

# The Anatomy of Fraud and Corruption

## Organizational Causes and Remedies

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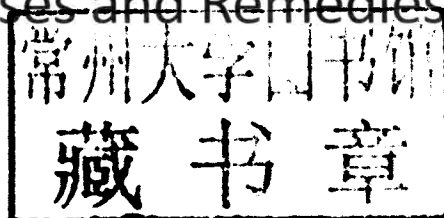
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**TOMAS BRYTTING**  
**RICHARD MINOGUE**  
**VERONICA MORINO**

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GOWER

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# The Anatomy of Fraud and Corruption

# About the Authors

## **Tomas Brytting**

Tomas Brytting is Associate Professor, DBA at the Stockholm School of Economics. He is presently Director of Research at the Institute for Organizational and Worklife Ethics at Ersta Sköndal University College in Sweden. Tomas Brytting has been lecturing, writing and giving advice on business ethics issues for more than 20 years. In Sweden he regularly appears as media commentator on business ethics and has published almost 200 texts on the subject.

## **Richard Minogue**

Richard Minogue BSc, CPA, CIA graduated from the Business School of the University of Notre Dame, Notre Dame, Indiana where he specialized in accounting. He has worked for 35 years in internal auditing, financial management and fraud risk management; performing investigation, litigation support and awareness training assignments in dozens of countries and on six continents. He holds the William S. Smith Certificate of Excellence awarded by the Institute of Internal Auditors. Richard Minogue currently works as a consultant for fraud prevention, detection and investigation.

## **Veronica Morino**

Veronica Morino has a BA in Sociology of Work and a Masters Degree in Organisational Science from the University of Rome. After initially helping organizations address dysfunctional issues, she broadened her expertise in the area of inappropriate and illegal behaviour. She worked as investigator into international fraud and corruption for some years and became increasingly convinced that prevention is far more cost-effective than investigation. In the last five years she has specialized in the development of successful anti-fraud and corruption programmes for global companies.

# Reviews of *The Anatomy of Fraud and Corruption*

*In choosing to explore the Anatomy of Fraud and Corruption, this book gets 'into the veins and tests the blood', ensuring that 'the heart' of the organization is working properly. It provides an excellent insight on how to perform 'remedial surgery' on relevant processes where required, and is a useful reference tool for any investigator, irrespective of experience.*

Simon Scales, Director Global Investigations, TNT Express

*A highly instructive and readable mix of psychological, sociological and first-hand practical insight into how fraudsters disrupt and damage organisations, the authors proceed to offer a clear route to effective prevention, which makes highly innovative use of dramatic narrative. If the aim is truly to raise awareness of the fraud and corruption threat amongst staff, this is definitely the book to read.*

Timon Molloy, Editor of *Fraud Intelligence*

*The most captivating and original textbook I have read about fraud and corruption. Drawing upon a range of non-traditional disciplines such as literature, conflict resolution and psychology, the book is not only enlightening but also entertaining. I look forward to putting the ideas into practice.*

Pall A. Davidsson, Director and founder of Ethikos,  
the Icelandic Centre for CSR

# Preface

We are all touched by fraud and corruption. The goods we buy are dearer, the environment is dirtier and our pensions are smaller as a result. The world is poorer. There are undoubtedly some winners, at least as measured in financial terms, but their winnings are small compared to the total losses. Fraud and corruption are the enemies of productivity. Fraud and corruption could be described as highly wasteful processes whereby benefits are transferred away from people who deserve them to others who don't. They violate our idea of justice and thereby also contribute to businesses' often undeserved reputation of being thoroughly cynical. In spite of the importance of the problem, business schools and management continuing education programmes have until very recently largely ignored fraud and corruption as risk areas that might be managed. Certainly most managers working today never received formal training to help them adequately deal with these problems on a practical level. Experienced practitioners seldom find the time to think about how their experience could be used for training others in how to recognize patterns and signs of fraudulent practices. The ambition of this book is to help fill this void.

Most of the world's wealth is controlled by organizations, each made up of people; owners, directors, managers and other employees working in a coordinated manner towards their respective common goals. Organizations (or you could say, its stakeholders) are often victimized by fraud. Similarly, organizations are often involved in serious corruption, for example paying bribes in order to obtain business or accepting bribes in exchange for favouring particular contractors or suppliers. Directors, managers and employees are responsible for protecting the organization against fraud and avoiding corruption, but at the same time directors, managers and ordinary employees are often (but not always) involved as perpetrators or accomplices. The fox is guarding the chicken coop. This is the inherent dichotomy of management fraud.

In this book, we will be mainly concerned with fraud and corruption in the organizational perspective. We will discuss how to prevent or reduce it. From the studies that have been done, it appears that despite massive efforts in the area of internal control, little or no progress has been made in managing these risks. There is of course a measurement problem; you can't measure what you

haven't detected yet. Any real reduction in fraud and corruption would only be apparent after a delay of some years. But there is no evidence to indicate that the disease has been cured yet. Fraud and corruption seem to be impervious to control efforts. Are we lacking something in our approach?

We suspect so. Certainly organizations should continue to improve their checks and balances, their internal controls, to make it more difficult to conduct unauthorized transactions. But much more effort is required to educate employees, including managers, so that they will understand the risks, be able to competently solve the dilemmas, recognize the danger signs and abstain from the temptations themselves. That is not to say we can make dishonest people honest, probably we cannot. But we can ensure that the people guarding our chickens are enlightened, that they are aware of the risks and conscious of what is appropriate and what is not. We need to motivate our managers and employees, and cultivate a culture that is both resistant and resilient to fraud and corruption. An organization equipped with effective internal controls *and* a majority of motivated and risk-aware employees will be much more able to resist fraud attempts by the intractable minority. The organization that has also prepared itself for the eventuality of fraud and corruption incidents will be more resilient, able to absorb the shock and bounce back when incidents do occur.

The concepts of the control environment, tone at the top, soft controls and so forth are not new. But we believe that the need to develop a control environment that is both resistant and resilient to fraud and corruption is not well understood. We wish to contribute with this book to a better understanding, both theoretical and practical, of this concept. On the theoretical side, much has been written about why people commit fraud or break the rules in general. We will build on this work with an examination of the organizational, as opposed to the individual, psychology. What are the structural and cultural elements in an organization that are likely to enable fraud? How can we recognize them? How can we change them?

On the practical side, approaches for raising fraud awareness within organizations have begun to appear, although the total awareness effort is dwarfed by efforts spent on developing and maintaining internal controls and on performing fraud investigations. In many organizations the entire fraud awareness programme is limited to a warning paragraph in the code of conduct posted on a rarely visited internal web site.

As authors, we have worked from both ends, the theoretical and the practical, and attempted to bridge the gap in between. The need is there. Universities and



schools have not been able to provide students with the practical knowledge and tools they will eventually need to fight fraud. Managers, also lacking this know-how, find themselves reacting to fraud rather than preventing it. We found that a theoretical study of fraud in the organizational perspective has provided valuable insight into why some of the practical methods we have already tried work, while others do not. We believe that applying the methods we describe to increase resistance and resilience will lead to a significant reduction in the frequency and severity of incidents and major cost savings for the organizations that adopt them. The theoretical content is to be found mainly in Part I, where the main text was written by Tomas Brytting and the more practical applications in Part II of this book, written mainly by Richard Minogue and Veronica Morino. The two parts of the book were written in close consultation between the authors. Then, as we each learned from the others, we together refined our theories and developed our practical guidelines into what we hope is a coherent whole.

We have included, by way of example, six fraud narratives based on real cases of fraud or other kinds of dishonest conduct. The narratives themselves are fictional and were written specifically for this book (a very special thanks goes to Nigel Iyer who so generously offered to give them both literary forms and qualities). The names and other facts have been changed, but the stories reflect the essence of what actually occurred. We refer to these stories throughout the book and compare them to our theory.

We refer often to 'fraud and corruption' together, although they are two distinct activities. Traditionally they are also treated as separate problems. Perhaps it is because fraud is seen as a business problem, while corruption is seen as a political one. Stock exchange regulators and internal auditors are concerned with fraud, while the United Nations, the Organisation for Economic Co-operation and Development (OECD) and Transparency International are concerned with corruption. This separation ignores the fact that the private sector is the major source of corrupt payments to high-level public officials. We have chosen to treat fraud and corruption together and interchangeably, because in the organizational perspective that we are examining, they share many similar characteristics, and they can be addressed with the same methods. For the sake of simplicity, we do not concern ourselves with legal distinctions between fraud and theft, embezzlement, misappropriation, corruption, extortion, money laundering, larceny, wilful neglect, gross negligence and so forth. Our intention is to examine misbehaviour at a general level.

We also gratefully thank Nous Design, who prepared all of the diagrams and pictures for this book, as well as Erik Blennberger, Jorgen Hansen and Robert Minogue for their valuable advice, comments and corrections. Finally we would like to thank our editor at Gower, and all those who contributed with their help and support.

# The Issue

*...it is necessary to know well how to disguise this (hypocritical) characteristic, and to be a great pretender and dissembler; and men are so simple, and so subject to present necessities, that he who seeks to deceive will always find someone who will allow himself to be deceived.*

*(Machiavelli, 1532/2004)*

Niccoló Machiavelli (1469–1527) thought he knew all about power, and gave the managerial wannabe a piece of good advice: trust no one because no one trusts you. Cheat if you can because others will cheat on you! Some say he showed future managers the road to success. But at the same time, and maybe unintentionally, he also revealed to the rest of us several profound insights into the logics and dynamics of fraud and corruption. It is a bit disappointing though that we still haven't learnt this lesson of his. Half a millennium later (Machiavelli wrote his book in 1513) we seem to lack enough awareness and knowledge to protect ourselves from fraudulent characters. The statistics are indeed uncomfortable.

The Association of Certified Fraud Examiners (ACFE, 2008) in the US reports that fraud and corruption, one way or the other, is touching practically every organization:

*Participants in our survey estimated that U.S. organizations lose 7% of their annual revenues to fraud. Applied to the projected 2008 United States Gross Domestic Product, this 7% figure translates to **approximately \$994 billion in fraud losses.** [Emphasis in original]*

PricewaterhouseCoopers (2007) reported that 43 per cent of all corporations – worldwide – have had experience of 'significant' fraud. On average, these companies lost 1.2 million USD per year plus costs for taking care of the problems once discovered.

Adding to the problem is the fact that fraud and corruption most often is a hidden form of crime. According to ACFE, almost 70 per cent of the fraud cases in private companies were detected by accident, or through some form of tip.

Thus, it seems that regular internal control systems are highly inadequate to combat fraud and corruption.

Treating fraud and corruption as a form of crime has certain implications. First and foremost, the main focus is on the perpetrators. Who are they? How is the scam set up? How do we collect evidence? How can we secure and regain the money that was stolen? Fraud and corruption becomes an issue of criminal investigation.

Our main focus is not to support fraud investigators. Hopefully they will find this book useful, but primarily this book has three other target groups. Firstly 'Bystanders'; you who witness, suspect or feel what is going on, we think you are the key people when it comes to detecting fraud and corruption. Unfortunately, you might also be fraudsters *in spe* if you don't watch out for warnings signs. Our aim is to increase your awareness of the risks and your knowledge to deal with them. Secondly, 'Designers of Organizations'; both organizational culture and structure are crucial ingredients in the complex process that eventually leads to fraud and corruption. Our ambition is to make you understand how corruptive organizational processes work so that you can ensure your organization is resistant to fraud and corruption. Finally, 'Trainers'; you who need to train employees to be more aware and to recognize the warning signs in order to put fraud and corruption under control. We supply ideas and tools for you.

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