Good compliance not only directly reduces corporate exposure to enforcement actions but also underpins value.

Throughout history, trading entities have been targeted for all types of corrupt behaviour and fraud. In today’s world, one of the greatest risks to businesses may be a lack of awareness of their exposure to fraud and corruption. But how do companies identify where their greatest exposure lies and assess the magnitude of this risk? Taking a close look at the numbers and underlying detail is a good place to start. As companies expand, either organically or through acquisition, there are increasing data and jurisdictional challenges, with multiple operating systems and massive electronic data volumes in multiple jurisdictions the new norm.

The current economic and regulatory enforcement climate is putting corporates in a difficult position, with pressure to reduce costs and enhance corporate governance. Share price is impacted both directly in response to regulatory enforcement action and where corporate governance failings are observed during compliance audits. However, not only does this directly reduce corporate exposure to enforcement actions (fines, legal costs, reputational damage etc) but also underpins value (access to and cost of capital), and should therefore more than pay for itself – although this is not always an easy sell. Companies that have already been through the enforcement wringer

Nevertheless, corporate resources are finite and a risk-based empirical approach is really the only way to go. This allows a business to focus its efforts on activities likely to expose it to the greatest risk of corruption and fraud. Many companies are now operating in countries in the new emerging markets with high corruption risks, and corporate investments are entrusted to local management and partners so central oversight is difficult.

Why would you need to test?

Fraud and corruption testing provides the factual context for legal analysis. Right across the varied landscape of economic crime from bribery and corruption to investor and market fraud; money laundering; anti-trust violations; sanctions breaches and procurement fraud, we, as forensic accountants, look for evidence in the financial and transactional data in order to determine what really happened.

Dechert partner Neil Gerrard observes: “Companies find themselves in a difficult position as to how to determine whether a fraud or corruption is taking place. In large company this could be several million pounds. Financial exigency is a dangerous condition. Policy-wise, implementation and testing amounts to little more than a check-box exercise. In the absence of testing, how can management provide any assurance to stakeholders and regulators that it has robust procedures and controls in place which will help prevent and detect fraud, bribery and corruption? Testing is involved in the transaction through each stage and confirming, where possible, entries against third-party data sources. Just because an email authorises payment does not mean a payment was actually made. Journal entries can be reversed, intercompany charges can obfuscate the audit trail, payments can be diverted, tender processes interfered with and so on. Third-party confirmation of data is essential, as is understanding the physical processes and stages within a transaction’s life. Only then can potential abuses be flagged – multiple systems often lead to gaps in the audit trail and windows for manual interventions.”

Norton Rose partner Sam Eastwood comments: “Companies that have water-tight paper policies and porous operational controls set themselves up for the worst kind of failure. Management needs to ensure that effective compliance controls are in place at an operational level and that management information, based on detailed risk-based transaction testing, flows up to the top. This is the only way to ensure accountability and ownership where management fails to open the audit conduct and prompt remediation when required. Simply put, a compliance program that doesn’t throw up red flags isn’t a compliance program.”

One of the challenges is non-uniformity of systems and data. Many companies have disparate systems (often following acquisitions) that may never know whether regional operations are running two sets of accounts, off balance-sheet or using vendors who overcharge for goods and services or are providing no services at all.

Who should undertake the testing?

It is important that fraud and corruption testing is performed by experienced internal or external forensic professionals, and be of sufficient credibility. The appointment of independent third parties with appropriate experience and expertise is essential.

Fraud and corruption reviews are very different to statutory financial audits, which are driven by financial equality and standards. A statutory audit may categorise a start-up operation in Turkmenistan as “out of audit scope” due to low asset values and revenue. However, from a fraud and corruption perspective this would obviously be near the top of the table based both on the country risk and on early stage interactions with government officials.

We adopt a risk-based, combined ‘top-down’ and ‘bottom-up’ approach to fraud and corruption reviews.

- Top-down: considers general industry and country-specific risks and involves key management. The risk assessment then tails the testing to each company, region and industry.
- Bottom-up: focuses on the transactional detail and is critical to understanding the key business risk and accounting areas that are often used to record or disguise improper payments. It is likewise important for testing to incorporate in-country reviews and physical sightings of assets.

The bottom-up approach uses data analytics to flag up both individual anomalies and abnormal trends in transactions. We conduct data interpretation and judgemental sampling, followed by accounting and financial document review, support by forensic and legal advice. The financial and operational staff to determine whether the documented controls are, in practice, being adhered to. Without boots on the ground, the head office may never know whether regional operations are running two sets of accounts, off balance-sheet or using vendors who overcharge for goods and services or are providing no services at all.

What do we test?

Our focus is on fraud and corruption risk, and in recent months there has been an enormous focus on anti-corruption compliance, particularly in respect of ‘adequate procedures’ in the context of the UK Bribery Act. Processes and controls designed to prevent and detect bribery and corruption are largely the same as those which would prevent many other types of fraud.

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