



Mitigating the Risk of Fraud During a Financial Crisis

Unprecedented. Surreal. Nightmare.

This is some of the terminology emerging from the current situation that our planet is facing, as a result of the COVID-19 pandemic.

The ‘new normal’ remote work environment, social distancing and the like has forced us to change the way we communicate and conduct business—to the extent organizations are able to do so. In certain industries, particularly those that are customer-facing or dependent on human contact, companies are increasingly forced to confront the inevitable decision about employment continuity for their staff.

Regardless of where on the spectrum your organization – or your clients’ organizations – find themselves today, during economic downturns, companies seek ways to cut back overhead, just to stay afloat; this could impact the system of internal controls, designed to keep the company operating efficiently and free of fraudulent activity.

The Challenges Impacting Internal Controls During Economic Crises

One of the basic internal controls in any organization is segregation of duties, whereby a function is divided up between two or more individuals in order to add a level of control. This could include ‘signs-offs’ by multiple individuals, in order to carry out transactions.

In the current environment in which large numbers are operating remotely, organizations are invariably facing challenges to find the appropriate balance between staying operational and managing risks.

Moreover, during challenging economic times and/or periods when resources have been cut back, the formalized processes and procedures designed to mitigate fraud tend to become less formal, less consistent, and/or and less supervised.

Two of the areas that rely on strong processes and internal controls to function effectively are payroll and purchasing.

Payroll

The employee onboarding process for many organizations involves having human resources setting up the new employee, while payroll generates the payment to that new employee; ideally, neither HR nor payroll can perform both functions, thereby mitigating the risk that a 'ghost' or fictitious employee can be set up on the payroll—that is, before consideration of collusion.

Notwithstanding these and other controls in place, some of the 'red flags' that organizations should be looking out for in the current economic environment as potential signs of **payroll fraud**, include:

- Changes in employee bank account information (*when no known changes have occurred during a particular period*)
- Duplicate information in the payroll register (*names, addresses, bank account details, etc.*)
- New employees added to the payroll (*during a period when there are no known new hires*)
- Increases to the rate of pay (*during a period when there are no changes to rate of pay*)
- Excess hours booked (*when it is known that no overtime is occurring*)

Purchasing / Procurement of Goods & Services

Another area that tends to challenge organizations, whether during difficult economic times or otherwise, is the company's purchasing function. Arguably, setting up a new (albeit fictitious) vendor and paying them is a common risk of fraud in any organization.

Most larger organizations require a formal, multi-step process to set up a new vendor, which can include preparation of forms, background due diligence and/or approvals. Therefore, it would follow that the risk of a fictitious vendor being created and paid, tends to increase during periods of economic crisis, particularly when companies reduce their resources.

In order to balance controls with efficiency, some organizations enable 'one-time' vendors and 'sole-source' vendors to address emergency situations that cannot follow the normal procurement rules, such as obtaining multiple quotes for the procurement of goods/services.

Some of the '**red flags**' that organizations should be looking out for in the current economic environment as potential signs of **purchasing** or **procurement fraud** include:

- New vendors set up in the vendor master file (*when there are existing 'approved' vendors with a history of providing those goods/services*)
- Exceptional number of 'one-time' purchases or payments (*particularly to vendors who have previously not provided services to the organization*)
- New vendors who are set up in the vendor master file without documentation (*particularly where there is no evidence of background due diligence performed*)
- Possible patterns of payments made to certain vendors (*particularly those that are suspiciously at or below the signing authority of certain employees*)
- Disproportionate number of purchase transactions attributed to individuals who historically have not made many purchases (*particularly around month-end, quarter-end, and/or year-end*)

Mitigating Fraud – Some Practical Strategies

While resources are constrained and we continue to operate in a lean work environment, it is commonly viewed that prevention—rather than detection—is the best deterrent against fraud. Therefore, organizations should try to add, rather than reduce, internal control measures to mitigate the risk of fraud.

Some **practical strategies** that could help reduce the risk of fraud and/or increase fraud detection during periods of economic downturn include:

- Clear and consistent communication – improving communication and awareness about fraud is a key element of any effective fraud management program. With many operating in ‘modified’ and/or remote work environments, reminding employees of existing or updated policies is crucial to keeping fraud risk top-of-mind
- Conducting ‘spot audits’—preferably performed by persons not responsible for carrying out those functions
- Rotating duties within a department – ensuring that different people within a department perform different functions, which increases the likelihood of detecting potential illicit activity (while discouraging would-be fraudsters)
- Putting in place additional—rather than reduced—measures, when adding employees or vendors
- Modifying existing procedures to adapt to the new circumstance

Visit contact us (<https://nagel-forensics.com/contact-us/>) to obtain more information about fraud risk mitigation in the current environment or to discuss any other matters with us.

Stay healthy.

Thank you to the frontline teams who are working tirelessly.

Edward, Avi, Cameron & Jonathan