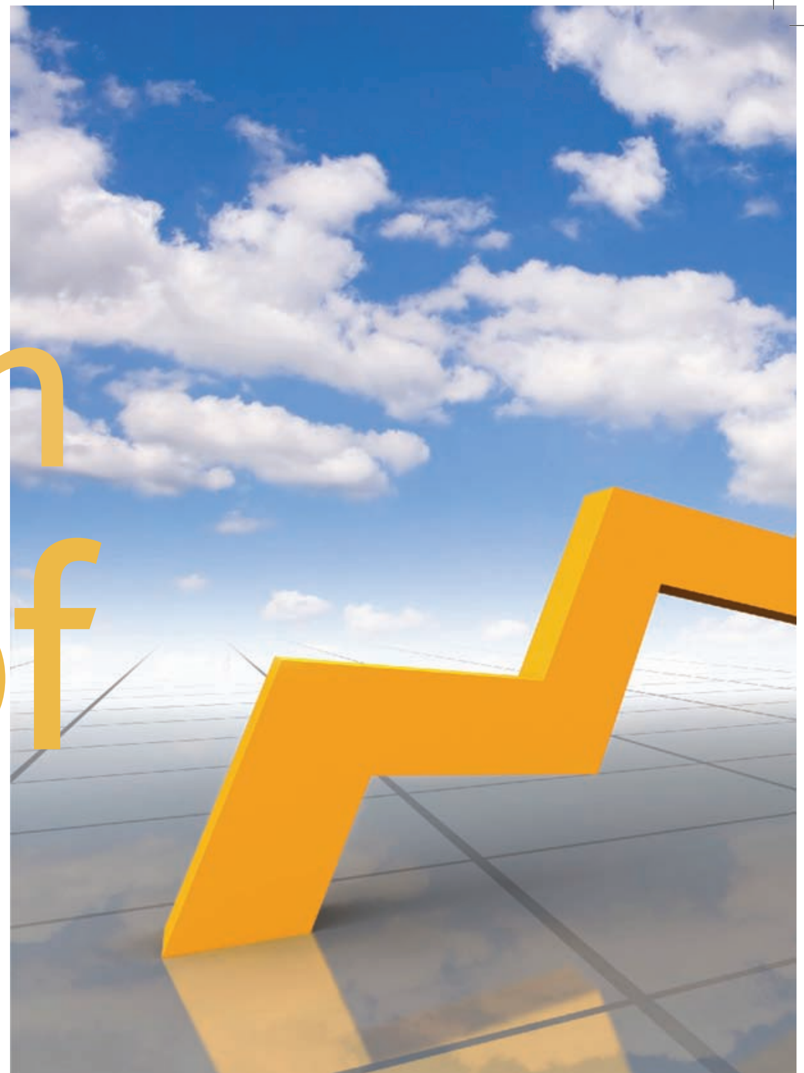
34-35 ops fraud apr09.qxd 20/3/09 11:44 Page 34

Through the roof



Executive summary

- Despite their vulnerability to (and widespread experience of) fraud, few companies make a significant investment in anti-fraud measures and controls. Treasurers need to take stock of corporate systems, controls and culture, and help protect the business better.

Recession typically triggers an upsurge in corporate fraud. Since the late 1980s, accountancy firm KPMG has published an annual Fraud Barometer, which records the number of fraud cases before the UK courts where the amount involved exceeds £100,000. In 2008, it recorded more than £1.1bn of fraud, the second-highest total since its inception.

KPMG expects the figures to rise as history repeats itself. However, Andrew Gordon, a partner of PwC's forensic services group and its head of investigations, cautions that while economic downturn provides greater incentive and motivation for fraud, it may also make it harder to perpetrate fraud. For one thing, much greater attention is paid to a company's financials, so costs paid without question when the economy is buoyant are more likely to be queried in a recession. Closer scrutiny may also pick up frauds – often long-standing ones – committed when business conditions were more favourable.

KPMG's findings are similar to those issued by accounting firm BDO Stoy Hayward, whose annual FraudTrack report recorded £1.19bn of reported fraud in the UK during 2008, a 14% rise on the 2007 total of £1.04bn. Both organisations say their reported figure is likely to significantly underestimate the problem.

"The financial and insurance sectors are where the money is. It is no surprise that this sector suffers the most," says FraudTrack's author and national head of BDO Stoy Hayward's fraud services team, Simon Bevan.

PERSONAL PRESSURES At Marsh & McLennan's risk mitigation unit Kroll, Richard Abbey, the head of its London financial investigations practice, confirms that financial crises and recession trigger more cases of corporate fraud. The incidence of frauds committed for personal gain rises, as individuals come under greater financial pressure.

"In the current economic climate, employee morale is often poor and this increases the motivation," says Abbey.

Recession can also see fraud perpetrated by trusted employees or self-appointed corporate saviours, who attempt to juggle budgets or manipulate cashflow to improve the company's balance sheet.

"With falling revenues and often high levels of debt, managers of businesses may be tempted to massage the figures to paper over the cracks in the hope that operational changes can be made to improve performance before creditors look more closely," says Philip Davidson, KPMG's European head of restructuring.

This type of fraud tends to be cumulative, as the hoped-for improvement in financial conditions fails to materialise and another go at cooking the books becomes necessary.

Although good risk management can reduce a company's potential losses, there are limits to its effectiveness when it comes to fraud.

"Good internal controls won't necessarily protect the company against fraud," says Abbey. "Controls can prove fairly ineffectual when there is collusion between employees."

His colleague Dean White, managing director of Marsh's financial and professional practice, adds that individual staff must realise that their efforts at fraud prevention need to extend beyond compliance.

There must be a system in place that lets employees report any suspicious activity in confidence and have confidence the company will act on their reports. White points out that this model means that "staff are effectively doing a community policing job".

He adds that fraud has long been a constant in banks' assessment of their risk exposures. They are specifically required to put capital aside and develop controls to address the problem. However, fraud has yet to feature as significantly in non-financial companies' assessment of their risks.

White says corporate clients with insurance against fraud have often "tucked the policy away in the bottom drawer". But over the past six to 12 months many companies – and not only those in the financial sector – have taken their policy document out and started asking whether it provides them with adequate cover.

34-35 ops fraud apr09.qxd 20/3/09 11:44 Page 35

CORPORATE FRAUD THRIVES IN PERIODS OF RECESSION, AND COMPANIES ARE BRACING THEMSELVES FOR A SURGE. **GRAHAM BUCK** INVESTIGATES.

The answer is not reassuring. Fraud is an area of continuous innovation, whereas insurance policies covering fraud tend to be backward-looking, focusing on the areas in which it has been experienced before now.

"There is an assumption that fraud necessarily involves theft, but as the 2007 Fraud Act recognised, there are a number of new and growing areas such as misrepresentation, hacking and cracking," says White. "Fraud policies haven't kept pace with these developments and there is a need to take account of the growing sophistication of fraudsters."

Like frauds carried out by staff, those perpetrated by third parties such as suppliers or customers have also increased sharply. BDO Stoy Hayward's FraudTrack recorded a 347% jump in third-party fraud between 2007 and last year, when the total reached £273m.

Examples included suppliers under-delivering goods, in some cases compounding the fraud by overcharging. The firm warns that companies with weak systems will be exploited by unscrupulous customers; for example, by claiming under-delivery from their supplier when the delivery was correct, and withholding payment for "disputed invoices" before disappearing without paying.

IN DENIAL Despite companies' vulnerability to fraud, a global economic crime survey carried out by accountancy firm PricewaterhouseCooper's forensic services unit suggests that only one in six companies regards it as major problem, even though half have suffered at least one loss. According to PwC's Andrew Gordon, this denial response means that many companies fail to make significant investment in anti-fraud measures and controls.

However, good internal controls can lessen the risk of fraud. PwC's figures suggest that a confidential hotline that enables whistleblowers to report their suspicions is particularly effective. Such hotlines can pick up around 45% of detected frauds, while increasingly effective internal audits account for 25%.

Box 1: The warning signs

Good risk management is vital in understanding and addressing the threats of corporate fraud and may mean the difference between survival and failure for many enterprises, according to insurer Marsh. The group recommends the following actions:

Vigilance: look out for increasing levels of employee stress or out-of-character behaviour patterns;
Controls: ensure segregation of duties in high-risk areas, enforce holidays and the handover of work;
CV check: if hiring staff, take up references and check qualifications;
Security: ensure exit procedures are robust and access to premises and computers are appropriately limited or removed; and
Staff buy-in: ensure that a comprehensive whistle-blowing policy is in place; encourage staff to raise concerns about malpractice and create an open working environment.

"But the treasurer must sit down with the head of internal audit to determine the key risks and consider whether the company's controls are sufficient to mitigate risk," Gordon adds. "Very often, internal audits are not organised to detect the possibility of fraud per se."

With many companies likely to be sailing close to the wind financially and under pressure to meet their banking covenants, the treasurer bears a heavy duty of responsibility to ensure that reporting is accurate as the company seeks to renegotiate its loans. PwC predicts that the number of corporate insolvencies will escalate in the second half of 2009, as more companies that have been artificially propping up their figures go to the wall.

Distribution companies are particularly vulnerable in this respect. It is possible to artificially inflate earnings when a company is close to its quarter-end or year-end by shipping product to customers in advance and booking the revenue straightaway. However, customers have the right of return – which many are likely to utilise in the current downturn – with the result that a credit must then be given in the subsequent period. Other means of artificially inflating the figures include continuing to show an outstanding debt as open when the customer has become insolvent and there is no chance of its repayment.

The tone set by management can do much to determine whether the corporate environment encourages fraud, says Gordon. For example, while a chief executive will naturally be keen for targets to be met it should be with the added proviso that this should not be at any cost. Adopting a hard line when wrongdoing is uncovered reinforces the message that fraud will not be tolerated.

From the treasurer's viewpoint, there are two key controls. First is to maintain the segregation of duties. At a time when companies are seeking to cut costs, the treasury department can anticipate pressure for less segregation of responsibilities. However, it is important to keep separate the individuals who approve payments and those who ensure that payments are made.

The second paramount control is for treasurers to ensure they regularly reconcile payments and ensure that any unreconciled items are followed up on a timely basis. After a fraud, and with the benefit of hindsight, it is often discovered that a simple reconciliation would have uncovered it at an early stage.

Graham Buck is a reporter on The Treasurer.
editor@treasurers.org