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WHY DIDN'T WE KNOW ABOUT THIS?

HOW TO GET A GRIP ON PRESSURE RELATED FRAUD

ANJA VAN ECK | VU UNIVERSITY AMSTERDAM | 23 OCTOBER 2018

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INCREASED ATTENTION FOR RISK AND FRAUD IN SUPERVISORY BOARDS

Introduction

Supervisory Board Members are expected to see the icebergs coming, but they operate at a distance from the shop floor and barely feel the pulse of the organization. And they have only a limited dashboard of KPIs available to them to ask the right questions. How can Board Members prevent calamity before it is too late or very costly to fix?

This whitepaper explores how our thinking about risk management has evolved over the years, the changing role of the supervisory board, and how to deal with the fact that many potential problems don't surface because people don't speak up. We use the fraud triangle to explore different aspects of fraudulent behavior and misconduct, and highlight emerging possibilities in the field of Artificial Intelligence to identify pressure points in the organization.

1. How our thinking developed

Half a century ago, insider trading was common practice. Nowadays it is considered a criminal offence.

25 years ago, setting the market and price agreements between competitors was commonplace. These days, we regard this as unethical and a sign of a corrupt market. Bribery scandals and cases of fraud constitute a growing part of corporate news in leading newspapers and magazines.

Legal and ethical conduct is increasingly important, among other things because of the high penalties that have been ruled for corruption and fraud cases in the US and the UK, next to a growing awareness of what is ethical conduct and what isn't, combined with new codes and regulations, and personal liability of company directors. Digital transformation has been a catalyst for these developments, because it has boosted possibilities for fraud and created transparency that ruins company and personal reputations overnight.

Larger organizations have instituted compliance departments, next to their legal, audit and risk management departments. Regulators are now busier than ever.

The question is whether the new codes, regulations and compliance teams will be able to effectively curb non-compliant behavior. Henk Broeders, chairman of the Dutch branch of the International Chamber of Commerce believes that we will reach a point of 'no corruption' in the future¹. Others think that the proliferation of regulations will actually induce misconduct, because offenders will find ever more

creative ways to bend the rules and tracing these new swindles will only become more difficult². According to Sylvie Bleker³, professor Compliance and Integrity Management at the VU school of Business and Economics, complying to the rules is essential to avoid chaos, but, compliance is behavior. Bleker is inspired by Charles Darwin, in particular his book "The descent of man". Darwin makes clear how people operate in groups and why they live up to the rules, or not.

The stakes of fraud and bribery are high. A 2018 study shows that the annual financial loss caused by company fraud amounts to an average of more than 5% of the operating income⁴. And the direct costs is one thing, but nearly as important is the damage of reputation, which is often felt for a long time⁵.

2. The role of the Supervisory Board

Due to this growing awareness, integrity management is nowadays high on the agenda of many executive and non-executive boards. But as research shows, not even 10% of the problems a company faces, reaches the board. More than 90% of companies' problems are not visible to people at the top.

Sidney Yoshida, a prominent Japanese consultant, published his research about the 'iceberg of ignorance' and illustrated this with the following facts:

- 4% of the problems are known to top management
- 9% of issues are known to middle management

¹ Interview Forum, december 2017

² Bijv. Fred Teven en Andrew Fastow die zich op de dag van de fraudeonderzoeker, 26 april 2018, op een dergelijk manier uitlieten.

³ Prof. S.C. Bleker-van Eyk, inaugural speech june 25th 2015, VU University Amsterdam

⁴ ACFE, Report to the Nations 2018

⁵ Reputation damage includes the time and money an organization spends managing the issue, any fines resulting from the fraud and a possible reduction of labor morale.

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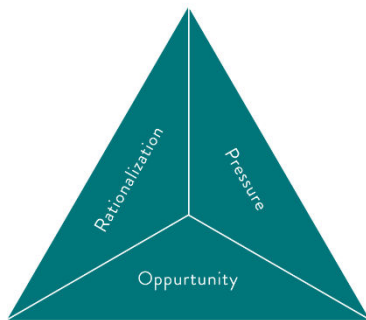
- 74% of issues are known to supervisors
- 100% of issues are known to employees.⁶

Time and again, it has been demonstrated that (potential) problems never reach the top, even when it is clear that they should. Employees often don't speak their minds to their superiors or their voices never reach the very top. This prompts research in an entirely new field: that of 'the unsaid'⁷.

The primary question in this whitepaper is: What happens if employees do not speak up or do not dare to speak up? What kind of problems does a Board face when this happens, and how can they best deal with it? Is there an enhanced risk of fraud?

The Fraud Triangle

In 1953, Donald R. Cressy introduced the Fraud Triangle⁸ which is still the predominant basis of scientific and forensic research on fraud. The Fraud Triangle focuses on fraudulent behavior by members of an organization and consists of three elements that may change regular human behavior into fraudulent behavior: opportunity, pressure and rationalization. According to Cressy, these elements can be used to explain and predict employee behavior on fraud and risk.



- Opportunity is about circumstances that enable unethical or questionable behavior, whether or not these circumstances are in balance with the necessary degree of flexibility and autonomy needed.

- Rationalization generates explanations or excuses that are used to justify misconduct. Typical explanations are "everyone did it", "if I wouldn't have done it, someone else would have", "this was the first time" or simply "I didn't know I was doing something wrong".
- Pressure: More often than not, misconduct happens when employees feel pressure. Employees are asked, or feel forced, to do something they wouldn't otherwise do. Pressure can be caused by personal problems like debts, expensive hobbies or an addiction.

The Fraud Triangle has differentiated into models like the Fire Triangle, the Compromise Triangle (both Albrecht)⁹ and the Integrity Triangle (Bleker)¹⁰.

1. Opportunity

In order to reduce the risk of fraud, the vast majority of organizations currently focus on reducing opportunity. By implementing strict processes and procedures, installing the proper organizational checks and balances along five lines of defense in managing risk (see insert), and by providing safety nets such as:

- A code of conduct that is recognized and adhered to in the organization;
- A registration point and speak-up procedure, as part of a whistleblower policy;
- Trusted mediators that can lower barriers for employees to speak their minds.

Most anti-fraud measures that are developed nowadays focus on reducing opportunity, which requires a change in processes. This is easier than intervening in rationalization and pressure. Because these factors are about changing behavior. But this should not lead to a situation where concern over fraud and misconduct tips the scale towards merely developing, filling out and monitoring checklists and dashboards. All three sides of the triangle are important and they deserve equal management attention.

⁶ Quality Management Symposium, Sydney Yoshida research, 1989

⁷ <https://www.linkedin.com/pulse/researching-unsaid-boards-marilieke-engbers/>

⁸ D.R. Cressy, *Other People's Money*, New York: The Free Press 1953

⁹ Albrecht & Albrecht 2009, pp 19-44

¹⁰ Prof. S.C. Bleker-van Eyk, *Handbook of Compliance & Integrity Management*, pp. 23-28

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Five Lines of Defense in risk management

5LoD is a method to check whether an organization is 'in control'. It is part of the COSO Internal Control – Integrated Framework (www.coso.org). It ensures a board that risks are on the radar and under control. The five lines of defense are:

1. First line: Business management. is responsible for identifying and mitigating risk
2. Second line: Teams and departments who advise and support line management, should monitor whether management is taking its responsibility. Risk and Compliance are important in this regard, but also Finance, Legal and HR.
3. Third line: Internal audit departments render independent and objective judgment over the quality of direction and control.
4. Fourth line: External accountant. Most important assignment is to review the annual account and if this is in line with financial rules and regulations.
5. Fifth line: Supervisory Board. Responsible for good governance and overseeing the executive board on behalf of the stockholders.

2. Rationalization

Rationalization of unethical behavior is more prevalent in organizations where people don't take time to reflect and where management does not create room and opportunity to discuss the effect of everyone's behavior. More and more organizations create space to challenge current thinking, often in the form of awareness training, e-learning, or workshops.

However, these initiatives are not enough, because there are more structural, fundamental aspects to rationalization than just lack of clarity on norms, or the individual's inclination to make excuses for conscious misconduct. There are usually more deeply rooted behavioral patterns in place that cause people to lose their moral compass.

In this regard, Kenneth E. Goodpaster¹¹ talks about teleopathy: the unbalanced pursuit of purpose in either individuals or organizations. In addition to fixation on one superordinate goal (that trumps all other considerations and values) and a certain degree of emotional detachment, he saw rationalization of decisions and behavior that is otherwise not acceptable as one of the principal symptoms of teleopathy: "We all have a tendency to reduce the number of aspects taken into consideration when taking a decision. In extreme cases, all but one 'privileged feature' will be suppressed. Often, loyalty is such a privileged feature." (E.g. "the boss wants this").

Senior management is best positioned to administer the medicine that Goodpaster prescribes: install a sense of perspective, pointing out that the goal that we set for ourselves and our organizations is part of a larger mission, the common good; ensure that the hearts and minds are engaged with this larger mission; and seek frequent interaction and practice in telling the truth, especially when exaggeration or denial appear attractive.

This kind of frankness comes to live in organizations where senior leadership encourages constructive cultural criticism rather than blind allegiance. The best opportunities for these good conversations are at the pressure points in the organization, at "moments that matter".

3. Pressure

Everyone is sensitive to pressure. But the degree to which varies greatly from individual to individual. Companies should know their individual employees well. They should know who may have financial issues, who is prone to addiction, etc. Most employers have support programs in place or are smart about (temporarily) placing these persons in the least sensitive areas, in order to prevent these issues from developing into disaster.

But also less vulnerable employees are sensitive to pressure. Many don't feel secure enough to speak up when they really should, for a variety of reasons: afraid of losing their job, to

¹¹ Kenneth E. Goodpaster, Ethics or Excellence? Conscience as a Check on the Unbalanced Pursuit of Organizational Goals, p.4, march/April 2004, the Workplace

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be singled out for possible ridicule by peers and managers, and in general because of a lack of trust in management.

Fear of speaking up increases at pressure points: teams, projects and points in time where stress is abundant and the stakes are high, e.g.:

- Departments engaged in mission-critical activities;
- Teams working on strategic projects, key accounts or deals involving large amounts of money;
- Employees who are working for a longer or shorter period in a different cultural environment.

Organizations should know where pressure points are on a continuous basis. But the Iceberg theory says that supervisory boards often don't know where pressure points are.

Fortunately, cutting edge Artificial Intelligence and machine learning technology is becoming available to help organizations to identify pressures points, anomalies and risk patterns. For example by analyzing natural language as a proxy for human behavior. A typical challenge to this technology is its impact on individual employee privacy. But current legislation (e.g. the European GDPR) has defined clear principles to safeguard this. Another factor driving adoption is the daily use of this technology by management, rather than it being exclusively relevant to specialized

reconnaissance professionals or surveillance and fraud detection experts.

One of these tools is the KeenCorp Index. KeenCorp's software analyses daily digital communication between people. It recognizes tension and patterns in written text, producing a single, scientific metric. It is predictive and a leading indicator highly correlated with business performance and risk. The KeenCorp algorithm collects data in real-time for many different groups in the organization. Individuals are clustered by department, location, years of service or any other meaningful 'split'. This provides a precise and actionable insight into where future issues may occur.

KeenCorp's proof of concept on the e-mail corpus of 150 top executives in Enron, identified a problem over a year before major business indicators and stock price showed decline (see graph).



Conclusion

Many organizations are already active in risk management and fraud prevention but predominantly in the areas of reducing opportunity and creating awareness of ethical norms. In addition to that, Supervisory Boards should ensure that they themselves and senior leadership engage in candid conversation about (potential) issues. Only in that way they can demonstrate that people are really being listened to, that people can speak their minds without fear of retaliation, that the organization is able to admit mistakes and reverse misguided decisions. And that 'doing the right thing' is more important than short term profit. These conversations preferably take place at 'moments that matter', where pressure is highest and risk of misconduct is greatest. To know when to engage in conversation with whom, is of crucial importance. The KeenCorp Index is a 'canary in the mine', that points senior leaders in the right direction and helps them close the fraud triangle.

