The Role of the Human Resource Department in Fraud Prevention

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Summary:

The objective of this article is to provide arguments in support of the thesis that the Human Resource Department plays a key role in fraud prevention. To achieve this objective this article has the following layout. First, the article presents statistics that expose the increase of fraud in companies and the losses that they bring. Second, the article makes an analysis of the definitions of fraud and types of fraud. Third, the article presents specific cases that expose the shortcomings in the work of the Human Resource Department that create conditions for fraud. Fourth, drawing on examples and statistical information about the most common frauds in companies, the article proposes three roles of the Human Resource Department with regard to fraud prevention. These are the roles of an “architect”, “observer and analyst” and “distributor of knowledge”. The role of an “architect” involves the introduction of rules and procedures in the Human Resource Department, related to internal controls to prevent the creation of an environment that fosters fraud. The role of an “observer and analyst” is connected with establishing a system for monitoring and analyzing changes in employee behavior and the relationships between staff members. The role of a “knowledge distributor” involves carrying out training for employees and managers regarding the organization’s policy on fraud prevention. Fifth, the article offers conclusions and recommendations pertaining to the roles of the Human Resource Department in fraud prevention.

Key words: fraud, insider behavior**,** roles of the Human Resource Department in fraud prevention, red flags.

JEL: M4, M5

1. Statistics

In 2011 a company named Kroll, in collaboration with the Economic Intelligence Unit, conducted an annual Global Fraud Survey. The respondents were 1,265 senior executives from around the world working in a broad range of industries and functions. One of the conclusions of Kroll’s Global Fraud Survey was that the majority of frauds ware committed by insiders. To be precise, 60% of frauds were committed by senior managers, junior employees or third party agents or intermediaries.

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Another interesting study was conducted by ACFE (Association of Certified Fraud Examiners) titled Report to the Nations on occupational fraud and abuse. The data presented in this report was based on 1,388 cases of occupational fraud. This case was reported by the Certified Fraud Examiners, which conducted the investigation into the offenses. The survey participants estimated that the typical organization loses 5% of its revenues because of fraud each year. According to the research, most commonly victimized were the banking and financial services, government and public administration, and manufacturing sectors. This research presented another interesting fact which shows that 77% of all cases of fraud that were analyzed in the study had been committed by individuals working in six departments: accounting operations, sales, executive/upper management, customer service and purchasing. Furthermore, most occupational fraudsters were with clean employment records. Two other facts that deserve attention are that the longer a perpetrator has worked for an organization, the higher fraud losses tend to be and perpetrators at higher levels of authority tend to cause much larger losses. Last, but not least this research shows us that in 81% of the cases, the fraudster displayed one or more behavioral red flags that are often associated with fraudulent conduct.

Based on the facts presented, several conclusions could be drawn:

- Fraud brings about not only financial losses, but also damage to the reputation of the organization.
- Fraud is committed by people who have a clean employment record, that is by honest people who subsequently become dishonest.
- Fraud is committed by people who know very well the lapses in the company's security system.
- Fraudsters exhibited deviant behavior, to which no one paid attention.

2. Definitions

There is no universal definition of fraud, but there are some definitions that deserve attention.

According to the criminal law, fraud is an act punishable by law, which is usually considered an evil act.

The IIA's IPPF (2009, p.1) defines fraud as: "… any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage."

According to the International Audit Standards, fraud is an intentional act of one or more members of management, individuals in charge of governance, employees or third parties, including deception to obtain an unjust or illegal advantage.

According to CIMA (2008, p. 7), "The term 'fraud' commonly includes activities such as theft, corruption, conspiracy, embezzlement, money laundering, bribery and extortion. The legal definition varies from country to country, and it is only since the introduction of the Fraud Act in 2006 that there has been a legal definition of fraud in England and Wales. Fraud essentially involves using deception to dishonestly make a personal gain for oneself and/or create a loss for another."

Another interesting definition describes occupational fraud. This definition is presented by the Association of the Certified Examiners of Fraud (2012, p.6). According to the definition, occupational fraud is "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets".

The analysis of the definitions of fraud gives grounds to draw the following conclusions:

First. Fraud is a criminal offense.

Second. Fraud is an intentional and premeditated action.

Third. Fraud can be committed by senior management and the employees in the organization.

Fourth. Deception is not always related to embezzlement of property and/or funds. Fraud can give the perpetrators illegal and unfair advantage.

Fifth. Fraud may not always lead to a direct benefit for the perpetrator.

Sixth. Fraud can therefore be categorized as either internal or external. Internal fraud is the one committed by an employee. External fraud is committed by outsiders such as suppliers. Mixed fraud could be added to these two categories. Mixed fraud is committed by internal staff in collaboration with an external person or contractor. For example, an employee could conspire with suppliers to provide invoices with inflated prices.

3. Shortcomings in the Human Resource Department performance that create conditions for fraud

The most common weaknesses in the activities of the Human Resource Department that create conditions for fraud are job design, selection, career progression, salary payment and monitoring of the working environment and individual behavior at work.

When are the weaknesses in the job design a prerequisite to commit fraud of the mixed type? A typical mistake is to design a job position in a way that fails to ensure the separation of functions. Restaurant X has a person who is responsible for the acceptance of the delivered fruits and vegetables. This person has the obligation to accept the goods delivered by suppliers and pay the invoices. Such a blending of functions creates conditions for the employee to conspire with the supplier to provide invoices with inflated prices. What and how does the employee gain? The employee pays the supplier the inflated price. The supplier must return in cash part of the amount paid by the employee.

What does the provider gain? At first glance he gains nothing because this deal increases the revenue of the company while reducing the amount of the actual revenue. Who would have an interest in such a scenario? This would be the supplier who gains financial income of unknown origin. The one who loses from the poor job design is the employer.

Another example of the flaws in the job design is the "line of succession". In company X the line of succession is not defined in the job description. So each employee has the right to appoint a person whom to replace him/her. For a period of five years an accountant and a cashier of the company were replacing each other. A joint external financial and human resource audit established cases of abuse of office committed by both the accountant and the cashier.

When are the gaps in the selection procedure a prerequisite for fraud by employees? Conditions for fraud are created in case the selection procedure does not envisage the verification of the educational degree of the recruits. Hence a prerequisite for fraud is the absence of the obligation to verify the accuracy of the information provided in the resume of the selected candidate.

After the deadline for candidates filing applications for the vacancy expires, the procedure should envisage that the verification of their documentation is assigned to external human resource consultants, as haste can be very costly for the organization.

What are the weaknesses in the career development of employees in the organization which the Human Resource Department has accepted so that they become a prerequisite for fraud? In organization X there is evidence that a woman has committed fraud in the company. Initially her boss decided to lay her off. Later on, however, instead of firing the employee the manager promoted her. The manager neither fired the employee, nor pressed fraud charges against her. Instead he involved her in signing fake corporate documents. Promoting the employee was some kind of a deal. In this case the Human Resource Department became an accomplice to committing fraud.

The lack of internal rules to regulate the responsibility of the Human Resource Department with regard to alerting the owners to the “dead souls” in the company brings losses to the owner. Owners may be notified of whether salaries and social security contributions are being paid to persons who do not actually appear in the office. In such a case “dead souls” do not pose a problem to the company but to the state, as this is an act of money laundering.

When do the weaknesses of the Human Resource Department’s function related to the monitoring the working environment and individual behavior at work foster committing fraud? Allowing harassment of employees (whether verbal, psychological, sexual) on the part of their immediate superiors is a prerequisite for committing fraud. Left alone in a hostile environment the employees who are subject to harassment tend to accept orders from their superiors to commit frauds, if this will reduce the harassment at the workplace. Another possible situation arises when the management creates the adequate conditions for career development (“fast track”) for the employee. Even the employee’s supervisor commits offenses to the advantage of the employee to demonstrate unconditional support. Subsequently, the employee is expected to honour all requests for carrying out illegal financial transactions and/or forgery. If the employee refuses to obey the orders, he faces the risk of having his career development terminated or working in an environment that impedes his career development. Moreover, other employees would readily join efforts to intimidate their colleague.

Monitoring employee behavior could also facilitate fraud prevention. In company X the accountant did not actually use his annual leave for a period of more than three years. Everyone in the company, even the staff from the Human Resource Department, thought that this was due to workaholism. Subsequently, it was established that the accountant had diverted company funds.

Another example is the case of a woman who worked for bank X for two years at the front office. Initially, the employee did not stand out among the other officials. Later on, however, she unexpectedly displayed a higher social status. She bought a huge flat and a new car. She started buying expensive designer clothes. The clerk was a young and beautiful lady so nobody questioned her fancy lifestyle. Everybody thought that the girl had a rich boyfriend. And probably this would have lasted forever, if a bank customer had not called the bank to alert them to a possible offense. He said that he did not hold a credit card and he was very surprised that he kept on receiving bank statements featuring information of how much money he had spent. Unfortunately, this day the beautiful lady was outside the bank office. Her colleague accepted the phone call. Upon a check into this case it emerged that the employee had issued false credit cards to customers who had deposits or current accounts at the bank.

When fraud prevention is not prescribed as part of the duties of the Human Resource Department and is not embedded in the human resource procedures, every employee runs the risk of becoming a suspect.

Drawing upon the experience presented in these cases, at least three conclusions can be made.

First. Flaws in the work of the Human Resource Department create favorable conditions for committing fraud.

Second. The Human Resource Department often serves as a willing or unwilling accomplice to managers in committing fraud.

Third. The Human Resource Department's insufficient awareness of the working environment and the fraud committed in the organization brings about flaws in its performance.

This analysis gives grounds to recommend three major roles that the Human Resource Department should play in the prevention of fraud.

4. Three key roles of the Human Resource Department in preventing fraud

The role of an "architect"

The role of an "architect" is associated with the introduction of such rules and procedures for the human resources management that include internal controls to prevent the creation of an environment that fosters fraud.

In performing such a role, the Human Resource Department should take three actions.

First. Employees from the Human Resource Department should be involved in the investigation of fraud because it will facilitate the identification of weaknesses in the human resource procedures.

Second. Employees from the Human Resource Department should undergo training on the nature and types of fraud and on the ways to detect the "red flags."

Third. The Human Resource Department officials should be held directly responsible for the elaboration of documents for appointing employees who do not fulfill the requirements. Also they should be held responsible for illicit promotion and for filling in payrolls with false content. Thus the involvment of employees of the Human Resource Department in committing fraud will be prevented.

The role of an "observer and analyst"

The role of an "observer and analyst" is related to a system for monitoring and analyzing changes in employee behavior and in the relationships between staff members.

As stated at the beginning of the article, in 81% of fraud cases, the fraudster displayed one or more behavioral red flags that are often associated with fraudulent conduct. That is why the Human Resource Department should monitor for red flags, such as an incompetent Chief Financial Officer, deviant behavior, insufficient focus on organizational culture and processes, such as living beyond one's means.

The role of a "knowledge distributor"

The role of a "knowledge distributor" is related to training (1) employees and managers in the organization's policy regarding prevention of fraud and (2) reporting fraud. The organization's policy for combating fraud should be embedded in the induction of recruits. During the induction, employees should be trained how to signal about the existence of frauds or suspicions about such. The training programs aimed at employees and managers should include topics related to the methods and means to prevent fraud.

5. Conclusion

The facts presented in the article eloquently demonstrate the key role of the Human Resource Department in the prevention of fraud. The Human Resource Department is vital in detecting and preventing fraud by performing the three major roles of an "architect", an "observer and analyst" and a "knowledge distributor". To carry out these roles two conditions should be met. First, the company management should create conditions for the Human Resource Department to fulfill its key role in the prevention of fraud. Second, the Human Resource Department officials should be very well trained to carry out their roles with regard to fraud prevention. Failure to fulfill these conditions means that in the future we will continue to analyze the same facts about fraud.

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