

Fraud Intelligence

April/May 2015

FEATURE ▸ CASE STUDIES / RED FLAGS

Actions speak louder than rules

There must be a better way to deal with fraud and corruption. We need to start leading by example instead of ruling by prescription, argue **Professor Yuval Millo** and **Nigel Krishna Iyer**.

As rules and the layers of control designed to prevent fraud and corruption keep on accumulating, we ask the question: “Are they more of a hazard today than a help?” Management which stands up to “rules for the sole sake of rules”, management that seizes the initiative and shows the way through action, can be an alternative although it is not a magic bullet.

Fraud and corruption – a very persistent problem

Fraudulent and corrupt behaviour against (and inside) organisations and corporations remains a persistent problem. Only the naïve would believe that it is a remote possibility. It happens all the time, right under our noses. Cases and surveys in recent years have demonstrated that levels of fraud and corruption in corporations and society have not been decreasing significantly. Some widely reported studies tell us that the real cost of fraud and corruption may equate to as much as 5% of turnover or GDP. [1] Of course, it can still be argued that since there is no absolute proof of these figures, they can be disregarded. All the same, experiences and straw polls at hundreds of management and employee seminars over the years indicate that managers believe the cost of fraud and corruption to lie somewhere between 1% and 5% (or more) of sales. At the least, we can conclude that the cost of fraudulent behaviour in corporations, therefore, is very high. Classifying fraud and corruption as a risk is to use a misnomer – fraud and corruption are a certain phenomenon, not a potential one.

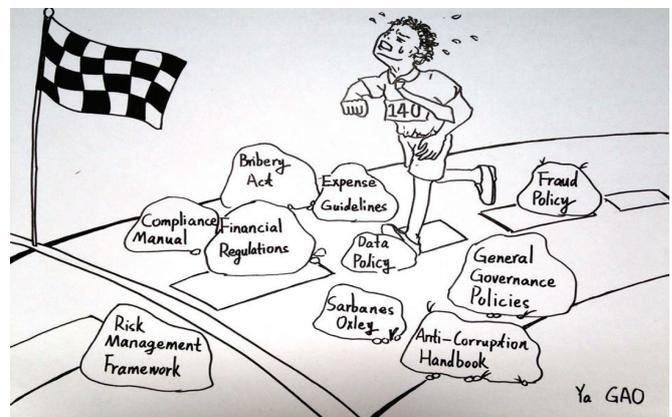
The growing volume of rules and regulations to be complied with, as well as all the associated guidelines to take into account, have created a mountain of paperwork and even more boxes for senior management to tick. Most readers will be aware of the increase in rule-based fraud fighting in recent years; this is exemplified by the UK's *Bribery Act 2010* and the US *Sarbanes-Oxley Act* of 2002. The resultant bureaucratic burden, for no marked reduction in fraud and corruption, is often

borne by finance directors, auditors, legal counsel and other professionals. The question that needs to be asked is: “Since rules and regulations seem ineffective against fraud, can we not think of an alternative, better approach?”

We are concerned here with the ‘total’ phenomenon called ‘Fraud and Corruption’ [2]. We draw the definition as broadly as possible, following the example of the former UK National Fraud Authority [3], to include “[A]ny unethical act done by any person, inside or outside an organisation, whether acting alone or in collusion with another person(s), which causes LOSS to that organisation.” This includes suppliers who blatantly overcharge, employees who steal or falsify figures, customers who do not pay, kickbacks, theft of property, goods and intellectual property, and much more. By ‘loss’ we mean loss of profits, value, damage to reputation and brand, erosion of organisational culture and any other negative impact which causes the organisation to perform less efficiently.

Example 1: S/he who looks... finds

The CFO of an energy company, on the basis that if you never look for fraud you will rarely find it, decided to commission an in-depth study to identify ‘red flags’ related to fraud in two of the four business divisions. The study focussed on where costs were incurred and on the behaviour of the top



Too many rules...too many boxes to tick...not enough time for action (illustration courtesy of Ya Gao and the University of Leicester School of Management)

70 managers who were responsible for authorising this expenditure. Using internal knowledge and experienced investigators, over 50 potential cases of unethical business behaviour were identified. These included gross supplier overcharges, employee and third party conflicts of interest and collusion, and unethical acts by certain senior employees. Management felt that it would be impractical to investigate each and every case but still wanted to take firm action. A number of concrete measures were taken to deal with the suspected fraud based on a root cause analysis of the culture in those 'pockets' of the company where the misconduct was found. The case was unusual, in our experience, (a) in that the management commissioned such a study in the first place – normally they don't want to look too hard when there are no *a priori* suspicions; and (b) they were not shocked by the findings and were willing to act on them.

Two years later, the board of the company received a report that in one of the divisions (which had not been within the scope of the earlier study) some members of the top management had unilaterally granted themselves very substantial additional performance bonuses and had been suppressing costs and ignoring warnings from junior accountants and other staff. On this occasion, the board removed the offenders and completely restructured the division; it installed a new, untainted management team, which led by example, and a number of very strong anti-fraud and corruption measures, which included encouraging all staff to look for signs of and report fraud.

Dealing with fraud and corruption – 'There may be many ways to skin a cat, but there is usually one that is very effective'

Against a backdrop that there is probably a lot of fraud and corruption around but the average senior manager still associates its discovery with 'bad news', we identify and contrast two main approaches to dealing with it. One is to add more specific and detailed rules and devise a rule-based control system accordingly. The alternative is to 'lead by example and actions' where managers aim to exemplify and embody desired behaviours.

We make two claims. First, we argue that trying to fight fraudulent and corrupt behaviour by adding more rules and adding details to existing rules is very costly and, at the extreme, destructive. Second, following this argument, we provide evidence that leading by example can alleviate some of the serious problems of rule-based management of fraud and corruption, while warning that it may call for significant changes to the way management operates and thus should not be seen as a quick and easy fix.

So, what is the problem with improving existing rules and adding more rules to fight fraud and corruption? First,

let us revisit existing definitions of fraud and corruption; these refer to fraudulent behaviour as something that lies outside what is seen to be desirable, acceptable, or legal corporate and managerial behaviour. Fraudulent and corrupt behaviour is defined as unethical, immoral, illegitimate and illegal. As such, what constitutes such behaviour from a knowledge perspective is outside what managers are being trained to do: this may sound obvious, as managers are certainly not taught to become fraudsters!

However, this implicit positioning of knowledge related to fraudulent behaviour has serious implications for the way companies and their management treat it. Fraud and corruption may be widespread but because it is not 'taught' to management, they conclude that they lack the expertise to deal with, that is, 'manage' it, and need outside help. We contend that the exclusion of fraud and corruption from the direct, required managerial know-how has contributed to the growing elaboration of rules aimed at combating fraud because the experts brought in by companies generate their own textual outputs in the form of rules, procedures, guidelines and regulations. In itself, this is not necessarily bad. Growing bodies of expertise may help us to illuminate problems and find better ways to solve them. However, increasing refinement in definition of fraud and corruption can serve to marginalise it as the preserve of experts. Indeed, the last few decades reveal a migration of fraud prevention and detection from managers to specialists.

In contrast, leading by example and action sees fighting fraud and corruption as primarily a managerial issue, based on concrete, situation-based examples of successes and exemplary behaviour. The desired outcome is that management will foster organisational resilience to fraud and corruption through example, action and resonant communication.

Example 2: Frustrations with rule-based fraud prevention

The deputy chief financial officer of a leading university was told by his internal auditors (who were outsourced from a major public accounting firm) that his institution lacked policies and procedures around fraud and corruption. As a result he spent many hours creating some 18 separate policies (over 20,000 words in total) and ensured they could be found on the university's website and were available to all staff. The policies were well-written and complied with the regulations at the time; they also satisfied the public accountancy firm. However, by the deputy CFO's own admission, the whole exercise was simply 'compliance for compliance's sake' and he accepted that virtually nobody would read the policies. Subsequently, after himself discovering a fraud involving a trusted employee, the deputy CFO determined that people in the organisation should be able to recognise and report cases of fraud and corruption in future. So,

to counteract the 'sleep-inducing' effect of the policies he felt forced to create, he also commissioned animated video training with interactive exercises and games lasting just ten minutes.

In addition to distancing fraud fighting from the domain of managers, the growing body of regulation and ever-increasing reliance on rule-based approaches to fraud and corruption have other undesirable effects. First, formally expressed rules, which stream from the various definitions of fraud, take far longer to evolve than management can afford to wait.

Furthermore, events tend to reveal discrepancy between existing rules and actual situations. The slow pace in establishment and change make rule-based fraud-fighting slow, expensive and reactive. The growing levels of detail embedded in rules may also give rise to a particular type of moral hazard: managers and other stakeholders may feel that behaviour or practices are perfectly fine if they are not expressly prohibited. That is, managers may suspend or disregard their independent normative judgement because they trust in the rules. This is problematic, of course, because it enables innovative forms of fraudulent and corrupt behaviour to breed and flourish, with the rules acting more like a smokescreen to hide behind.

Leading by example and actions: benefits and challenges

The difficulties of rule-based fraud and corruption-fighting motivates some managers to develop and employ different ways to lead by example, which bring their own challenges: while rules may be stable, albeit inflexible, managers and their styles may vary in quality, impacting effectiveness in fighting fraud and corruption. This, of course, is a general managerial issue (as, after all, all companies want good managers), but it has more bearing if sufficient emphasis is placed on evaluating managers' behaviour and not just their performance.

Secondly, it may be difficult for managers to assess how effective their communication of good, imitation-worthy behaviour has been because, by its nature, fraudulent behaviour is intended to be hidden. For example, managers may believe that low levels of fraud detected are attributable to successful leading by example when, in truth, they are due to weak fraud detection.

Finally, when relying less on rules, how do managers decide the appropriate reaction to any given situation? For example, how do management deal with an isolated incident? An 'enlightened' manager will know that when an isolated incident of fraud and corruption is discovered there will be plenty more that goes undiscovered. In the past, the approach of showing 'no mercy' has been used as a deterrent. However, we question if this really works and whether the act of coming down hard on the few who are caught rather deters many others from coming forward to admit that they might, in some small way, have

been involved in potentially unethical activity. Showing restraint and some degree of tolerance could, in the long run, be a much more effective way of encouraging people in organisations to talk about and accept the true extent of fraud and corruption, thereby bringing many more incidents to light.

Example 3: Sorting out the hard-nosed crooks from the ones who show genuine remorse – is Zero Tolerance practical?

Manager X, who was in charge of maintenance in the real estate department had been receiving favours (such as discounted work done on his home) in exchange for directing more business to a certain contractor, although there was no conclusive proof. When approached about the matter X made a full confession, showed genuine remorse and offered to recompense the company for the damage caused.

Manager Y, a successful sales manager, was found to be purchasing large volumes of gift vouchers, gifts and other items, supposedly for his clients or as inducements to buy, but instead was diverting these to himself (privately). In spite of conclusive evidence, Y denied all wrongdoing and trivialised the matter by explaining that since he was so successful, he was entitled to such "fringe benefits". While the amounts concerned in the case of Manager X were larger than those involving Manager Y, it was decided that the sanctions imposed on X should be lower and a little more lenient than for Y.

Example 4 – When you are wrong, admit it; humility gains respect

A head of internal audit had resigned from the organisation where he worked after senior management repeatedly blocked him from looking for signs of fraud and corruption. Three years later a very large scandal involving bribes and embezzlement erupted in the same corporation.

The former head of audit had taken a similar position in a large state-owned business and, after settling in, again wished to start looking for indicia of fraud and corruption. The chief financial officer and management were sceptical but after repeated discussions the CFO reluctantly agreed to a very limited review in one area, which culminated in a workshop where the ten examples of potential fraud were discussed. Although he was at least two levels above the accountants taking part in the workshop, the CFO insisted on attending. As the cases were discussed it was clear that he was becoming both uncomfortable and irritable. In response to one of the examples where it appeared that a supplier of media services had blatantly managed to overcharge, the CFO stood up and exclaimed, "This is not possible... I am sure that while it may look strange

to you, it will be addressed in the contract and frame-agreement!” The CFO then left the room. After about a half hour he reappeared holding a single-page agreement, which he said he had obtained from a safe. “This so-called contract is not worth the paper it’s written on... It’s as if we’ve given the supplier a cheap licence to print money... I am sorry, I was wrong. Well done.” Afterwards, both the head of internal audit and the accountants said that they felt their respect for the CFO had increased significantly because he had shown humility.

Leading by example and actions – some practical rules of thumb

1. Have a few simple guidelines, but stick to them

When fighting fraud and corruption through leading by example and action, managers need to focus on behaviour and less on rules. So, have a few simple general guidelines, but make sure you follow these fully. Focus on embodying the guidelines and not on interpreting them.

2. If the rules are overwhelming, search for innovative ways of complying with them

You will probably have fraud-fighting rules that you will need to follow. Try to fulfil the requirements without becoming a slave to box-ticking and compliance for compliance sake.

3. Show what to do and not only what not to do

Management need to get their hands dirty in dealing with fraud and corruption. Typical actions could include:

- Not being afraid to commission a study to find examples of unethical behaviour against your organisation by insiders and outsiders alike – get involved in the study and don’t be shocked if a lot turns up;
- Take a role in brainstorming new and innovative ways to fight fraud and corruption – this could be scenario workshops, development of films and short animated training or, at the most simple level, talk about it with colleagues over a cup of coffee;
- Show compassion – be seen as fair: zero tolerance is a principle, not a rule and it can and deserves to be broken. After all, tolerance and compassion are both virtues.

Actions are stronger than words and their positive effects will be noticed. So, communicate your actions, not your analyses of what should or should not be done. Do the right things and your actions will reverberate through the organisation loudly and clearly.

4. Admit it when you are wrong and correct things!

Not everything you do will be correct or effective, but if you admit it immediately and offer remedial action, it will help others to continue regarding you as an example-setter.

Around ten years ago the phrase ‘tone at the top’ became very popular. But the question still needs to be asked: is that tone measured by how many rules are prescribed and what management SAY needs to be done, or is it measured by the effectiveness of leadership through example and action?

Notes

1. The Association of Certified Fraud Examiners (Report to the Nations on Occupational Fraud and Abuse 2014) estimates a median loss of 5% of revenue in an organisation due to fraud (and corruption) each year.
Estimates show that the cost of corruption equals more than 5% of global GDP (OECD Report ‘CleanGovBiz’ – Yermo and Schroeder, 2014).
2. The words ‘fraud’ and ‘corruption’ are regularly used synonymously and in overlapping contexts; many definitions of one term seem to wholly or partially encompass the other. It does seem, and probably will be the case in years to come, that different organisations will continue, for their own purposes, to define and classify fraud and corruption slightly differently. For example, the OECD paper ‘CleanGovBiz – Integrity in Practice’ (Yermo and Schroeder, 2014) describes embezzlement as a part of corruption and ‘fraud’ and ‘money laundering’ as an ‘associated practice’. On the other hand, the Association of Certified Fraud Examiners (Report to the Nations on Occupational Fraud and Abuse 2014) categorises corruption as a subset of fraud and, while not mentioning embezzlement by name, goes into great detail when describing ‘asset misappropriation’.
3. In 2012, the UK National Fraud Authority estimated the cost of fraud (using a very wide definition including most aspects of corruption) at around 5% of gross domestic product of the UK.

■ **Yuval Millo** (+44 (0) 116 229 7385, ym95@le.ac.uk) is a leading contributor to the emerging field of Social Studies of Finance and is currently Professor of Social Studies of Finance and Management Accounting at the University of Leicester School of Management. He has previously held positions at the London School of Economics and the University of Essex.

■ **Nigel Krishna Iyer** (+47 90654410/+44 752 357 0004, nigel.iyer@septiagroup.com) has over 25 years’ experience preventing, detecting and investigating fraud and corruption. He also teaches widely and is a qualified screenwriter making numerous dramas and theatrical productions about corruption and fraud. Since 2011 he has been a visiting fellow at the University of Leicester School of Management where he is engaged in developing new management programmes such as the CIMA-accredited ‘Defending Your Organisation Against

Fraud and Corruption' CPD course (<http://www2.le.ac.uk/departments/management/CPD/fraudandcorruption>) together with the other academic staff.

This paper originates from the ongoing collaboration between academic staff at the University of Leicester School of Management and a group of experienced practitioners who wish to explore and implement more effective and innovative ways of reducing the impact

of fraud and corruption. The paper draws on a number of studies, interviews and empirical data. The authors would like to thank their colleagues on both sides of the (hopefully lessening) academic-practitioner divide.

The second part of this article will explore in more detail examples of practical actions that can be taken to discover and mitigate fraud and corruption, including how and why management need to get involved in the detail to find it.