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Fraud risk increases in difficult economies

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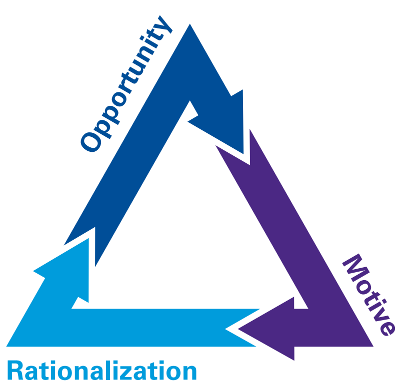
In difficult times, there is usually increased pressure on organizations to conserve through the close management of costs. Whether a company reduces its headcount, rationalizes processes and controls, cuts back on internal audits or restructures some of its businesses these decisions can have significant consequences for the organization. At the same time, there are greater incentives for employees, suppliers, customers, agents and others to commit fraud during recessions and other periods of economic distress.

The Fraud Triangle, developed by criminologist Donald R. Cressey in the 1950's, illustrates how financial pressure leads to increased fraud risk:



Each leg of the Fraud Triangle represents a condition which, when happening together, allows fraud to occur:

Motive

Motivation is a key driver to committing fraud. An individual or group of individuals within an organization must have motive to commit fraud, which is generally caused by financial pressure or a real or perceived need. Motivators can include personal gain, financial difficulty, personal reputation, or business targets. Companies will experience both external and internal factors that provide motives for fraud.

KPMG's 2013 Global Profile of the Fraudster survey analyzed the fraudsters KPMG professionals had investigated between 2011 and 2013. Our fraud investigators were given 14 potential motivations for fraud and could choose as many as they believed to have been a factor in each case. Out of 1,082 specific responses, 614 (57 percent) responses indicated that the fraud motives were greed, financial gain or financial difficulty.[2] In KPMG's 2016 Global Profile of the Fraudster survey, 66 percent of reported frauds were motivated by personal financial gain or greed.[3] This indicates that the need for a company's vigilance and focus on controls should not be slackened but enhanced during economic declines due to increased motives for fraud.

External pressures that can motivate fraudulent conduct include:

- Pressure from analysts and investors to meet expectations or maintain financial results
- Meeting debt covenants, liquidity and financing requirements
- Meeting or exceeding competitors' performance

These external pressures increase in an economic downturn, and will increase the risk of fraud connected with accounting misstatements. Fraudulent financial reporting attempts to bolster a company's position by exaggerating or painting an incorrect picture of its financial results and position.

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[1] The assistance of Allison McAuley, Staff Accountant, KPMG LLP, in the preparation of this article is acknowledged.

[2] http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/Documents/global-profiles-of-the-fraudster-web.pdf

[3] https://assets.kpmg.com/content/dam/kpmg/pdf/2016/05/profiles-of-the-fraudster.pdf

Opportunity

Opportunity is the second key component of the Fraud Triangle and it relates to the existence of circumstances that create possibilities for fraud. Opportunities occur when internal control deficiencies exist which can be exploited, when processes or management oversight procedures are weak, and when there is a low perceived risk of being caught.

KPMG's 2016 global fraud survey indicated that weak internal controls were a factor in 61 percent of the frauds reported. However, fraud is not always due to lack of controls. Our global fraud survey indicated that 21 percent of fraudsters simply were able to disregard the company's controls and 16 percent of fraudsters colluded to evade controls.

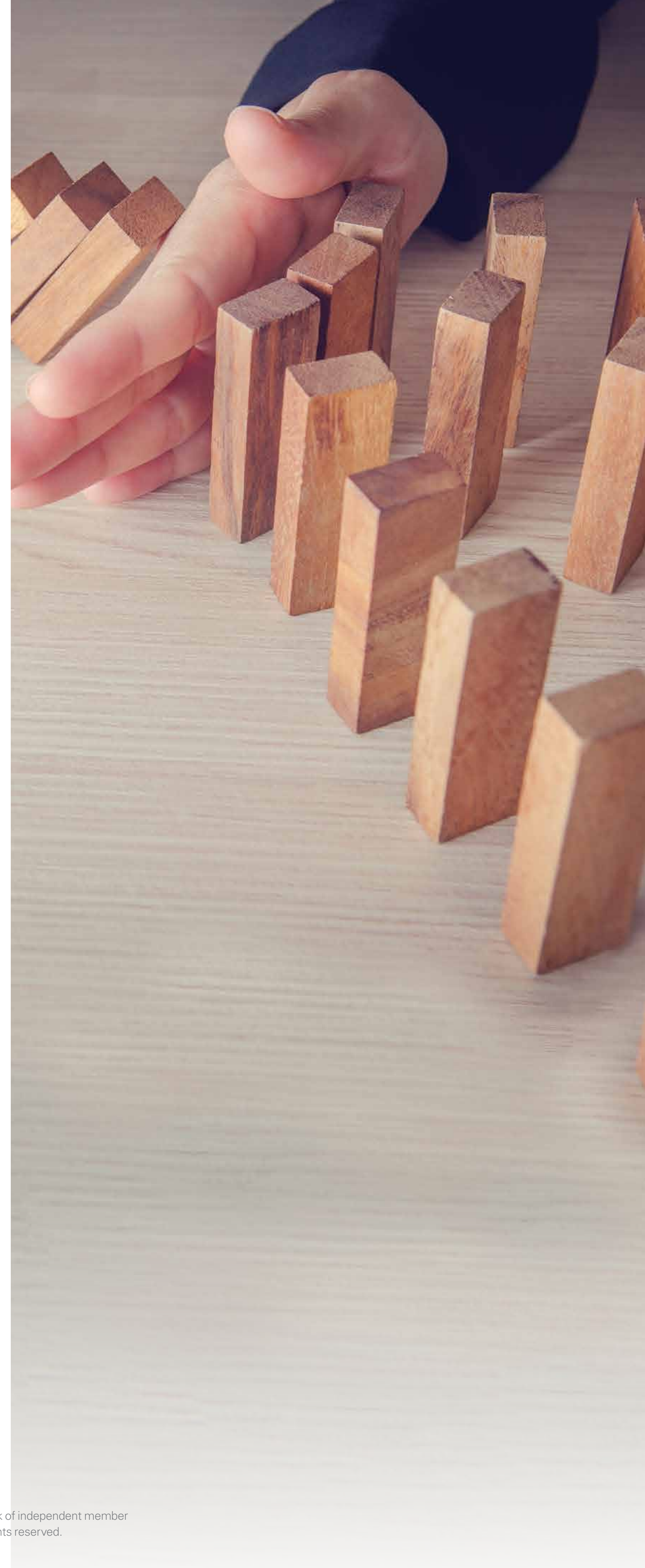
Individuals have a greater opportunity to commit fraud when companies reduce the number of staff who had been performing important control functions. Restructuring is another factor that will impact controls and processes, often weakening or eliminating important controls. As a result, individuals may find opportunities to exploit controls and harm the company through fraud.

Rationalization

The final component of the Fraud Triangle, Rationalization, relates to motivation and refers to the reasons behind a person's actions. Our experience suggests that criminals will be able to provide a rationale for their actions.

In a difficult economic environment, individuals may believe that improper conduct and actions are justified. For example, pay freezes or cuts can be viewed as justifying some scheme to recover "lost" remuneration. Or protecting the value of one's stock options might, for some, be an acceptable rationalization for financial statement manipulations.

Many of the largest frauds in history have been a result of fraudulent financial reporting, some of which has been rationalized with the belief that the modified results will be reversed in the future when the economy recovers. Being able to rationalize unlawful actions enables individuals to avoid the feeling of guilt and allows them to believe they are maintaining an ethical code and are justified in their actions.



What should be done to reduce the risk of fraud in hard times?

Managing the risk of fraud and other misconduct should be an area of focus for every company, especially when there is an economic downturn. Companies should review their commitment to preventative controls including their code of conduct and detective controls such as their whistleblower line, proactive data monitoring, management oversight and the review of period end journal entries. When companies have been forced to reduce staff to mitigate the impact of the economy, and some of those staff performed important control functions, mitigating controls should be put in place.

Other preventative measures can include:

- Supervising and watching for changes in employee behaviour
- Implementing a strong Employee Support Program
- Minimizing pressures on employees

In order to achieve the highest level of integrity and mitigate the risk of fraud, companies should ensure that their fraud risk assessment program is up to date and adjusted for any increased risk faced due to economic pressures. Companies' fraud risk assessment programs should:

- Prioritize efforts in areas where fraud is most likely to occur and where the monetary impact resulting from fraud is high
- Establish and manage a secure, efficient and impartial reporting channel for whistleblowing
- Manage the cost of risk, litigation, investigations, and regulatory enforcement action

Summary

Changes in personal circumstances or pressures to meet demanding business targets may motivate misconduct within an organization. Meanwhile, opportunities for misconduct can be created as a result of these changes. It is seen frequently that organizations do not put enough focus on fraud prevention by setting up appropriate controls. However, it is crucial to ensure proper controls and/or tighten existing controls in order to mitigate the risk of fraud within the organization during difficult economic times.

There is no way to completely eliminate the risk of fraud. What drives a person to commit such illicit behaviour is "motive", which is difficult for companies to control. However, "opportunity" can certainly be reduced. In Dr. Cressey's Fraud Triangle theory, it is implied that weakening one or more of the essential components contributing to the risk of fraud reduces overall risk. Thus, companies need to address fraud risks by ensuring the appropriate preventive and detective controls are present, and that they are being properly monitored.

The following is a cautionary tale of the how actions spurred by a tough economy coupled with financial need and weakened controls can lead to fraud and substantial financial losses.

The tale of Peter the loans officer

Peter, a loans officer at a small credit union, knew he and his partner were facing a financial problem. His partner operated a high end gift store in a small tourist town. That store had been successful, thanks in large part to strong traffic in the summer months from American visitors. Peter and his partner agreed only a year before to move the store to a larger premises to take advantage of that success. The new store was three times larger, and in a location with better visibility and traffic. Of course, the cost of operating the new store was increased greatly. Unfortunately, they did not foresee the large reduction in cross-border visits by American tourists that occurred after increased border restrictions and a financial downturn. The increased costs, combined with the slowdown of traffic and sales, resulted quickly in monthly losses. With few savings to fall back on, Peter faced a financial crisis.

But by coincidence, Peter's manager at the credit union had recently retired. To save some costs, the president of the credit union decided not to replace the loans manager. He reasoned that he could oversee the loan portfolio and the new loan activities. Peter soon realized that the review of proposed new loans was not being done by the president. The president was too busy. Since Peter was an experienced and trusted employee, the president thought he did not need such close supervision.

Peter, seeing an opportunity to access some badly-needed cash, began to prepare false loan documents, and make loans to fictitious companies. Those false loans were funneled to his own bank account, and then to the store. Peter expected that once the tourists came back, the store would be profitable and the false loans could be repaid. Unfortunately, that did not happen before an accounting clerk at the credit union stumbled on to the scheme, and blew the whistle on Peter.

After the scheme was investigated, Peter was jailed for his fraudulent activities, and his partner's store was forced to close.

This unfortunate story was allowed to happen because:

- Financial pressure was felt by Peter because of an unexpected economic downturn
- Peter's employer allowed an important internal control to lapse in an attempt to reduce costs
- There was no other mitigating control to deter Peter from making false loans

KPMG Forensic

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KPMG Forensic helps organizations in their efforts to achieve the highest level of integrity and to manage the cost and risk of litigation, investigations, and regulatory enforcement actions by assisting with the prevention, detection and response to fraud, waste, abuse and other forms of misconduct; the avoidance and resolution of disputes; and the collection, discovery and analysis of electronically stored information.

KPMG Forensic (Canada) has offices and qualified forensic professionals throughout Canada, with major offices located in Halifax, Montréal, Ottawa, the Greater Toronto Area, Southwestern Ontario, Calgary and Vancouver.

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