

A Study of Management Principles Incorporating Corporate Governance and Advocating Ethics to Reduce Fraud at a South African Bank

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Abstract—In today's world, internal fraud remains one of the most challenging problems within companies worldwide and despite investment in controls and attention given to the problem, the instances of internal fraud has not abated. To the contrary it appears that internal fraud is on the rise especially in the wake of the economic downturn.

Leadership within companies believes that the more sophisticated the controls employed the less likely it would be for employees to pilfer. This is a very antiquated view as investment in controls may not be enough to curtail internal fraud; however, ensuring that a company drives the correct culture and behavior within the organization is likely to yield desired results.

This research aims to understand how creating a strong ethical culture and embedding the principle of good corporate governance impacts on levels of internal fraud with an organization (a South African Bank).

Keywords—Internal Fraud, Corporate Governance, Ethics, South African Reserve Bank, The King Code.

I. INTRODUCTION

INTERNAL fraud is a global phenomenon that affects each and every country and all sectors of the economy. Reference [11] defines internal fraud as “the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organisation's resources or assets”.

Fraud is a complex and complicated phenomenon. It could be inspired by greed, a quest for survival or financial pressure; however, these personal motivations for fraud are insufficient explanations for the phenomenon of fraud. There are also certain conditions within an organisation that could facilitate the perpetration of fraud, such as insufficient, inadequate internal control mechanisms or more harmful poor company culture and lack of strong good corporate governance principles that may be permissive to fraud.

The general perception is that South Africa is an anarchic country. It is also believed that this perceived lawlessness is manifested in business through the lack of good corporate governance and more importantly ethics. Exploratory research in the form of a gap analysis comparing a financial

institution's compliance to the King Code of Corporate Practices and Conduct hereafter referred to as the “King Code”, was conducted by the author, the results of which revealed several aspects. The most important was that the organisation's corporate governance is based on form rather than substance as the organisation applies the very basic requirements of the “King Code”. Whilst the organisation established a whistle blowing hotline, on average the hotline receives only a handful of calls per month. The form of whistle blowing exists, but the substance is lacking if the hotline is not used to report staff defalcations. The conclusion is that the organisation's approach to corporate governance is form over substance.

Results of that gap analysis led to a literature review of corporate governance and more importantly ethics with a view to gather information of how those requirements should be best implemented and managed within an organisation in order to address the problem of internal fraud. It is important to review corporate governance and ethics given the close correlation.

Qualitative research was then carried out in the form of an internal ethics survey intended to measure the perception of ethics management within the organisation. The survey results supported the assumption of appearance over substance perception given that at face value the organisation was compliant insofar as the ethics requirements of the “King Code” were concerned. The issue was that the results of the survey mainly exposed that ethics management within the organisation was not uniformly applied and that staff are intimidated and do not feel free to report unethical behaviour due to fear of victimisation.

It is further suggested that the organisation improves the culture of corporate governance by applying certain management principles to the management of corporate governance, and additionally that executive leadership and senior management regularly communicate their support of corporate governance initiatives to all employees. More comprehensive gap analysis must be conducted in conjunction with a review of the Banks Act, 1990 (Act No. 94 of 1990), Section 38 so that the organization can develop a robust plan to not only comply with bare minimum requirements of the “King Code” but to embrace good corporate governance throughout the organisation.

Many companies have invested heavily in world class systems and processes to detect fraud; however, the best

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systems and controls are only as effective as the employees utilising such systems and processes. Within an organization there ought to be a major focus on creating a corporate culture that dictates that no form of internal criminal activity will be tolerated and that approach must be consistently applied when internal fraud is discovered. Whether the errant employee is a junior staff member or Chief Executive Officer all fraud must be treated in a consistent manner.

Insofar as ethics is concerned, recommendations for a comprehensive and clearly articulated ethics management plan have been noted. Such plans include continuous monitoring and testing of the application of the organization's ethical code and also the creation of an autonomous body that would ensure correct and fair enforcement. It is evident that an independent body managing ethics will stimulate employees to report unethical behaviour including internal fraud.

II. LITERATURE REVIEW

According to [12], large corporate failures have often encouraged discussion about corporate governance which led to regulatory and other types of reform. In the United Kingdom the Cadbury Code of 1992 was stimulated by the collapse of Maxwell Publishing Group towards the end of the 80's. In Japan the collapse or failure of large financial and non-financial organisations led to changes in their regulatory universe and prompted legal changes.

In the United States the matter of Enron and WorldCom also prompted major debate and changes to legislation. In these instances of corporate failure, several aspects stood out. The most significant aspects related to the quality of leadership; its independence, corporate governance within the organization and the organization's culture.

The collapse of some major organisation's such as the Enrons and Worldcoms involved fraud or the active cover-up by leadership or both. Weak corporate governance has been an important factor in many corporate failures and this has prompted the need to review the application of corporate governance.

Corporate Governance originated eons ago when the management and ownership of businesses separated. Owners required means to monitor the performance of managers. According to [12], "The concept of stewardship and the role of the external auditor to check that proper stewardship had taken place, developed from the separation of management and ownership. The industrial revolution brought a need for large amount of capital to be raised and resulted in 'incorporated' enterprises. These arrangements also enabled the enterprise to raise large amounts of capital in complex ways, which led to regulation and control in order to protect the interests of owners. Initially, corporate governance arrangements were regulated by corporate legislation only. Internationally, national governance structures developed at different times in history, in different ways and as a result of different reasons or trigger events. Capitalism is so-called because it is an economic system organized around the

production and allocation of capital. Yet the ways in which economies accumulate and allocate capital are quite different in different countries, and seem closely related to how each handles corporate governance issues".

Reference [5] states that the audit committee is key to ensuring the integrity of integrated reporting and internal financial controls (IFCs). In addition, the audit committee should have oversight of financial reporting risks. Reference [4] recommends the alignment with global best practice principles.

Section 38 of the Banks Act, 1990 (Act No. 94 of 1990) requires banks to report to the South African Reserve Bank (SARB) on corporate governance within the "King Code", which incorporates an external audit review of the following:

- The Board and Directors;
- Risk Management;
- Internal Audit;
- Accounting and Auditing;
- A Code of Ethics.

The "King Code" is the standard for best practice against which the bank's corporate governance is benchmarked.

According to [5], it is imperative that an organisation evaluate its internal financial controls (IFC) in order to address the risk of fraud. In the past, fraud was most commonly thought of in terms of misappropriation of assets, however, more recently, manipulation of financial reporting has been the more common fraud. In addition to a thorough assessment of fraud risk and the identification of appropriate controls; controls to safeguard assets; the adequacy of internal audit activities; other key considerations must include:

- The existence and proliferation of a strong and clear code of ethics;
- The existence of an effective complaint gathering and handling process which is to include a whistle-blower program.

Insofar as ethics is concerned [3] states that "responsible corporate citizenship implies an ethical relationship between the company and the society in which it operates." The concept of ethics and good corporate citizenship is nothing new; however, [3] gives it more teeth than it had in the past whilst highlighting the link between ethical leadership, company strategy and sustainability. It holds true that successful organizations are ones that endure and are sustainable. Reference [3] states "as a cornerstone of sustainability, sound ethics and leadership are increasingly proving their worth as drivers of competitive advantage".

According to [3] more specifically Principle 5: Code of Conduct requires that organisations have a written code of conduct and a system that ensures the conduct and applicable laws are followed to the letter and spirit. According to [3]:

- A corporation's business can be severely adversely affected, and in certain cases, result in closure and a total loss to shareholders due to misconduct by the corporation, CEO, the board, or its employees.

- Misconduct can take various forms such as mismanagement, improper accounting and disclosure, inattention to product quality, valid customer complaints, bribery to or from customers, suppliers or others, and non-compliance with laws, or non co-operation with regulatory authorities. This issue is of critical importance to all stakeholders, including institutional investors. To show their seriousness in dealing with this risk, all enterprises should have a written code of business conduct.
- Guidelines codifying business conduct should be succinct and sufficiently detailed to give a clear direction to staff and board members and other parties that deal with the corporation.
- A template setting out conduct guidelines can be accessed by reference to the “King Code”.
- In addition, the techniques that can be employed to help fashion implementable codes can be found on the web site of the Institute of Business Ethics. An antifraud hotline can be useful in identifying fraud, and in deterring unacceptable conduct and should be mandatory for listed companies.
- Developed economies should discourage and/or prohibit corrupt practices by companies incorporated in their jurisdictions in their dealings with developing countries. Any form of corruption, whether through improper paying or receiving of benefits, is not to be tolerated.
- Stock exchange bodies and regulators should require companies and financial institutions to publicize their codes of business conduct.

According to [10], insider fraud is an embarrassing topic for organisations operating in the financial services industry as such crimes are perpetrated from within their own ranks by trusted employees having long-service records. It places such organizations in a difficult situation in that employees are as part of their jobs given access to the critical systems and sensitive data which allows employees to serve clients. Inherent in that trust is always the risk that the employee may abuse the system to defraud the organisation and/or its clients. In most instances the reputational damages far outweigh the actual monetary losses incurred.

Reference [7] highlights that fraud remains one of the most problematic issues for organisations the world over and despite focus by regulators and investment in controls the levels of internal fraud have not subsided, to the contrary one out of every two companies globally, fell victim to economic crime in the past two years. Internal fraud is ever present within the financial services industry which has adverse effects on the South African economy, considering the monetary value of losses. Fraud affects the amounts of money paid for insurance and it adversely affects the organisation’s profitability as the cost of conducting investigations and public relations efforts to rebuild its reputation are high. Prevention and detection of internal fraud is rooted in the promotion of ethical behavior.

According to [10] internal fraud cuts across all spheres of a banking organisation, from tellers, call center representatives to branch managers and top-level executives. Whilst such frauds are sophisticated and diverse, they fall into three main categories:

- Stealing money from the bank. In this first instance the errant employee pilfers money directly from the organisation.
- Stealing money from the customer. In these instances the errant employee fraudulently debits client accounts. Accounts with high creditor balances, accounts belonging to elderly clients, inactive accounts with large balances are usually targeted.
- Stealing proprietary data. Theft of personal data is the latest and most alarming trend and often involves large organized crime syndicates. The fraudsters use personal information of clients to conduct identity-related frauds.

Reference [10] highlights that large internal fraud losses occur over a period of time as the perpetrator usually starts off with stealing small amounts and this increases exponentially as time passes. An employee may find loopholes in the systems and after first taking small amount he/she may increase the amounts stolen as there is a possibility of going undetected. As time goes on they start to rationalise their actions.

Reference [7] states that it is generally accepted, by criminologists and fraud investigators that three things must be present for a fraudster to set to work:

1. The opportunity to commit the fraud;
2. The incentive to commit fraud; and
3. The fraudster’s ability to rationalise their own action

Each aspect will be briefly discussed:

1. The opportunity to commit fraud is generally regarded as a perceived opportunity having two parts. The first being general information and this is simply the knowledge that the employee can manipulate or abuse his/her position of trust. The second part refers to technical skills required to perpetrate the fraud. The errant employee would have acquired these skills in the normal course in order to perform his/her daily functions.
2. The incentive would be that in addition to being non-shareable, the problem that drives fraudsters is usually described as financial and this is because these are the type of problems that generally can be solved by the theft of money or other assets.
3. Rationalisation is the final contributing factor in the triangle and this is the essential factor before the fraud can be committed and is part of the decision to commit the crime. An errant employee would not consider themselves as being criminals and must therefore justify their actions prior to committing the fraud.

Statistics involving internal fraud as per [7] shows that 61% of all frauds are committed by employees. 17% of those frauds were committed by senior personnel who have an average of seven years of service. Criminological research suggests that most fraudsters tend to be risk-takers, very decisive,

extroverted, career or success orientated individuals, which are ironically the very characteristics that are sought when employing staff.

Extracts from [6] states that prior research focused mainly on external frauds within different domains and using different techniques, those studies used predictive data mining, they focused on internal fraud as internal fraud represented the majority of costs, as also identified in [7].

Reference [9] cites figures of up to US\$600 billion in employee-related frauds and states that research into the area of financial fraud is difficult as such research is often hampered by problems of access to data relating to the offender, the organisation and information on the actual fraud. In addition organisations are reluctant to admitting that they have issues with fraud inside their operations.

This talks directly to the culture that an organisation promotes. Is the organization's culture one that accepts internal fraud as a cost of doing business or a culture that dictates that internal fraud must be brought to the fore and a zero-tolerance stance adopted?

According to [1] the term culture refers to a system of shared meanings which includes aspects such as attitudes, feelings, behaviour, value systems and group norms. Norms are shared values between the members of a group which also regulates behaviour that is deemed appropriate and those actions that warrant disciplinary sanctions for deviation from such norms.

It is the author's view that basic management principles could be used to advocate a strong ethical culture and ensure that corporate governance is meticulously implemented and continuously managed. In so doing it will ensure that the process of adopting and applying corporate governance initiatives are planned effectively, implemented consistently and applied justly.

Management is a process during which persons in leadership roles within the organisation utilise human and other resources as efficiently and as possible in order to produce goods and/or render a service, with the aim of satisfying specific needs of clients whilst achieving the goals of the organisation.

According to [5] the manager is a critical element as he or she leads the business to achieve its stated objectives. Managers are tasked with and responsible for motivating employees, ensuring that all stakeholders understand the organisation's goals, and aims to increase the efficiency and effectiveness of the business.

According to [5] in General Management the following are the four basic principles of management:

a) Planning

Planning is a tool utilised for change. The basic principles of corporate governance need to be taken into consideration for any plan by the organisation. Planning is a thought and action process which defines what should be done and how it should be done. It enables management, with use of available information and knowledge to make the necessary decisions

for the future. In the case of this research it is using historic data to establish how King III is to be meticulously implemented and a clearly articulated code of ethics driven throughout the organisation.

b) Organising

The organising function assists employees to carry out the plan. According to [2] the organising phase of general management consists of defining the authority, reporting, and support relationships. Organising will also include identifying where in the organisation responsibilities as well as authority to manage specific aspects reside. Management will need to clearly define roles and responsibilities insofar as implementation and adherence to sound corporate governance and ethics is concerned.

c) Activating

Reference [2] states another positive catalyst for strategic change is a philosophy of continuous improvement. An organisation that truly seeks to improve continually embraces change as a way of life. Leadership must be clear about the purpose and provide a rudder for the organisation.

d) Controlling

Reference [2] states that controlling covers the activities defined as "knowing what is happening and being able to take effective actions". Organisations accept certain risks with the aim of reward. In the financial services environment there is a specific increase in demand for accountability for such risks and in order to mitigate such risks, organisations must implement risk management systems and efficient internal controls.

There are various categories of control measures within an organization and internal control is a process, affected by an organisation's Board of Directors, management and other stakeholders. These controls are designed to provide a level of comfort that the organisation will be successful in its primary business objective being performance and profitability. Various controls must also be used to protect against asset misappropriation and also maintain proper financial records and ensure such financial data is reliable.

The Benefits of Managing Corporate Governance

Investors consider corporate governance as important as financial performance. If an organisation undertakes to implement corporate governance beyond form (ticking the box to comply with legislation) the substantive value for the organisation will be improved in terms of the following:

- Sustainability;
- Social Power;
- Good Corporate Citizenship
- Societal Values;
- and Corporate Reputation.

The Benefits of Managing Ethics

According to [8] a study showed that companies with a code of ethics outperformed those without in 3 out of 4 areas,

namely economic value added, market value added and price to earnings ratio. Companies with a code of ethics also experienced far less price earnings volatility over the four year period in review.

Improvement of ethics management and corporate governance implementation would have a positive impact on the triple bottom line. Shareholders are willing to pay more for shares of well governed companies.

III. RESEARCH METHODOLOGY

A. Research Design

The researcher opted to conduct a qualitative study to assess ethics and corporate governance within a South African Bank. The approach was to assess the quality of ethical practices within a bank, specifically among employees at management level. An empirical study was conducted to determine perceptions about ethical behavior and corporate governance practices.

B. Data Collection

As a starting point an ethics survey was developed, and circulated via electronic mail. The method of distribution and collection was the most apt method due to time constraints and it was significantly cheaper.

The purpose of the survey was to test for awareness of the ethics policy and implementation of such policy.

The gathering of information focused on the secondary objectives as that aided in addressing the primary research objective which was to improve ethics management and corporate governance implementation leading to a reduction in internal fraud.

The information gathered also included:

- Current Code of Ethics Policy;
- Fraud data from the databases and systems used by the organisation;
- Internal fraud by region, category and demographics of employees;
- Forensic Investigation Reports compiled for each incident of internal fraud.
- Statistics obtained from the Human Resources Department to establish the number of employees dismissed for committing fraud and whether the Ethics Policy had been clearly communicated;
- Attendance records to establish whether those dismissed employees attend ongoing fraud awareness training programs,
- Information on outcomes of disciplinary hearing for each category of fraud to ensure consistent application if applicable;
- Surveys conducted with leadership, senior managers, and employees from various regions to obtain view on internal fraud, ethics and adherence to principles of King III within the bank.

In addition any record of internal communications / videos by leadership promoting ethical behavior is held. This enables

one to determine how well the Code of Ethics has been communicated and understood and whether leadership places great emphasis on the principles of King III in an effort to reduce internal fraud.

C. Sampling

Stratified sampling was adopted for this research.

Eighty employees were considered a reasonable sample of the population. Due to time constraints, it was not realistic that the sample should proportionally represent each business unit, or even that every business unit should be embodied into the research.

Employees were selected from a list of all employees with a rating of junior management level and higher. The employees were chosen randomly, from a broad range of business units within in the bank. The respondents were asked to participate in the survey and submit the questionnaire electronically. The participants were sent an email, explaining the reason for the research and requesting their participation in the survey. There are 47 regional offices situated country-wide, and therefore an electronic survey was most appropriate.

IV. RESULTS OF STUDY

The internal ethics survey conducted supports the view that the bank's ethics program is deficient insofar as implementation and monitoring is concerned and that corporate governance is form over substance. There is a fear of victimisation by employees who feel intimidated by leadership. Employees do not feel that ethics is impartially or consistently applied throughout the organisation.

Clarity of the Groups Ethics

80% of the respondents indicated that having a clearly defined Code of Ethics and having knowledge of its application is important. Only 67% of respondents indicated that the Code of Ethics was discussed openly and explained.

Commitment of Staff to Code of Ethics

72% of respondents stated that the Code of Ethics was consistently applied and only 75% of respondents indicated their commitment to the Code of Ethics.

Translating the Organisations Ethics into Action

75% of respondents indicated that the organisation had effective procedures and processes for adherence to the Code

The Application of the Code of Ethics

The results showed that respondents scored creation of environment that promote ethics scored relatively high at 85% and with regards to fear of victimization the score was very low at 63% showing that employees were scared of being victimized.

Accountability within Organisation with Regards to the Application of Ethics Code

The respondents rated the effectiveness of the disciplinary code as 78%; however, respondents believe that the

organisation does not deal with unethical behavior consistently. 80% of respondents rated management accountability high.

Service Issues

Respondents provided commentary on whether they had difficulty with the application of the Code of Ethics within the organisation. Only 9% indicated that they have experienced problems. However, of those only 19% of the respondents reported that the problems had been resolved.

V. RECOMMENDATION

There is a clear perception that the Code of Ethics is not applied consistently or fairly. It is recommended that the organisation adopt policies as addendums to the current code. Those policies must include detailed process on how to deal with ethical dilemmas and grievance procedures and it should ensure consistent application.

There is fear of victimization and staff members feel neither encouraged nor safe to openly discuss ethical concerns. To that end it is recommended that a culture change is needed and management of ethics must be an independent function and an external whistle-blowing hotline be considered or established.

A robust Code of Ethics when implemented would reflect positively on the organisation's bottom line, particularly the financial aspects. The results will be two-fold in that investors are always willing to pay premium for stock in companies that practice good corporate governance and secondly having a well-managed ethics program would reduce staff defalcations and losses due to internal fraud. Prevention and detection of internal fraud is entrenched in the promotion of ethical behavior honesty, integrity and an anti-fraud culture. An entity must clearly detail what is considered illegal, improper and fraudulent behavior in addition to publishing all instances of internal fraud and creating a culture that supports zero tolerance and transparency.

Results clearly show that ethics is not adequately explained or frequently discussed in open forums. It is therefore recommended that ethics be incorporate into induction programs whereby the Code of Ethics is discussed in great detail with new recruits. In addition an annual review, incorporating the application of ethics, for existing staff members must be made compulsory.

VI. CONCLUSION

The Gap analysis revealed that Corporate Governance within the organisation is more form over substance. It is recommended that the organisation comply more substantively with the "King Code" by adopting the following:

- Commission an independent, detailed, gap analysis comparing the organisation's corporate governance practices with the "King Code". The gap analysis should be conducted at the most granular level (business unit);
- Improve the culture and application of corporate governance within the organisation by applying the

management principles of planning, organising, leading, and controlling to the application of corporate governance.

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