

## FIGHTING FRAUD – WHAT WORKS, WHAT DOESN'T?



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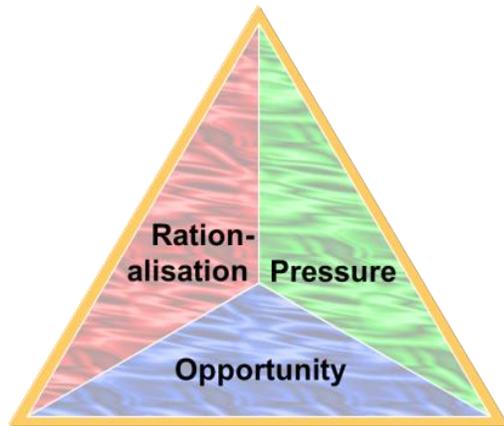


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## Fraud – a Global Problem

As most people in the auditing and accounting fields will know the fraud triangle<sup>i</sup> is a model for explaining the factors that cause someone to commit occupational fraud.



It consists of three components which, together, lead to fraudulent behavior:

1. Perceived un-shareable financial need that the person feels cannot be solved by legitimate means and includes both professional and personal **pressures**.
2. Perceived **opportunity** due to a lack/breakdown of controls or by a person abusing their position of trust.
3. The fraudster **rationalises** or justifies the crime to himself to make it more acceptable.

Some people have tried to 'update' the fraud triangle by saying there are 4 or 5 parts so we ended up with the fraud-diamond<sup>ii</sup>, which added 'capability' and then the fraud pentagon<sup>iii</sup>, which further added 'arrogance'.

What these 'new' models seem to have overlooked is that Donald Cressey, the creator of the fraud triangle, already stated that 'opportunity' comprises two parts:

**General information** (the knowledge that the employee's position of trust could be violated as he perceives a weak control environment) and **Technical Skill** (refers to

the abilities needed to commit the fraud, i.e. capability). Arrogance would logically fit under 'rationalisation' so **the iconic fraud triangle stills endures!**

## What is a Leading Practice Solution?

So, if the fraud triangle is what allows a person to become a fraudster any effective solution must tackle all three parts of the triangle in order to prevent the fraud yet in most organisations only one part seems to be focused on and that is the '**opportunity**' element. If you are wondering why this is so I think the following quote by Joseph Wells, the founder of the ACFE, sums it up:

*"Most accountants think 'internal control' is the answer to fraud, yet companies with adequate controls still have fraud. Controls are important but not the whole answer. Accountants need to understand that fraud prevention and internal control is not the same thing".*

Okay, so now we know that **internal controls** by themselves are **not** enough to fight fraud, so what else does an organisation need?

There are a few frameworks that can be used to prevent and detect fraud but the two most widely known are the COSO Internal Control Cube<sup>iv</sup>...



and the ACFE's Fraud Prevention Check-up<sup>v</sup>...



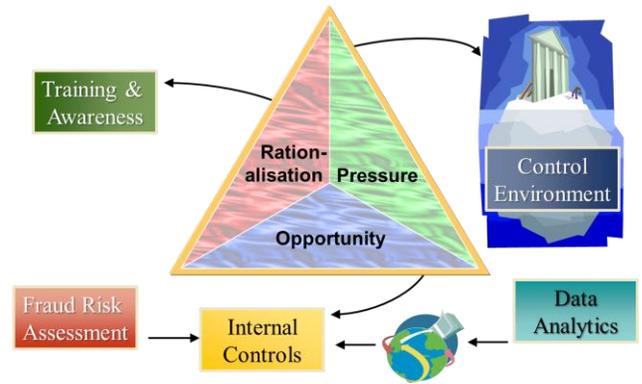
We have stacked the ACFE's Check-up components as a cube so that it resembles the COSO Cube and we also color-coded the ACFE blocks to show how similar the components of both are to each other.

### Mistakes Made by Organisations

**A. The Menu** - As you will see, internal controls are just one element of the total solution and the mistake many organisations make is that they see these elements as **menu items**, and they choose one or two.

These frameworks are an **all or nothing solution** – each element works together with the others to ensure a fraud-resistant organisation.

The following graphic demonstrates how all the elements of the fraud building blocks work together to diffuse the three parts of the fraud triangle:



- The **opportunity** part is tackled by a **fraud risk assessment** being performed on certain high-risk business functions to gauge where the organisation is most at risk to having fraud, i.e. where the **Internal controls** are missing, weak or could be overridden. From experience we know that the fraud risk assessment report tends to not be taken seriously by management as the point of the exercise is not to find fraud but to determine where the organisation is most at risk, hence we perform **data analytics** at the same time and if management poo-poo the results of the risk assessment we then produce the data analytics report that shows actual anomalies and this tends to get management's attention.
- The **Rationalisation** part is tackled by **fraud training and awareness**. Many staff members unwittingly allow frauds to be committed or don't recognise the red flags of fraud because they are ignorant.
- The **Pressure** part is tackled by the **control environment**, which comprises the tone at the top, code of ethics, hiring, policies, hotline and accountability.

**B. Hard & Soft Controls** - Another mistake is that the focus tends to be on the **hard controls** only, as organisations tend to have a compliance mind-set where they tick boxes in terms of the various elements being **in place** but they don't go further to

ask whether all staff members **are aware** of their responsibilities and whether the elements are **achieving their aim**. For example, most organisations have a code of ethics and a hotline but employees may not understand the code or they may fear victimization if they blow the whistle. They should therefore also be focusing on the **soft controls** (culture, values, etc.) as these are the foundations of the hard controls.

**C. Internal Audit & Forensic departments are stretched** - Most organisations have now realised they cannot rely on their external auditors to detect fraud, due to audit deficiencies,<sup>vi</sup> so they rightly depend on their internal audit and/or forensic audit departments to detect, investigate and advise management how to best prevent fraud.

Many of these departments, however, are under-resourced and they end up being reactive instead of proactive. This then begs the question, what is the ideal resource model?

The following graphic demonstrates the four options with differing levels of control and costs.



- **Doing nothing** should not be an option! Fraud is pervasive and occurs in every organisation in the world, yes even in churches!
- **In-sourcing** provides the most control but is also the most costly. Having an in-house forensic function makes sense for the large corporates

and financial services organisations but even here they will often co-source for certain key skills like digital forensics.

- **Out-sourcing** provides less control and can still be costly.
- **Co-sourcing** is usually done for one of two reasons: to fill gaps or to build a function. Co-sourcing provides enough control at a reduced cost.

**D. Change Tactics** – Antonio is growing an avocado tree at home and it's growing very well. You know the scenario, take the avo pit, pierce it with toothpicks and then place it on a glass with water covering the bottom of the pit.

Antonio's son saw this and challenged his dad – he was going to also grow an avo pit and its growth would overtake his father's plant.



All avocado pits have a 'bottom' (from where the roots will grow), and a 'top' (from which the sprout will grow). The slightly pointier end is the top, and the flat end is the bottom.

In order to get the pit to sprout, you will need to place the bottom root end in water, so it's very important to figure out which end is the

'top' and which is the 'bottom' before you go piercing it with toothpicks.

Antonio's son had his upside-down so it's not going to grow! **He's applied the correct methodology but in the wrong way.**

We can apply this same analogy to organisations that do implement all the elements, but they can still fail as they have the right **strategy** but not the right **tactics**.

The strategy is the big picture – all components have been implemented but the tactics have become stale and predictable or they have been implemented incorrectly.

Many organisations have not changed the way they do these things yet the criminals keep changing their modus operandi.

As a result, organisations can end up with a compliance mindset where they tick all the boxes but the methodology has not been optimally applied.

Organisations therefore need to become unpredictable and think smarter. Remember, this is a war where the criminals want your money or assets and each month brings new battles!

### How Can Organisations Think and Act Smarter?

Keep in mind that the traditional 'consultant' mind-set is to sell the client more & more...



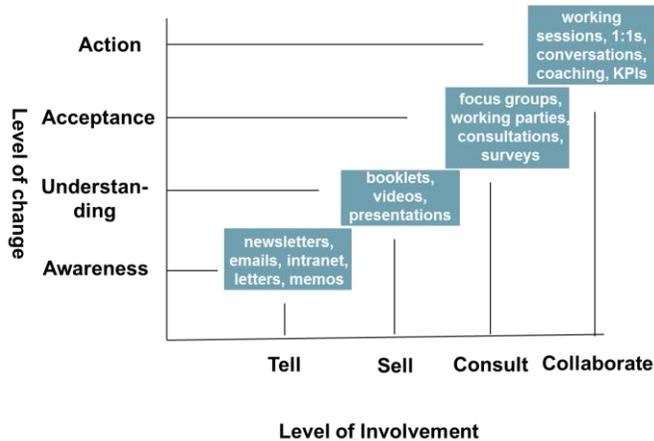
...so try and co-source in order to find a consultant who offers to:

- ◎ **Transfer Skills** – why should you hire consultants year after year to perform the same tasks when the consultant can perform the work with the employee in year-1 and thereby transfer the necessary skills to your employee?
- ◎ **Automate elements** – Another goal should be to automate functions, such as data analytics. You hire the consultant once and we write the scripts and then the software runs automatically and provides daily anomalies. This eliminates the need for consultants or an employee to run the data analysis function.
- ◎ **Combine elements** – as Aristotle said, **“The whole is greater than the sum of its parts.”** When elements are combined the perceived value is so much greater. For example, we combine surveys with fraud awareness training so that management receive a report showing the transfer of knowledge and highlighting potential hot-spots in the business – no longer is the value just a signed attendance register!

### How Should You Co-source?

Many organisations simply hire consultants on an **ad-hoc project basis** and when the consultant is done there is no continuity and the project is found to have very little long-term benefit.

Let's take the example of fraud awareness training and the following graphic<sup>vii</sup>...



Many organisations start with sending out a newsletter (**telling**) but they realise that staff members may not read it or may not understand it, so the next logical step is to hire a consultant to deliver an awareness course (**selling**) with videos and case studies.

Research<sup>viii</sup>, however, has shown that after two weeks we remember **10%** of what we read, **20%** of what we hear, **30%** of what we see and **50%** of what we hear and see and as time marches on, the retention percentages keep dropping.

Most organisations leave training at these first two stages and they wonder why they don't see changes.

They need to move to the next level and start **consulting** with employees and that's why we have combined surveys with our awareness training - to bridge the gap and hopefully start dialogue between employees and management so that there is acceptance.

And then finally the last step is **collaboration** where employees and managers are working as a team to fight fraud and ensure an effective control environment.

**The problem is that when we leave most clients, we are walking away at the second stage and there is no one internally who carries the telling and selling to the next stage.** This means that

the fraud / ethics awareness training will be effective for just a week or two instead of for the next year or two!

Some organisations have seen this need and we have signed **6-month to 24-month co-sourcing contracts** with them, or become a **temporary employee**, which means the client owns us for a few days each month for the specified time period and our job is to ensure that the training has worked and that employees are implementing what they learned.

We become the monitoring and quality-control parts of the program to ensure **long-term success**.

Every organization wants a **return on their investment** and what better way to achieve this than to co-source with specialists who will ensure that the program, be it training, computer forensics, investigations or data analytics, is working and that there is a transfer of skills.

## Conclusion

According to the ACFE, most organisations are suffering losses from fraud, estimated to be in the region of **5%** of annual turnovers.

Current anti-fraud strategies seem to **not** be working so organisations need to rethink their old ways and do things differently.

Recent studies<sup>ix</sup> and our own experience, suggest that co-sourcing is a superior alternative to in-house or outsourcing arrangements.

An anti-fraud program that is designed, implemented and monitored by co-sourced specialists can significantly reduce the chance of fraud occurring and remaining undetected within an organization.

Co-sourcing can be a **win-win** situation for organisations because they can benefit from all these advantages of co-sourcing...

*“I have used the services of Exactech for the past 7 years and initially hired them on an ad-hoc basis but in 2013 I decided to co-source with them and we signed individual contracts that have been renewed right up until this year.*

*This gives me access to wider pool of staff members who introduce knowledge and specialisms from other sectors. The management of the supplier remains with me without all the potential staff headaches, and I can still change suppliers whenever I need to.*

*Both Mario and Antonio are specialists in their fields so I can choose which resource I need when, depending on whether my team has the necessary skills or if I have an urgent project but no staff availability.*

*Another major benefit for me has been the fact that they transfer skills to my team and the quality of their work has enhanced the reputation of the Internal Audit department.”*

- Chief Audit Executive, Parastatal

The key is to co-source with **specific individuals** otherwise you stand the risk of getting people who don't know your organization and who may not be as skilled.

## Reference Sources

<sup>i</sup> <http://www.acfe.com/fraud-triangle.aspx>

<sup>ii</sup> <http://www.nysscpa.org/cpajournal/2004/1204/essentials/p38.htm>

<sup>iii</sup> [http://www.drillie.com/a620/Article/fraud\\_pentagon.pdf](http://www.drillie.com/a620/Article/fraud_pentagon.pdf)

<sup>iv</sup> <http://www.coso.org/ic.htm>

<sup>v</sup> <http://www.acfe.com/fraud-prevention-checkup.aspx>

<sup>vi</sup> [http://www.thecaq.org/docs/press-release-attachments/caq\\_deficienciesmay2013.pdf?sfvrsn=2](http://www.thecaq.org/docs/press-release-attachments/caq_deficienciesmay2013.pdf?sfvrsn=2)

<sup>vii</sup> Communicating Vision & Values, Allman Communications

<sup>viii</sup> Edgar Dale, Audio-Visual Methods in Teaching (1969)

<sup>ix</sup> Co-sourcing and External Auditors' Reliance on the Internal Audit Function, IIA Research Foundation

## About Exactech

Exactech Pty Ltd was formed in 2007 and specialises in Digital Forensics and Fraud Prevention, Detection & Investigation.

Exactech provides services to private & public sector clients from across the globe, with a strong focus on the African continent.

To Find out How Exactech can help Your Organization Combat Fraud, Contact Us as follows:

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