

## Whitepaper

# Using the Fraud Triangle to design and assess internal controls

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## Background

### Purpose

According to the Factsheet 'Fraud and Corruption':

*"Organisations need to have a fit-for-purpose co-ordinated approach to fraud and corruption control that needs to focus on awareness / prevention / detection / investigation / reporting."*

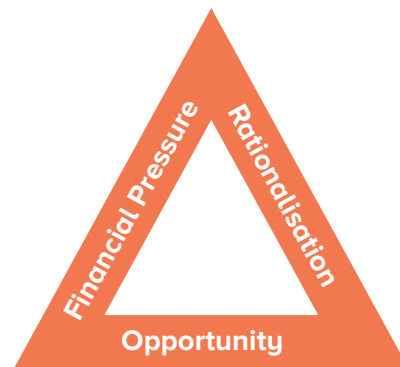
This White Paper aims to assist internal auditors assessing anti-fraud internal controls through applying the Fraud Triangle as a useful tool. If the Fraud Triangle is used appropriately, it can supplement or replace a checklist approach and provide greater flexibility and assurance that controls are relevant and fit-for-purpose. Checklist approaches have their place but are often not adaptable to every organisation and every risk profile, and are therefore necessarily limited.

### Background

The 'International Professional Practices Framework' issued by the IIA Global states in Internal Audit Standard 1210.A2 'Proficiency' states:

*"Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organisation, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud."*

The Factsheet 'Fraud and Corruption' comments on the Fraud Triangle which is a model for explaining the factors that cause someone to commit occupational fraud. It consists of three components which together lead to fraudulent behaviour.



## Discussion

### Issue

It is useful to have a flexible and reliable tool when assessing anti-fraud controls. The Fraud Triangle is such a tool when used properly.

### History

The Fraud Triangle is based on Donald Cressey's statement

*"Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalisations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property."*

The Fraud Triangle considers that fraud occurs when there are three elements present:

- › Financial pressure.

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- › Rationalisation.
- › Opportunity.

Over time the three elements have been expanded so they do not refer only to financial factors.

## Discussion

This White Paper examines each of the three components of the Fraud Triangle – financial pressure, rationalisation and opportunity.

## High risk areas

Additional anti-fraud controls may be appropriate for high-risk areas.

Organisations often have branches or units where activities undertaken may be considered as high-risk because the consequences of fraud are high or the area is more vulnerable to fraud. Factors that may affect the level of risk could include items such as:

- › Degree of discretion.
- › Nature of the transactions.
- › Level of control.
- › Degree of supervision and monitoring.
- › Ease with which a fraud could be perpetrated.

Examples of high-risk areas could include:

- › Regulatory and inspectorial activities in government agencies.
- › High value and unusual procurements and asset disposals.
- › Approving loans or claims in financial institutions.
- › Guards in correctional facilities.
- › Many areas of law enforcement.

## Lists presented in this White Paper

The lists contained in this White Paper are general. They do not contain every internal control and not all controls may be relevant for every organisation. They are provided to show how the Fraud Triangle can be used to generate ideas when designing or auditing anti-fraud controls.

## Financial Pressure

Implement controls to prevent people being placed under pressure and mitigate the level of risk if they are pressured.

The pressures may be one or a mix of various types, including:

- › Financial pressure.
- › Gambling, drug or other addictions which require funds.
- › Psychological pressure from depression, delusions or other mental illness.
- › Psychological need to impress others with wealth or generosity.
- › Peer pressure from corrupt workmates.
- › Peer pressure from family, relatives, friends and associates in private life.
- › Pressure from criminals and especially organised crime, often arising from previous dealings.
- › Being blackmailed because of relationships, indiscretions such as visiting certain websites, paying off gambling or narcotics debts, etc.
- › Pressure from seemingly powerful people such as senior managers, directors, government ministers, local government councillors or senior officials.

Controls might include:

- › Have an employee assistance program (EAP) for vulnerable people that is widely advertised to staff and is easy to access.
- › Consider providing access to financial advice services for those in financial difficulties.
- › When an employee's wages are being garnished, subject to privacy requirements consider informing their operational manager, internal auditor or other relevant manager as this is an indicator of financial pressure.

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- › Where there are indicators of financial or other pressures, consider increased monitoring of transactions and re-arrangement of the employee's duties.
- › Have policies and procedures in place that require staff to avoid conflicts of interest where practical, especially those staff in high-risk areas.
- › Have effective policies and procedures for the declaration, management and monitoring of conflicts of interest, so that individuals with whom your employees have personal relationships are less able to use those relationships to pressure your staff to commit fraud.
- › Deal with 'slippery slope' situations where staff are induced to make a small improper act and this is then used to blackmail them to commit fraud. Controls might include dealing sympathetically with employee self-reporting, providing training in these dangers, and controls such as gift registers.
- › Teach people in high-risk areas how to spot grooming by outsiders trying to entice them to commit fraud, and how to act if they are potentially a target.
- › For high-risk organisations such as corrective services, law enforcement and certain government defence industries, have policies and procedures for employees to avoid contact with organised crime or other groups, by for example being prohibited from certain criminal-run or associated clubs, bars and other businesses.
- › Ensure people understand what is and is not acceptable so they do not leave themselves open to being blackmailed.
- › Help your staff where appropriate instead of threatening them – zero tolerance sometimes pushes people who have minor infringements on the 'slippery slope' to fraud.
- › If applicable, for high-risk areas develop protocols and provide guidance for dealings with powerful individuals such as government ministerial staff, local government councillors and company directors where employees may feel pressured to do something they know is the wrong thing.
- › Deal with peer pressure so that it becomes positive rather than negative – consider culture-based controls including encouraging trust and a positive perspective of the organisation.
- › Deal with pockets of negative peer pressure – move people around, isolate trouble-makers, improve training and working conditions, have negative consequences for those applying negative peer pressure, improve supervision and management.
- › Enhance whistleblowing so it is easy to report those applying pressure from whatever source.
- › For high-risk areas have protocols and positive re-enforcement for those reporting offers of bribes.
- › View reports of negative pressure from managers and supervisors to commit unethical acts as positive, rather than with suspicion. Ensure reports are properly handled, analysed and investigated where appropriate. Consider enhancing anonymous reporting.
- › Consider pressure at the hiring stage and apply due diligence for this more rigorously in high-risk cases.
- › Assess interactions of staff with outsiders to minimise risk of them being blackmailed, threatened or placed in potentially compromising situations. Enhance documentation and have formal procedures and protocols to protect staff from being put in these situations, for example with allegations of harassment, bullying or other misconduct.
- › Conduct risk assessment of other entities in high-risk areas who may be put under pressure to defraud or corrupt your organisation. Consider contracts, tendering processes, due diligence, working arrangements, training for their staff, formal processes in the other entity, etc.
- › For high-risk areas ensure contracts, codes of business practice and other documents with third parties make it clear they must act ethically towards your employees and may not put them in conflict of interest situations, offer them excessive gifts, or do anything that may compromise integrity of the employees.

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## **Rationalisation**

The theory is that people do not commit fraud unless they are able to justify it to themselves. In considering rationalisation or attitude it is useful to understand it is not only the person's attitude to fraud that matters, it is also their attitude to their organisation, their workmates, their managers, and sometimes even the industry that determines whether they can justify committing fraud.

Controls that may be relevant for rationalisation or attitude may include:

- › Have policies and written procedures stating what is and is not acceptable so people do not get involved in inappropriate practices because they did not know they were inappropriate.
- › Train in key ethics policies that includes not just detailing the policies, but includes a motivational component about why certain behaviours are called for or proscribed.
- › Have the policies easily accessible, easy to understand and relevant for people's needs.
- › Reward good conduct and not allow bad conduct to go undealt with.
- › Remind people regularly of the policies and procedures.
- › Consider whether high-risk areas should have higher standards than the rest of the organisation together with special written procedures.
- › Take surveys, monitoring trends and where necessary implementing measures to improve employee attitudes to the organisation, their managers and workmates.
- › Take surveys, monitoring trends and where necessary implementing measures to improve employee ethical views.
- › Use data analytics to monitor whether there appears to be significant non-compliance with policies and procedures for example order splitting, questionable expenditure, inflating revenue, etc.
- › Monitor compliance mechanisms such as gift register and conflict of interest register.

- › Have annual compliance declarations to assess whether there is general adherence and identify instances of apparent non-compliance.
- › Monitor red flags such as harassment, bullying and other complaints to identify areas of disregard for ethical conduct which could expand to tolerating and perpetrating fraud.
- › Consider the attitude to carrying out internal controls, especially anti-fraud controls.
- › Have clear ethical standards for suppliers and other entities you deal with including in contracts, codes of ethics and other documents.
- › Where appropriate require other entities to provide their staff working on your projects with copies of the codes and policies, and ensure they are able to report fraudulent and inappropriate conduct directly to your organisation.
- › Behavioural economics and nudge projects have identified that in many situations people act more ethically if forms and practices are designed to encourage integrity. Examples are having people sign a form close to the beginning of the form rather than at the end encourages them to give more honest information, and reminding people of an ethics code discourages them from being fraudulent.

## **Opportunity**

For people to perpetrate a fraud there has to be the opportunity for them to do so. Usually, the opportunity is presented by a weakness in systems of internal control.

When considering controls, consider not only control activities, but also the control environment. Remember that people carry out controls and consider whether the controls are appropriate for the individuals, the organisation and branch structure, the corporate and ethical culture in the area, and other relevant factors. Heuristics should also be considered when assessing the design and operation of anti-fraud internal controls.

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## Conclusion

### Summary

The Fraud Triangle consists of financial pressure, rationalisation and opportunity. Each of the three components should be taken into account when assessing anti-fraud internal controls.

### Conclusion

The Fraud Triangle is a great prompt to use to help ensure internal auditors adequately assess anti-fraud internal controls and identify important controls that may be missing.

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### Purpose of White Papers

A White Paper is a report authored and peer reviewed by experienced practitioners to provide guidance on a particular subject related to governance, risk management or control. It seeks to inform readers about an issue and present ideas and options on how it might be managed. It does not necessarily represent the position or philosophy of the Institute of Internal Auditors–Global and the Institute of Internal Auditors–Australia.

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The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

The IIA-Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

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