MANAGING THE RISK OF FRAUD IN A GLOBAL ENVIRONMENT

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DURING

ICPAK'S 28TH ANNUAL SEMINAR HELD AT THE PRIDE INN SAI ROCK, MOMBASA, KENYA, MAY 23-25, 2012

RISKS AND NEWER RISKS

- Advances in technology (ICT), expedited pace of business, globalisation, increasing *financial sophistication* and the uncertainty of politically motivated attacks have enhanced the complexity of risks.
- Enterprise Risk Management (ERM) is a newer approach that ensures the treatment of a vast variety of risks in a holistic manner, and elevating risk management to a senior leadership responsibility.
- However, *some unquantifiable* risks still remain: *manipulation, human intervention* and *newer risks, including newer frauds*!

DEFINITION OF FRAUD

- A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, in order to deceive another person so that the individual will act upon it to her or his legal injury.
- Dishonesty calculated for personal advantage.
- Using deception to dishonestly make a personal gain for oneself and create a loss for another.
- Fraud is a type of risk, a white collar crime, an economic crime and a type of corruption.

TYPES OF FRAUD

- Embezzlement, false billing, false claims, forgery, tax fraud and evasion, false advertising, false identity, theft, corruption, conspiracy, embezzlement, money laundering, bribery, telemarketing, Nigerian Letter/419 extortion, prime bank notes, pump and dump, creation of false companies: phony, ponzi and pyramid schemes.
- Note that computer and internet/wire frauds have emerged as the fastest growing types of fraud.

PERVERSIVENESS AND MIGRATION OF FRAUD

- Globally speaking, fraud continues to migrate from more secure to emerging economies and less secure regions. This is generally accelerated by increasingly sophisticated and organised criminal gangs that exploit security vulnerabilities.
- Criminals now launch sophisticated attacks on networks and international merchants.
- A single fraud can wipe out all profit, chase investors, ruin a brand, or bankrupt any type of organisation.

PERVERSIVENESS AND MIGRATION OF FRAUD

- Kroll's Fraud Report 2011-2012: North America had the lowest average fraud; Canada performed very well, although Mexico had widespread fraud; Overall fraud decreased in Europe;
- Africa had the highest incidence; Middle East witnessed substantial growth in bribery, corruption and supply chain fraud; India had a higher prevalence than the average; S.E. Asia reported the highest rates of vendor, supplier, procurement fraud and conflict of interests.

SOME WORRYING STATISTICS ON FRAUD AND TYPES OF OFFENDERS

- Fraud is more than double what is reported!
- “A high percentage” of fraud is committed by senior management and executives.
- Post-graduate employees have losses five times greater than high school graduates.
- The losses for male employees are four times greater than those for females.
- Only a small percentage of losses from fraud are recovered by organisations.
- Fraudsters often work in the finance function.
- Corruption is estimated to cost the global economy about $1.5 trillion each year.

FRAUD IN CORPORATE COLLAPSES

- BCCI was closed down in 1991 due to fraud;
- Barings Bank brought down in 1995 due to fraudulent trading by its head derivatives.
- Enron collapsed in 2001 due to fraudulent and risky accounting.
- HIH Insurance was liquidated in 2001 due to fraud and unsupervised delegation.
- In 2002 WorldCom collapsed due to fraud.
- The 2008 Global Financial Crisis claimed a number of companies due* to fraud(!)

FRAUD IN CORPORATE COLLAPSES: THE KENYAN CASE

- Eurobank collapsed in 2003; Delphis Bank Limited went under in June 2001; thirteen banks collapsed in seven months in 1993 and seven banks were combined to form Consolidated Bank in 1989.
- Reasons: non-performing loans, political connections, insider lending and unsecured loans.
- Others? Angloleasing, Goldenberg, NHIF!

THE RECENT JPMORGAN'S CASE

- US banking giant JPMorgan Chase has lost US $ 2 billion on derivatives since March in what the CEO, Jamie Dimon, called a ***"flawed,*** poorly executed, poorly reviewed, complex, egregious and self-inflicted mistakes"(!).
- The loss came over in the bank's risk management unit, the *Chief Investment Office,* trading in credit default swaps.

MANAGING THE RISK OF FRAUD

- Refer to Professor Donald R. Cressey's work in his most cherished book, *"Other People's Money"* published in 1953: The "Fraud Triangle", which includes a **perceived non-shareable** financial need - motive, incentive, pressure; a **perceived opportunity;** and **rationalisation,** giving rise to **fraud factors.**
- An effective method should *minimise motive, restrict opportunit*y and *limit* the ability for potential fraudsters to *rationalise* their actions.

MANAGING THE RISK OF FRAUD: Cressey's hypothesis:

- Trusted persons become trust violators when they conceive of themselves as having a financial problem which is *non-shareable,* are aware this problem can be *secretly resolved* by violation of the position of financial trust, and are able to apply to their own conduct in that situation *verbalizations which enable them to adjust their conceptions of themselves* as trusted persons with their conceptions of themselves as users of the entrusted funds or property.

MANAGING THE RISK OF FRAUD

- **Fraud Prevention in Organisations:** *Developing and implementing a sound ethical culture -* definition of high and effective ethical practices and standards; a code of ethics; anti-fraud policy; good corporate governance standards and best practices; IT governance practices; fraud risk training and awareness; reporting mechanisms and whistleblowing; periodic assessment of fraud risk; and "walking the walk" – leading by example.

MANAGING THE RISK OF FRAUD

- **Fraud Prevention in Organisations:** *Developing sound internal control systems and procedures* - the Shareholders; Board; Audit Committee; Management; procurement, ethics, fraud officers; internal auditors; external auditors.
- **Fraud Deterrence**: Note that fraud is "more of a social than an accounting problem". Apply:
  - *Certainty**;
  - *Swiftness;* and
  - *Severity of Punishment Rule.*

MANAGING THE RISK OF FRAUD

- **Fraud Detection**: Look for the indicators, warning signs and fraud tips; benchmarking, systems analysis, trend/ratio analysis, mathematical modelling.
- The fraud detection units: Internal audit; Audit Committee; internal tip-off; risk management system; external tip-off; by accident; law enforcement investigation; change of personnel/duties; corporate security; external/forensic audit.

MANAGING THE RISK OF FRAUD

- **Fraud Response**: This is a structured mechanism put in place for dealing with detected or suspected cases of fraud:
  - Clear reporting mechanisms;
  - Thorough investigations;
  - Disciplining* of the individuals responsible;
  - "Full recovery" of stolen funds or property;
  - Improving the anti-fraud strategy to prevent similar behaviour in the future.

MANAGING THE RISK OF FRAUD

- **Cross-Border and Global Strategies**:
- Effective, ethical political leadership; effective framework of laws, consumer protection agencies, institutions and practices.
- Establishing a domestic system for combating cross-border frauds against consumers.
- Developing and enhancing notification, information sharing, investigative assistance, co-operation and mainstreaming mutual legal assistance treaties among member countries.

MANAGING THE RISK OF FRAUD

- Improving the ability to protect domestic consumers from foreign businesses engaged in fraudulent and deceptive commercial practices.
- Protecting foreign consumers from domestic businesses engaged in fraudulent practices.
- Considering how to ensure effective redress for victimised consumers.
- Developing consumer sentinels - secure online database of millions of consumer complaints.