
CREDIT ISSUES

WOODGATE & CO.

Chartered Accountant

MAY 2014

THE COST OF FRAUD

The penalties available

In March 2014 the Australian Securities and Investments Commission ("ASIC") published a report comparing the penalties for corporate wrongdoing in Australia to those in Canada, Hong Kong, the United Kingdom and the United States of America. The report noted that the maximum prison term in Australia for fraud is 10 years, which was comparable to the other jurisdictions, with the exception of the United States of America, where the maximum prison term is 20 years. The report also compared the maximum penalties available to be sought by ASIC under the *Corporations Act 2001 (Cth)* ("*Corporations Act*") to the maximum penalties available to other Australian regulators.

The report noted that the maximum prison terms for fraud under the *Corporations Act* were as follows:

<u>Section</u>	<u>Maximum term</u>
Section 184 – Good faith, use of position and use of information	5 years
Section 596 – Frauds by officers	2 years

The maximum fines for contraventions of Section 184 and Section 596 of the *Corporations Act* were \$340,000 and \$17,000, respectively. By contrast, a conviction for fraud pursuant to Section 192E of the *Crimes Act 1900 (NSW)* ("*NSW Crimes Act*"), could result in a maximum prison term of 10 years and a maximum fine of \$110,000. The maximum penalties for fraud in the other States and Territories range from prison terms of five years to 15 years and maximum fines ranging from \$75,000 to \$459,500.

By contrast, in the United Kingdom, there was no limit on the quantum of a fine that a Court could impose, whilst in the United States the maximum fine for a corporation was \$US25M and for an individual US\$5M. The United Kingdom and the United States also had a broader range of administrative penalties, including the disgorgement of profits obtained by fraud. The report concluded that the penalties available to ASIC had not been reviewed for over a decade and in some cases did not meet community expectations.

The size of the problem

There are many different types of fraud, including fraud involving credit and debit cards, cheques and social

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security. Bribery, corruption, counterfeiting and other deception may also be considered forms of fraud. For a fraud to be committed there must be a motivated offender, a prospective victim and the absence of reliable internal controls. The victims of fraud can include individuals, corporations and governments.

The definition of fraud varies from jurisdiction to jurisdiction. Statistics obtained from the State and Territory Police forces for the year ended 30 June 2013 recorded the following fraud related offences:

	<u>Number of offences</u>
NSW	48,154
Vic	26,177
WA	19,619
Qld	19,021
ACT, NT and SA	<u>3,698</u>
	<u>116,669</u>

This only represents the instances of fraud reported to police. According to the Australian Institute of Criminology, fraud is an underreported offence, with less than 50% of incidents being disclosed to the police.

According to a survey of fraud, bribery and corruption in Australia and New Zealand prepared by KPMG in 2013, 75% of major corporate frauds were committed by insiders, usually employees of the organisation. For major frauds the typical offender was a male, with no known history of fraud, whose salary was nearly \$100,000 a year and who acted alone. The most common motivations for fraud were greed, lifestyle costs or personal financial pressure. The Australian Institute of Criminology noted that most serious fraud offenders were born in Australia or New Zealand and had completed secondary education

or had some professional qualifications. Serious fraud offenders were more likely to be a company director or an accounting professional, with relatively stable employment at the victim organisation.

According to the KPMG survey, the total losses from fraud experienced by its respondents during the period from 1 February 2010 to 31 January 2012 amounted to \$373M, with the total number of fraud incidents in Australia and New Zealand amounting to 194,454. Whilst the average value of the fraud committed was less than \$2,000 per fraud incident, some serious fraud offenders commit many frauds on a victim organisation. Therefore, the individual loss to an organisation may be significantly greater. According to KPMG, there were 20 incidents with losses over \$1M, with the largest single loss amounting to \$12M.

The warning signs of fraud

Some of the warning signs of fraud include:

- employees who rarely take holidays;
- employees whose lifestyle is not commensurate with their salary;
- employees who have gambling or substance abuse problems;
- excessive secrecy concerning a function, particularly if requests from external accountants or auditors for information are not complied with;
- a lack of segregation of duties in the subject area;
- weak internal controls, particularly in the administrative function;
- reconciliations not being performed on a regular basis, on the bank account(s), wages clearing and tax control accounts. Failure to perform regular physical

stocktakes and then reconcile to book values, may also be a warning sign;

- the organisation's financial performance is inconsistent with that of competitors. For example, the organisation appears to be performing much better than competitors;
- photocopied or missing documents;
- management that is dominated by an individual or a small group of individuals. This is a particular danger if the founder dominates the organisation;
- unusually close relationships with certain suppliers or customers, and,
- bypassing normal procedures for ordering goods or services.

Fraud prevention strategies

Prevention of fraud is almost always better than its cure. Some strategies to prevent fraud include:

- (a) thorough pre-employment probity checks of employees;
- (b) reviewing and maintaining sound internal controls, including regular reviews of internal controls;
- (c) having a workplace culture that is intolerant of unethical, fraudulent or corrupt practices, generally. Most fraud offenders start soft and small. Therefore, taking a standard against what may be seen as relatively minor infractions, such as unreasonable expense claims, will send a message that dishonest conduct will not be tolerated; and,

- (d) having capable and well-resourced external accountants and/or auditors.

Reporting fraud

If an organisation suffers from a fraud many organisations do not report the fraud to the police. This reluctance to report fraud may be due to:

- (i) the fear of throwing good money after bad;
- (ii) a desire to avoid reputational damage;
- (iii) a wish to have a bargaining chip to negotiate with the offender;
- (iv) uncertainty as to whether a crime has been committed; and,
- (v) a reluctance by management to allocate time and resources to assisting the police or other authorities with their enquiries.

Many of these fears are well grounded. For example, a company director perpetrated a fraud of \$1.5M which was discovered in September 2008 and reported to the NSW Police in January 2009. The victim organisation was a subsidiary of a European multinational. Civil legal proceedings were commenced in November 2008 to recover the funds and the director became a bankrupt in October 2009. The funds recovered by the victim organisation post-bankruptcy were modest.

The director pleaded guilty in February 2012 to five counts of cheating and defrauding under the former Section 176A of the *NSW Crimes Act* and was sentenced to two years imprisonment, to be served by way of an intensive corrective order in the community. Following a successful appeal by the Crown, a custodial sentence was imposed in December 2013 with a non-parole period of 2½ years. The

actual custodial sentence was $\frac{1}{4}$ of the maximum term of imprisonment under the *NSW Crimes Act*, some five years after the fraud was detected. It is doubtful whether strengthening the penalties available in Sections 184 and 596 of the *Corporations Act* would have changed the result. The answer may be for the Courts to take a more serious view of white collar crime.

For those disheartened by the prospects of a serious fraud offender not being sentenced to gaol for a lengthy term, choosing not to report the crime is not the answer. Section 316 of the *NSW Crimes Act* states that a person who fails to report conduct which amounts to a serious indictable offence is liable to prosecution and may be imprisoned for up to two years.

Solution

The key to dealing with fraud is having a strong corporate culture, employing good people, maintaining sound internal controls and being aware of the warning signs of fraud. Woodgate and Co. are experienced in assessing fraud risk and formulating solutions including internal controls. Further, Woodgate & Co. are experienced in conducting investigations, analysing evidence, considering contraventions of relevant laws and preparing expert witness reports.

Woodgate & Co. can also provide an assessment as to the likelihood of recovering funds from an offender. Whilst most frauds do not result in an organisation becoming insolvent, in small organisations serious frauds can be financially fatal.

WOODGATE & CO.

Chartered Accountant and Insolvency Practitioners

**Business Recovery Services
Official Liquidators & Trustee in Bankruptcy**

Level 8, 6 - 10 O'Connell Street, Sydney, NSW, 2000
GPO Box 882, Sydney, NSW, 2001
Telephone: (02) 9233 6088 Facsimile: (02) 9233 1616

www.woodgateco.com.au

Associated Offices: **Melbourne · Brisbane · Adelaide · Perth**