Understanding Fraud and Corruption and Fraud Triangle

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Structure of the presentation

• Categories of Fraud and Corruption

• Factors influencing Fraud and Corruption

• Selected Case studies
"Just as it is impossible not to taste the honey or the poison that finds itself at the tip of the tongue, so it is impossible for a government servant not to eat up at least a bit of the King’s revenue".

- Kautilya in ‘Arthashastra’
Kautilya’s ‘Arthashastra’

440 ways of embezzlement of government money.
Our objectives

• Categories and types of Fraud and Corruption
• Common Modus operandi of fraud
• Why people commit fraud? Factors influencing fraud & corruption
• Case Study
Let’s solve these FAQs...

• What do you mean by ‘Fraud’?
• What is corruption?
• What is an error?
• Who are the parties involved in:
  • Fraud
  • Corruption
• What are the factors that influence people to commit fraud?
CATEGORIES OF FRAUD and Common Modus Operandi
Broad Categories of Frauds

• Occupational Frauds
• Corporate Frauds
• Cyber Frauds
• Economic Crimes
Why do people commit frauds?
FACTORS OF FRAUD TRIANGLE

Opportunity

Rationalization

Pressure
The Fraud Triangle: Pressures

The most common pressures are:

- Financial
  - Not being able to pay one’s debts, nor admit it to one’s employer, family, or friends
  - Credit cards
  - Business reversals
- Emotional
  - Fear of loss of status
  - Physical isolation
  - Difficulties in employer-employee relations
  - Divorce, extramarital affairs, problems with children
- Lifestyle
  - Status gaining
  - Drug/alcohol addiction
  - Gambling
The Fraud Triangle – Pressure

- Pressure can be real or imagined
  - Financial debts
    - Health care
  - Family problems
The Fraud Triangle: Opportunity

• Common opportunities that enable fraud:
  • Lack of internal controls
  • Failure to enforce controls
  • Excessive trust in key employees
  • Incompetent supervisory personnel
  • Inattention to details
  • Inadequate staff
The Fraud Triangle: Opportunity

• Internal controls that may be lacking or un-enforced include:
  • Authorization procedures
  • Clear lines of authority
  • Adequate supervision
  • Adequate documents and records
  • A system to safeguard assets
  • Independent checks on performance
  • Separation of duties
The Fraud Triangle: Rationalization

- Allows perpetrators to justify their illegal behavior
- The only way they can commit their frauds and maintain their self image as principled individuals is to create rationalizations.
The Fraud Triangle – Rationalization

• Employees, vendor, others justify fraud:
  • “They owe me” or “I earned it”
  • “I need it more than they do”
  • “It’s only fair”
  • “God will forgive me”

• Rationalization is a form of denial. The person is not accepting reality.

• Rationalization is the hardest area for management to influence or control.
Fraud Diamond-A Different Way to Think About Fraud Risks

THE FRAUD DIAMOND

Incentive

Opportunity

Rationalization

Capability

- **Incentive:** I want to, or have a need to, commit fraud.
- **Opportunity:** There is a weakness in the system that the right person could exploit. Fraud is possible.
- **Rationalization:** I have convinced myself that this fraudulent behavior is worth the risks.
- **Capability:** I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.
Fraud Recognition

• Auditors are not required to legally determine that a fraud has or has not occurred but to recognize the essential constituents of fraud during audit.
Tackling Fraud – Be Proactive

“IT IS BETTER TO DRAIN THE SWAMPS THAN TO FIGHT THE ALLIGATORS”
Modus operandi of fraud and factors influencing fraud
Modus Operandi of frauds

• Misappropriation of cash or embezzlement of cash
• Receipts side of cash book

resh
omitting to enter cash received
under-recording of cash
recording lower amount on counterfoils than actual receipt
fictitious payment
over-recording of actual payment
Modus Operandi of frauds (Contd.)

Payments side
• False charging of personal expenses
• Double payments against single transaction
• Inclusion of dummy workers in wage bill
• False credit to various personal accounts for withdrawal later
Modus Operandi of frauds (Contd.)

- Other forms of embezzlement
  - Teaming & leading
  - Depositing funds at one branch by using inter-branch account settlement process and withdrawing funds from a different branch.
  - Using correction entries to embezzle money from accounts, transferring funds from other accounts to make up shortages
  - Citing-withdrawals against cheques that have not been collected
  - Lapping-stealing of cash from accounts receivable
Modus Operandi offrauds (Contd.)

Mis-appropriation of goods & services

- Omitting to enter goods received
- Recording less quantity than received
- Recording excess issue than actually issued
- Procurement of low quality goods
- Hiring services at high cost
Modus Operandi of frauds (Contd.)

• Manipulation of accounts
  ▪ Under valuation of stock
  ▪ Over valuation of stock
  ▪ Fictitious purchase
  ▪ Wrong allocation of revenue and capital exp.
  ▪ Recording next year’s revenue as income for current period as income for current period
  ▪ Overstatement of profit or understatement of profit
  ▪ Over or under invoicing
Fraud & corruption may co-exist in certain ways...

- Conflict of interest situation
- Non existent company whose invoice is presented by an official involved in purchase process
- Excess purchases with a view to divert for personal use
- Split purchases to evade competitive bidding in exchange of favours
- Extortion
- Nepotism
- Tax or duty evasion through false representation involving negligence of Govt. official
# Occupational Frauds

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<tr>
<th>No.</th>
<th>Category</th>
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<tbody>
<tr>
<td>1.</td>
<td>Misappropriation of cash or embezzlement of cash</td>
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<td>2.</td>
<td>Misappropriation of stock/store</td>
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<td>3.</td>
<td>Misappropriation of receipts</td>
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<td>4.</td>
<td><strong>Document alteration</strong></td>
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<td>5.</td>
<td><strong>Drawing</strong> duplicate bills</td>
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Frauds in Government Sector: Magnitude, Implications and Anti-Fraud framework
• A study was conducted to:
  
i) determine the magnitude and the trend of losses suffered by the victim departments,

  ii) determine the profiles of the victim organisations and their control weaknesses that facilitated frauds,

  iii) determine the profiles of the fraudsters that perpetrated the frauds and methodology followed by them, and

  iv) assess the action taken by the victim organisations.
Source of data

• This study is based on audit paras reported in the State Civil Audit Reports of the Comptroller and Auditor General of India for the years 2002-03 to 2006-07, covering all the States and Union Territories involving 23 departments of various State Governments

• The results are based on the scrutiny of 106 audit paras on frauds reported during these years
Summary of findings

• Almost every State in the country suffered frauds. The total reported loss suffered by various States worked to over Rs. 203 crores in five years. In about 86% of the cases, frauds involved losses at least Rs. 1 crore.

• Bihar stood first amongst the State that had suffered maximum loss i.e., both in terms of the frequency of occurrence as well as the quantum of loss.

• Bihar is followed by Kerala and Manipur in terms of the frequency of fraud occurrence.

• Bihar, Assam, Nagaland Madhya Pradesh and Chhattisgarh were the top five States that accounted for nearly 79% of the total frauds reported.
State-wise number of cases:

- West Bengal: 3
- Uttarakhand: 1
- UP: 6
- Tripura: 1
- Tamil Nadu: 1
- Sikkim: 2
- Rajasthan: 1
- Punjab: 0
- Pondicherry: 4
- Orissa: 2
- Nagaland: 2
- Mizoram: 0
- Meghalaya: 1
- Manipur: 10
- Maharashtra: 10
- M.P.: 5
- Kerala: 3
- Karnataka: 4
- Jharkhand: 6
- J & K: 3
- Himachal Pradesh: 1
- Haryana: 2
- Gujarat: 2
- Delhi: 1
- Chhattisgarh: 4
- Bihar: 20
METHODS USED TO COMMIT FRAUDS

There is usually an underlying reason why people commit frauds. Every fraud is an outcome of combination of three factors viz., pressure (to perform better, unrealistic deadlines, maintain high profits etc..), opportunity (poor internal controls), and rationalisation (developing a justification for wrong actions) which is commonly known as 'Fraud Triangle'. Capability (programming/ hacking/ cracking skills), could be a fourth factor, particularly relevant in case of technology related frauds.
Cases divided into three main categories

1. Cases involving loss of revenue
2. Cases involving fraudulent disbursement of cash (expenditure)
3. Cases involving fraudulent disbursement of cash and revenue loss.

Methods commonly noted in all the above categories were classified under the following sub-categories.

- Forgery
- Forgery & Misappropriation of cash
- Forgery & Misappropriation of store
- Misappropriation of cash
- Misappropriation of stores
Comparison of control weaknesses

Where is the weakness?

- Prescribed checks not exercised: 61.32%
- Management failure to review: 33.96%
- Absence of Internal Controls: 4.72%
Fraudsters responsible for the fraud

Source of trouble?

- Insider: 87.74%
- Outsider: 10.38%
- Collusion: 1.89%
Auditing Standards- consideration of fraud

• AAS 4 requires:
• Auditors to adopt professional skepticism
• Active engagement with team members regarding fraud risk
• Evaluation of internal controls to address fraud risk
• Circumstances indicative of risk of material mis-statement
• Necessity of disclosure in case of significant fraud
• Responsibility to inform, if required, law enforcement agencies
SAI India: Standards & ASOSAI guidelines

• ASOSAI: “while determining materiality levels, SAI should be more responsive to risk arising from fraud and corruption”
• Basic Postulate-3.2-C&AG’s Auditing Standards
• SAI India should comply with INTOSAI auditing standards in all matters deemed material
• SAI India-Auditor to exercise own judgment, depending on circumstances, in determining procedures
  • Implies auditor will perform enhanced audit procedures in case of suspected fraud
Responsibility for disclosure

• **ASOSAI**
  - *Responsibility of audit to ensure that management has addressed risk of fraud and corruption*

• **SAI India**
  - *Emphasises consistent application of accounting standards for expression of fair opinion on financial results of audited entity*(4.6)
  - *Advises Govt. on acceptable accounting standards for financial reporting & disclosure*(4.5)
Responsibility for controls

- **ASOSAI**
  - *SAI to pro-actively report to mgt to improve control environment to minimize fraud and corruption*

- **SAI India**
  - *Auditor is responsible for submitting proposals and recommendations to improve inadequate controls or to institute these. (4.7)*
Factors that reduce probability of Fraud

• Preventive Measures
  • Strong Internal Controls
    • Policies/procedures
    • Segregation of duties
    • Control Self Assessment
  • Computer access controls
    • Input, process and output controls
    • Access controls (system security)
Built-in controls to prevent attempts of fraud *(A Management responsibility)*

- Accounts Codes (Public Works/Forest)
- Treasuries Rules.
- Applicable laws, rules and regulations
- Legislative Acts
- Audit trail is visible indicating the line of command and the accountability for various decision taken.
Red Flags

• Red flags are fraud indicators

• See the hand outs showing sample red flags and anti-fraud measures prepared by RTI, Nagpur in case of:
  • Auditing Public works
  • Auditing Accounts Payable Process
Red Flags & Anti-Fraud Measures in Public Works

A Research Paper

Indian Audit & Accounts Department
Regional Training Institute
26/1, Civil Lines, Nagpur
“A nation can be corruption free only when its states are corruption free, a state can be corruption free only if its districts are corruption free, a district can be corruption free only if its Panchayats are corruption free, a Panchayat can be corruption free only if the people are corruption free, people can be corruption free only if they have imbibed the value system from their childhood.”

- Dr. APJ Abdul Kalam, Former President of India
Thank you.

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Fraud:

- wrongful or criminal deception intended to result in financial or personal gain
- Fraud is a type of criminal activity, defined as: 'abuse of position, or false representation, or prejudicing someone's rights for personal gain'. Put simply, fraud is an act of deception intended for personal gain or to cause a loss to another party.
- A false representation of a matter of fact—whether by words or by conduct, by false or misleading allegations, or by concealment of what should have been disclosed

Corruption:

- dishonest or fraudulent conduct by those in power, typically involving bribery
- the process by which something, typically a word or expression, is changed from its original use or meaning to one that is regarded as erroneous or debased.
- Corruption is the misuse of public power (by elected politician or appointed civil servant) for private gain.
- Corruption is the abuse of public resources to enrich or give unfair advantage to individuals, their family or their friends.

Error:

- a mistake.
- the state or condition of being wrong in conduct or judgment.
- An act, assertion, or belief that unintentionally deviates from what is correct, right, or true.
Illustrative fraud and corruption in contracting for goods and services

Bribery and Kickbacks: Money or any other form of reward is exchanged between a public functionary and a provider of goods and services in order to obtain some benefit e.g., acceptance of substandard goods or obtaining unauthorised information.

Changes in Original Contracts: Changes are made in the original contract requiring flow of additional funds from the government to the contractor or supplier, which may affect the basis on which the contract was awarded to the contractor or supplier in the first instance. This may also involve front-loading of contract in the hope of increasing the price of the original contract through change orders or subsequent modifications to the contract.

Duplicate Payments: The contractor or supplier claims and receives payment for the same service or work done or goods supplied under the same or different contracts.

Collusive or Cartel Bidding: Contractors or suppliers form cartels to fix artificially high prices for goods and services supplied by them.

Conflict of Interest: Contracts are awarded on the basis of vested interests of the decision makers.

Defective Pricing: The contractor or supplier submits inflated invoices.

False Invoices: The contractor or supplier submits invoices for goods that have not been delivered or do not properly represent the quantity or quality of goods and services supplied or work done as per contracted specifications.

False Representations: The contractor falsifies the goods specifications or his ability to provide certain services.
Splitting of Purchases: The purchases of goods and services are split either to avoid open competition or having to seek the approval of the higher authority.

Phantom Contractor: Purchases are made from a fake supplier or contractor.

Pilferage of Public Assets: Public funds are used to acquire goods for personal use or public assets pilfered by officials.

Tailored Specifications: Specifications and time limits are manipulated to favour a certain contractor or supplier.

Supply Orders: in excess of, or without establishment the requirement/need and much ahead of the actual requirement.