

Who's afraid of the red flags of fraud and corruption?

By Nigel Krishna Iyer, Partner Septia Group and a Fellow of the University of Leicester School of Management

Anna (Internal Auditor)

"...I think we may have found ... quite a bit of ... er ... fraud"

John (CEO)

"WHAT!?!\$¥€! That's BAD... or... maybe... it's ... GOOD...?"



"Should someone, whether its Internal Audit, or anyone else for that matter, actively be looking for the red flags of fraud and corruption...even when there are no current suspicions? And when the red flags are discovered, is this good or bad news for management?".... Nigel Iyer reflects.

Recently I have been putting these questions, to senior management, internal auditors, external auditors, other risk professionals as well as members of the public. The answers always intrigue me. When I first came to work in Norway in April 1989 in Norsk Hydro Internal Audit they definitely knew about fraud (we had just had a rather big one in Metals Trading), but I can't say it was a topic on management's or internal audit's agenda. Fraud and Corruption was seen as an isolated incident, a one-off rarity. We most certainly did not go out there looking for it.

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Today, I think in Norway, and most other countries there is an acceptance that fraud and corruption is pretty commonplace. Most people, especially internal auditors, know it happens. Fraud is an ever present factor in most organisations. And depending on which surveys and studies you want to believe, the true cost of fraud and corruption can be measured and lies somewhere between 1 and 5% of sales. As Michael J Comer¹ remarked: "S**t happens and so does fraud".

At a recent Nordic conference in Oslo a colleague and I were holding a session

for a group of IT-risk professionals on how to detect the red flags of fraud and corruption in transaction payment streams. It was an interactive session and the 40 or so participants were constantly challenged to be able to spot fraud in realistic data-files of payments and on documents. In this competitive atmosphere I thought that they managed rather well. At the end I asked them the question "How many of you think there should be someone in your organisations looking for red flags like you have just done now?" I was a little surprised when only ONE person put his hand up. Later

¹ Michael J Comer - a practitioner who wrote some of the first books on corporate fraud over 30 years ago <https://www.ashgate.com/default.aspx?page=4688>

on it dawned on me that they were probably afraid of the next question... *“should it then be them?”*

When I ask this question answers vary from *“Yes we should really do it, but the management won't be so pleased”*, *“we are aware of it and should be able to spot it if we come across it”* (which is not really the same thing), to *“it's not our job to poke our noses around... people may think we are the police...”*.

To be fair, I can sympathise with all of these responses. I mean, who really wants to have the job of delivering “bad news”? Would the conversation at the

start of this article ever really happen? Would John, the top guy really be able to see that the discovery of potential fraud and corruption in their own organisation, by his own organisation was good news? for the senior management?

Just before Christmas I worked with Internal Audit in a pan-Scandinavian financial company. They wanted to study where internal controls were being abused and along the way we discovered (together with them) about 30 examples, big and small, where it looked like they were being defrauded - suppliers overcharging them, deals with front companies and conflicts of interest.

These were all serious enough incidents but nothing that would sink the company. The Internal Audit manager's immediate reaction was how these 30 or so findings should be used (if at all) when they reported back to the senior management on the state of internal controls. At some point I asked them *“you're not scared of the senior management are you?”* “Oh no...” she answered somewhat ironically... “...we're not scared of the senior management...we're TERRIFIED of them!”

Put yourself in management's shoes. How would YOU react if some auditor came up to you and told you:



We have found a supplier which seems to have no virtually other customers than ourselves; they were started by a group of ex-employees a few years ago, there have been no public tenders, and the people behind the company could have friends in your division.

We are paying quite a bit money to a consulting company which is a local branch of a British Virgin Islands company - in other words we don't really know who owns them.

One of our maintenance managers seems to have recently started his own consulting hiring out equipment and vehicles - it's been an active company since last autumn. Right now we are not sure why but there seems to be an indication that he is renting out our own equipment and vans.

One of your senior staff seems to buy quite a lot of what appears to be private goods on trips and we are not even that sure where he is going and why on these trips. We suspect that some of these trips are private - probably the person approving the expenses does not have time to look at the underlying vouchers.

...Oh, and these are just some examples from a small study. There are lots more but we simply do not have the resources to look in any more depth at the moment.

Bad news or Good news? If YOU were the senior manager receiving this sort of news would you be genuinely pleased that someone had found all these things and told you that there was probably a lot more. Would you immediately THANK the internal auditor? Or how would you actually feel? Ambushed? Angry? Defensive? Would you feel uncomfortable that someone else had “interfered in your affairs”. Anyway if there was something going on then of course you would have found it?

In reality when someone tells us something which does not match up with what we want and expect to see, we experience what psychologists call “dissonance”. We are not hearing pleasant news and it does not agree with what we WANT to believe, so we need to find ways to deal with it. What happens is that we try to find ways to rationalise that “there must be some logical explanation”, or that “the auditor is wrong”, or that “it can’t be true because no one has ever spotted it before”. The list of possible excuses we could find can go on and on. If we don’t want to see something and if we are not looking for it, then we will most probably NOT see it.

There is this famous experiment called “The Monkey Business Illusion” by Daniel Simons². It’s been used hundreds of times to demonstrate that people tend to focus on what they think they SHOULD be looking for. You are asked to watch a basketball game and are supposed to count the passes made by the team in WHITE. It’s just under a minute long and most people come up with the right answer, which is SIXTEEN passes. Excellent. But then the presenter asks you “Did you spot the gorilla?” About half of the audiences I have seen are rather surprised by this question, but when we replay the video we see that this HUGE GORILLA actually walks onto the court waves at everyone and walks off. It’s not a real Gorilla of

course, it’s someone in a gorilla suit, but the point is over half of us don’t even SEE IT. And there are several other things that happen around the game which we don’t notice either.

The message is, if you are not specifically looking for the gorilla (or fraud for that matter) then you probably won’t see it. When I ask senior management the question “if there was big fraud, then they would expect the auditors to find it?” the almost overwhelming answer is “yes, I would expect my auditors to spot it”. When I ask them if they mean internal or external auditors, then they often reply “any auditors”. Try asking your management the same question.

I believe that there is a simple paradox: We are all much more aware that fraud and corruption happens around us, but we would like to believe that it does not happen to us. So why should anyone bother to look?

Over the past 2 years I have been recording in my notebook some of the very valid reasons why companies prefer not to go out and look for the red flags. Here are my “top seven” reasons:

1. We are so swamped by a “tsunami” of new rules and regulations which we have to comply with, we don’t have time for much else.
2. We have established a hotline or whistle blower line as our detection apparatus.
3. It’s not the job of the internal auditor to go out and detect fraud (even if we know that it happens) – it’s our job to ensure that there are controls to detect fraud. Management are aware of fraud and corruption, we have a code of conduct and have developed procedures. If there were fraud, then management should be detecting it.

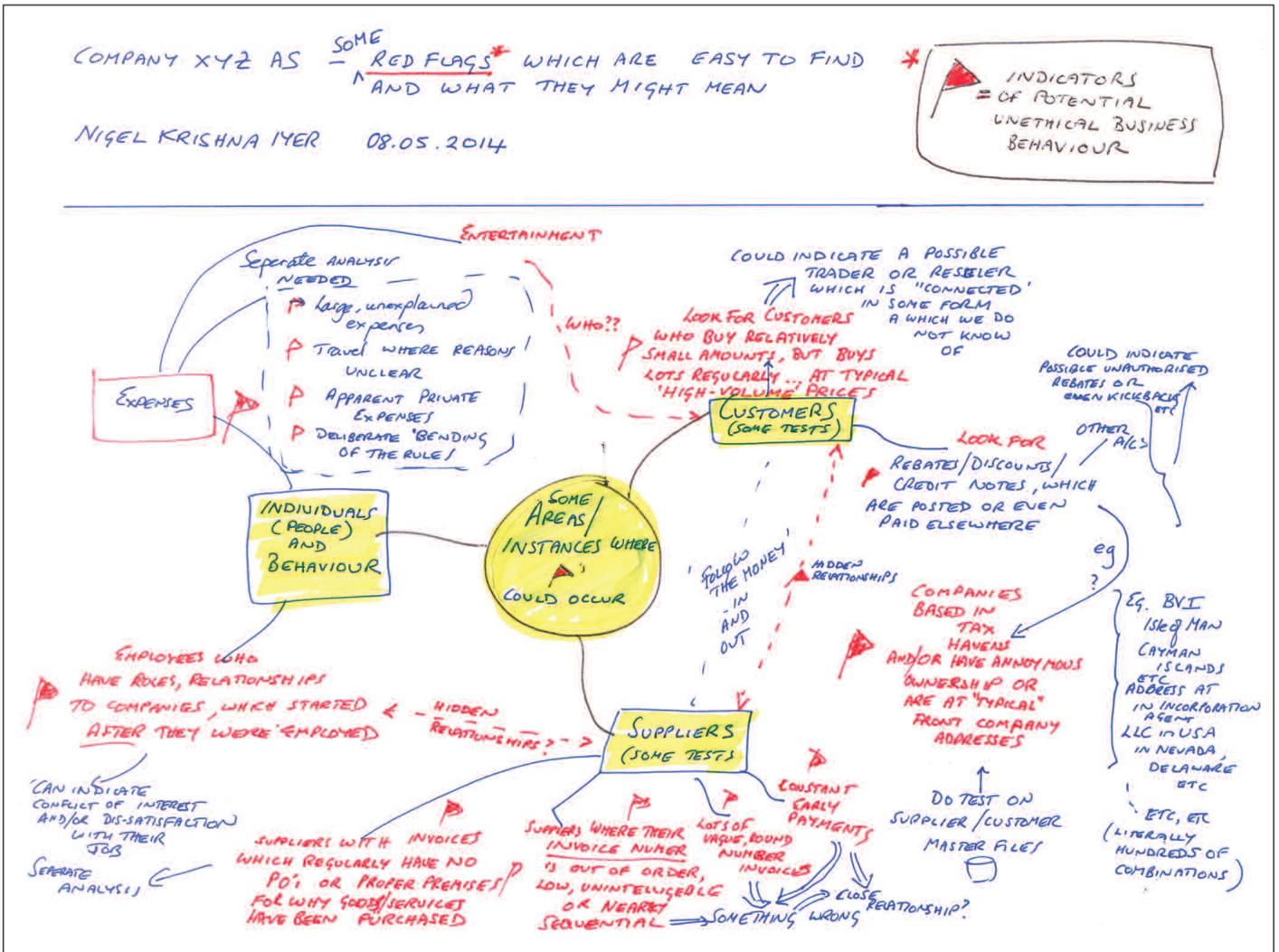
4. It does not feel comfortable going out and detecting fraud – people would see us as if we were the police, or even worse “Sherlock Holmes”.
5. We do not have the skills to look for fraud and corruption, we have tried but we did not find it last time.
6. If we found lots of red flags, we would feel that we were compelled to investigate them- that would just swamp the organisation and cause lots of fuss and disruption.
7. It may, as you say, be easy to find red flags – finding hard evidence is virtually impossible.

Given these valid reasons it’s not difficult to understand why over the past 25 years I feel I have seen an actual decrease in the desire to look for fraud and corruption - it’s just not a job worth taking!

Getting started looking for red flags is, in fact, rather easy. When I start looking for fraud in any organisation, one of the first things I do is to sketch out a picture of where I think the simplest frauds will be and how I could find them. Sometimes just letting your imagination fly is best way. Here is an example of one of these pictures. Please excuse the fact that it’s hand-drawn. Sometimes I like to be a little more free from the constraints of technology.

And while there isn’t an easy answer to the conundrum “since there is probably lots of fraud out there how should we look for the red flags of fraud?”, I think there is a way to get there, one which will both enhance the standing and reputation of Internal Auditors with management and also protect them from being seen as the “bringers of bad news” or worse “the secret police”. But first some common ground rules need to be established.

² https://www.youtube.com/watch?v=IGQmdoK_ZfY



Illustrasjon: Nigel Iyer

- As Internal Auditors we should revisit the topic with management; fraud and corruption happens all the time, and we are not particularly different to other organisations. “Fraud” and “Corruption” should not be seen as scary words!
- Finding the red flags is not about hunting down people and finding offenders; the primary goal is to prevent waste now and significant costs in the future.
- Align expectations: It’s everyone’s job to spot red flags and Internal Audit can help. The process of looking for red flags when no

previous suspicions exist, helps in identifying where policy and internal controls are being undermined so we take action to rectify things. Red flag detection should not be confused with that more frightening and costly word “investigations”.

Whilst the views in this article are my own, shaped by experiences, I think the most important next step is to re-invigorate the debate, both amongst internal auditors (*do we really want to look for fraud?*) and just as importantly with management (*how would you like us to look for the red flags of fraud and corruption?*).

I would take the challenge to management rather than waiting for them to come to you. Doing this will only increase respect for and enhance the reputation of Internal Audit.

“An ounce of prevention is worth a pound of cure”. I think we can all today agree with Benjamin Franklin, one of the founding fathers of the USA’s famous quote about fire prevention. Surely Benjamin did not just equate fire prevention with rules and procedures but also early warning systems like smoke detectors.