is necessary and helpful to deter fraud and in some cases punish the perpetrators, companies can often help themselves by proactively managing their own resources to discipline the perpetrators, recover the stolen assets and discourage others from committing similar crimes.

Note: For more information on fraud risk, see Mike Savage’s “*Fraud Risk in Difficult Economic Times—Questions for Directors to Ask*”, July 2009.

About the Author:

Eleanor Kwan, CSP, is a Toronto-based consultant and trainer, who provides expertise in the areas of business development, sales and service through strategy consulting and professional skills training to help companies increase revenues and client satisfaction. For more information, visit www.ShapeYourVision.com.