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Managing the Risks Within: Spotting the signs of corruption

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1. INTRODUCTION

Corruption does not occur in a vacuum. Behind each act are many factors that, while each of them are recognizable such as financial stress or lack of recognition as motivation for the perpetrator, inadequate oversight and weak internal controls as opportunity, when all individual factors are added together they create a unique story.

Determining the precise motivations for an individual to accept a bribe from a third party is not always straight forward, however understanding that an opportunity exists for a bribe to be accepted and corruption to then occur from internal control weaknesses can be more clear cut. Simply put, an individual occupies a position that allows him or her to make or influence decisions that can benefit a third party, a weak corporate culture is present and internal controls preventing acts of fraud and abuse are absent or are not being observed.

This paper will describe a number of common signs that opportunities for corruption exist within an organization that are identified from research into fraud and corruption, guidelines and norms on combating corruption issued by organizations that demonstrate best practice, and from actual cases investigated by the author.

2. RESEARCH

2.1. Where does corruption happen in organisations?

The most recent *Report to the Nations on Occupational Fraud and Abuse* [1] published in 2010 by the Association of Certified Fraud Examiners [2] in the United States includes a number of findings and observations on where corruption occurs within an organisation and what contributing factors were present when it occurs. The 2010 Report is the sixth edition and draws on 1,843 case examinations provided by Certified Fraud Examiners from 106 countries.

An iteration of the case examinations provided for the Report has fraud cases categorised by the departments in the organisations where the fraud events had occurred by what type of fraud event was experienced. Of 299 cases of fraud in the primary operations of the victim organisations reported to the ACFE for the 2010 report, the most common scheme [3] at 31% was corruption [4]. Of 225 cases of fraud reported to the ACFE to have occurred in the Sales Department, Corruption was again the most common at 34% [5].

224 cases of fraud perpetrated in the executive or upper management of the victim organisation were reported. The proportion of cases involving expense reimbursement and billing fraud were far higher than the average for all cases, but 49% of the cases involved a corruption scheme of one sort or another.

Not surprisingly a very high proportion of the 103 cases of reported fraud in the purchasing department of the victim organisation involved a corruption scheme – 72% [6].

Where the report analyses corruption cases by industry, corruption occurred in 32% of the cases reported for the ACFE survey from the Government and Public Administration sector, which placed it in the middle of the pack at 12th of 22 [7]. The Mining, Oil and Gas, and Construction sectors ranked first, second and fourth, an interesting result given the prominence of these sectors in the corruption story, particularly in developing economies, as demonstrated by these sectors being at the top of the list of sectors involved in the bribing of public officials and state capture in the *Bribe Payers Index 2008* published by Transparency International [8].

The results of an executive opinion survey conducted by the World Bank at the 2005 World Economic Forum stressed the prominence of bribery in procurement in OECD countries over and above bribing of judiciary, tax authorities and bodies with the authority to issue licenses that rated more highly in responses from non-OECD countries [9].

The primacy of procurement and purchasing in the Corruption story in developed economies is key.

2.2. Corruption in Procurement – when does it happen?

Thematic research of trends in corruption of procurement processes produced by the OECD highlight the risks present at the pre bidding/needs assessment phase. A lack of an adequate needs assessment, conducted in a short time frame resulting in poorly-defined objectives for the tender can hide unnecessary goods or services to be provided by a favoured company, oversupply, tagged contracts and unmanaged conflicts of interest [10].

The same risks are often indicated in the bidding stage by inconsistent access to information among the bidders, lack of competition, and an absence of records on the bidding procedure [11].

In the post-bidding, contract management stage, substantial variations to the contract terms, product substitution and on the invoicing and payment side the presence of duplicate payments, and overcharging are the identified fraud risks [12].

Of the three stages of public procurement described in the OECD's *Bribery in Public Procurement* – pre bidding, bidding and post-bidding - evidence of corruption is more likely to come to light in the post-bidding stage as the good or services provided exhibit deficiencies, and because the opportunities for detecting the collusion that facilitates the corruption of the pre-bidding or bidding stages are limited [13]. Corruption occurs out of collusion earlier in the process but is, unfortunately, detected later when lack of performance is apparent and the reasons behind it are investigated.

2.3. What are the signs?

Turning to the red flags, i.e. those events or sets of circumstances that indicate the risk of fraud and abuse is elevated, respondents to the survey in the *Report to the Nations on Occupational Fraud and Abuse* 2010 were asked to nominate the control weaknesses they felt contributed to the fraud events they reported.

A lack of internal controls, in particular a lack of a segregation of duties, was cited as the biggest contributor in 38% of the cases reported, and second was the overriding of internal controls at 19%. Ineffective or absent internal controls was identified as the core reason behind nearly 60% of the fraud cases reported.

The next two most cited reasons for the fraud events experienced relate to the attitude and involvement of senior management and combined for a 26% result in total, 18% in relation to a lack of management review and 8% for poor tone at the top [14].

The Report to the Nations made the revealing point in dissecting responses to its survey questions regarding the causes of frauds greater than $1 million, that tone at the top was cited three times as often as the key reason for the fraud by respondents. Elsewhere in the Report is the calculation that frauds by owners or executives caused the highest median loss at (USD) $723,000 [15]. Add that to the result that frauds perpetrated by senior management involved a corruption scheme in 49% of cases then it can be argued that tone at the top is of greater significance in acts of corruption as compared with its overall contribution to acts of fraud in general.

The internal controls introduced as a result of fraud, the two leading reforms by a significant margin were increased segregation of duties at 61% and formal management review of internal controls at 51%. Third was surprise audits which was brought in for 23% of the events reported [16]. The lack of these controls would have been apparent prior to the detection of the fraud, even if their consequences were not.

2.4. Can we see the signs?

The question is while red flags such as a lack of segregation of duties, overriding of internal controls, or absence of management review may become apparent in the investigation of a case, can we be confident that if someone were to review the activities of a procurement division, in circumstances where no event is suspected or reported, would these red flags be apparent given that the alarm has not been raised?

The problem, from a fraud and corruption control point of view, of auditors not reviewing accounts for evidence of fraud is well understood. A good auditor will identify a control weakness and issue recommendations for that control weakness to be fixed but it is not necessarily within their remit to investigate if that weakness has been exploited [17]. The art of fraud prevention and detection is, without a tip off having been received, reviewing the red flags around the control weakness to determine if an act might have occurred and then commencing an investigation.

At a macro level there are generally recognised guides to follow in determining if an environment or prevailing culture is conducive for corruption. The Independent Commission against Corruption issues the following nine conditions that can facilitate corruption:

- policies and procedures are absent, unclear or not adequately enforced
- employee training is inadequate
- checks such as audits are lacking
- communication and reporting lines are unclear

- employee supervision and performance management are inadequate
- employees have high levels of discretion in their decision-making
- employees develop close relationships with external stakeholders
- accepted ethical standards are lacking
- the corporate culture condones rule breaking and short cuts. [18]

At the level of identifying specific acts of corruption, the Integrity Unit of the World Bank has issued a fraud and corruption awareness handbook for its staff to draw attention to telltale signs of corruption taking place. The World Bank's purpose with this document is to assist in the detection and prevention of fraud in procurement for development projects however this advice and guidance can be usefully applied to other circumstances [19].

The Handbook divides procurement into four phases, dividing the Bidding phase into two: Planning; Bidding Process; Evaluation; Contract Management.

In the Planning phase the Handbook describes red flags such as items unnecessary for project requirements included in the bid document and split contracts resulting in a less competitive procurement method among others. The red flags for various types of collusion schemes in the Bidding Process and Evaluation phases are described. Deviation from contract terms, product substitution, under delivery and payments exceeding contract value are some of the red flags for corruption apparent in the contract management stage the handbook describes.

Anti-corruption authorities readily issue such guides and they are on the whole very useful documents, both for a public and private sector audience. Their utility and the fact that there are consistent elements to them would indicate that the signs of corruption are there before and during the act for those actively looking for them.

3. CASE STUDIES

The following case studies illustrate some of the signs of weaknesses in controls and culture that would have been present should someone have been looking for them at the time the acts were committed:

3.1. Case Study 1

In 2006 a Client was bidding for a highway construction tender being funded directly by the European Commission in a satellite state of the EU. On the day before the tender result was to be announced our Client received an email sent from an unknown webmail account soliciting a bribe amounting to a percentage of the project value to guarantee our Client would win the project. The Client did not respond and the tender was awarded to another party.

The initial complaint of our Client was investigated for what evidence could be obtained and the results forwarded to the European Commission anti fraud body OLAF in a complaint. The resulting investigation revealed a number of contributing factors, in what proved to be tender rigging by an employee of the EC who was ultimately convicted of the offence by the Belgian courts, which would have thrown up red flags of potential fraud:

- The tender was being managed from the local EC office which had low headcount, junior staff and limited reporting lines or oversight from headquarters in Brussels (**No Management Review**)
- The perpetrator was in charge of a number of functions (**Lack of segregation of duties**)

- The tender process was not followed through gates established for accountability and transparency (**Override of internal controls**).

3.2. Case Study 2

In 2009 a public entity commissioned an investigation of a suspected conflict of interest. Employees were linked to a company that had provided services to the Client.

An investigation commenced which involved document review, a search of email traffic, interviews and a search of records maintained by the Australian Securities and Investments Commission.

Evidence was obtained that the company was successful in a tender process managed by an employee who had direct links with the company. The employee in question completed his employment with our Client shortly after the tender process; however it was discovered during the investigation that other serving employees were also associated with the company. The following red flags were identified:

- The Client had a Conflicts of Interest policy that was not properly implemented (**Lack of Internal Controls**)
- A Quotation process was finalised after the work commenced and no quotes were obtained from the competing suppliers named in the process (**Abuse of Process**)
- Manager who provided approval did not review supporting documents or ask questions when alerted to a “possible” conflict of interest (**No Management Review**).

3.3. Case Study 3

In 2010 we investigated information provided to executive management at our Client by an informant that two employees in charge of its fabrication workshop were receiving kickbacks from a transport contractor. Our investigation uncovered information that indicated payments were made by the contractor to workshop employees. In addition it was determined the Contractor was overcharging the Client and numerous other suspected frauds perpetrated on the company by the two employees were discovered. The following red flags were identified:

- Workshop where it occurred was run by two individuals with minimal management oversight (**No Management Review**)
- Project Managers using the workshop would sign Material Requisitions, prepared after the services had been provided, when presented with them by the second individual (**Override of Internal Controls**)
- One of the two individuals implicated was responsible for commissioning work from the contractor, preparing Material Requisitions to be signed by project managers in charge of budget and often signed bills of lading as well (**No Segregation of Duties**)
- No requirement that invoice detail match the detail on the Material Requisition before payment was processed (**Override of Internal Controls**).

3.4. Case Study 4

This year we were asked to investigate suspected overcharging by a supplier providing services under contract. The investigation began as a data review for duplicate payments and when a number of events were detected the investigation was widened and further anomalies were detected including progress payments processed without adequate justification or the milestone associated with the payment not having been reached. Payments or invoices that could not be linked to any particular work were also found.

A review of the relationship with the vendor indicated a sudden increase in volume of work three years previously. The following red flags were found:

- Absence of documents in relation to the awarding of the contract the work was being performed under (**Override of Internal Controls**)
- Information passed only to the contractor and not the other competing parties on previous bids (**Abuse of Process**)
- Tender documents written so as to favour the contractor by the individuals that recommended the successful supplier (**No segregation of Duties**).

4. CONCLUSION

Here are some possible signs of corruption in procurement division at a hypothetical public agency:

- Procurement is physically separate from other divisions
- A code of conduct exists but was last amended/circulated two years previously
- No consistent agency wide programme of fraud awareness training is in place
- The Head of Procurement is at a level just under the executive team and has been in the same position for over five years
- The Head of Procurement is required to report to the Managing Director but has delegated financial authority up to $500,000 and final approval on tenders up to the amount
- Has close relationships with key suppliers
- Keeps control of processes on key contracts, some of which the Head of Procurement has had the longest involvement with of any staff. This includes tender selection and approval, even though duties are segregated and certain responsibilities devolved to juniors
- Procurement contracts are subject to numerous variations
- Procurement contract costs are increasing

If the scenario above was made into a film, one might imagine a title scene with the words “Based on a true story”. Knowing where to look for them and what signs to look for is an important starting point for managing the risks of corruption. What can then follow are policies aimed at preventing corruption that accommodate an accurate risk profile for an organisation, training and awareness programmes that target the risk points, effective segregation of duties, and well-directed surprise audits to detect acts of corruption.

5. REFERENCES

[1] *The Report to the Nations* was first published in 1996. Five repeat editions have been issued in 2002, 2004, 2006, 2008 and 2010. 2010 was the first edition where international cases were included
[2] The Association of Certified Fraud Examiners is based in Texas, U.S.A and is a 55,000 member organisation whose purpose is to provide anti-fraud training and education
[3] The following classification of schemes was applied: Corruption, Billing, Expense Reimbursement, Non-Cash, Skimming, Cash on Hand, Cheque Tampering, Payroll, Cash Larceny, Financial Statement Fraud, Register Disbursements
[4] ACFE, *The Report to the Nations on Occupational Fraud and* Abuse, 2010, p. 64
[5] Ibid., p. 65
[6] Ibid., p. 68
[7] Ibid., p. 37
[8] Transparency International*, Bribe Payers Index,* 2008, p. 11
[9] OECD*, Integrity in Public Procurement,* 2007, p. 8
[10] Ibid., pp 22-23
[11] ibid.
[12] Ibid., p. 25
[13] OECD*, Bribery in Public Procurement: methods, actors and counter-measures,* 2007, pp 63-65
[14] ACFE, op cit., P.45, The full list of internal control weaknesses cited, by CFEs are, in order: Lack of Internal Controls; Override of Existing Internal Controls; Lack of Management Review; Poor Tone at the Top; Lack of Competent Person in Oversight Roles; Lack of Independent Checks/Audits; Lack of Employee Fraud Education; Lack of Clear Lines of Authority; Lack of Reporting Mechanism
[15] ACFE, op. cit., p. 49
[16] Ibid., p. 47
[17] Albrecht, Albrecht, and Zimbelman, *Fraud Examination,* **South**-western Cengage Learning, 2009, p 138
[18] http://www.icac.nsw.gov.au/about-corruption/conditions-allowing-corruption
[19] http://siteresources.worldbank.org/INTDOII/Resources/INT_inside_fraud_text_090909.pdf