



# OCCUPATIONAL FRAUD AND NEPALESE SCENARIO

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## I. WHAT IS FRAUD

Fraud is defined as “A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.” (Black’s Law Dictionary)

Nepal Standards on Auditing (NSA) 240 defines a fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

**Fraud is always intentional, deliberate and hidden**

The Association of Certified Fraud Examiners defines occupational fraud as: “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

Consequently, fraud includes any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means. Fraud is an act of deception intended for personal gain or to cause a loss to another party.

The companies Act of India 2013 defines fraud in relation to affairs of a company or any body- corporate, to include, any act , omission , concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner with intent to deceive, to gain undue advantage from, or to injure the interests of the company or its shareholders or its creditors or any other person whether or not there is any wrongful gain or wrongful loss.

## II. CAUSES OF FRAUD

Donald Cressey, a sociologist and criminologist was one of the first persons to explain the cause of fraud. The fraud triangle, developed by him, 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.

“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 verbalizations 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.” Donald R. Cressey, *Other People’s Money* (Montclair: Patterson Smith, 1973)

**Fraud Triangle is the best model to explain the causes of fraud**



**The Fraud Triangle**

The three elements of the Fraud Triangle are: Opportunity, Pressure (also known as incentive or motivation) and Rationalization (sometimes called justification or attitude). For fraud to occur, all three elements must be present.

## OPPORTUNITY

Opportunity refers to circumstances that allow fraud to occur. In the fraud triangle, it is the only component that a company exercises complete control over. Examples that provide opportunities for committing fraud include:

### 1. Weak internal controls

Internal controls are processes and procedures implemented to ensure the integrity of accounting and financial information. Weak internal controls such as poor separation of duties, lack of supervision, and poor documentation processes give rise to opportunities for fraud. Lack of internal controls accounted for 32% of overall occupational frauds whereas override of existing internal controls and lack of management review accounted for 18% each of the overall occupational frauds investigated during Jan 2018 to Sep 2019, as reported in the ACFE's Report to the Nations 2020.

### 2. Poor tone at the top

Tone at the top refers to upper management and board of directors' commitment towards being ethical, showing integrity, and being honest. A poor tone at the top results in a company that is more susceptible to fraud. As per the ACFE's Report to the Nations 2020, Poor tone at the top accounted for 10% of the overall occupational frauds investigated during Jan 2018 to Sep 2019 where as it accounted for 22% of the overall financial statements fraud.

### 3. Inadequate accounting policies

Accounting policies refer to how items on the financial statements are recorded. Poor (inadequate) accounting policies may provide an opportunity for employees to manipulate numbers.

## PRESSURE

Pressure, refers to an employee's mindset towards committing fraud. Examples of things that provide incentives for committing fraud include:

### 1. Bonuses based on a financial metric

Common financial metrics used to assess the performance of an employee are revenues and net income. Bonuses that are based on a financial metric creates pressure for employees to meet targets which, in turn, may cause them to commit fraud to achieve the objective.

### 2. Investor and analyst expectations

The need to meet or exceed investors and analysts expectations can create pressure to commit fraud.

### 3. Personal incentives

Personal incentives may include wanting to earn more money, the need to pay personal bills, a gambling, addiction etc.

## RATIONALIZATION

Rationalization refers to an individual's justification for committing fraud. Examples of common rationalizations that fraud committers use include:

### 1. "They treated me wrong"

An individual may be spiteful towards their manager or employer and believe that committing fraud is a way of getting payback.

## 2. “Upper management is doing it as well”

A poor tone at the top may cause an individual to follow in the footsteps of those higher in the corporate hierarchy.

## 3. “There is no other solution”

An individual may believe that they might lose everything (for example, losing a job) unless he or she commits fraud.

Wolf and Hermanson (2004) added fourth variable “Capability” to the fraud triangle and introduced Fraud Diamond model. They believed that many frauds would not have occurred without the right person with right capabilities implementing the details of the fraud.

Crowe Horwath’s Fraud Pentagon model added two more factors “Competence” and “Arrogance” to the three factors of Fraud triangle.

## III. TYPES OF FRAUD

Based on Industry, Fraud may be of following types:

- Bank Frauds
- Corporate frauds
- Insurance frauds
- Health Care frauds
- Cyber frauds
- Securities frauds
- Consumer frauds

In the Corporate environment, frauds which are committed by the employees of the organization are referred to as Occupational Frauds. According to the Report to the Nations 2020, the organizations all over the world lose around 5% of their revenue to the occupational fraud each year.

Occupational Fraud is broadly classified into three types:

1. Corruption
2. Asset Misappropriation
3. Fraudulent Financial Statements

### Corruption

There are three types of corruption fraud: conflicts of interest, bribery, and extortion. According to the ACFE’s Report to the Nations 2020, corruption was involved in around 43% of all frauds investigated during Jan 2018 to Sep 2019 with a median loss of US\$ 200,000.

In a conflict of interest fraud, the fraudster exerts their influence to achieve a personal gain which detrimentally affects the company. The fraudster may not benefit financially, but rather receives an undisclosed personal benefit as a result of the situation. For example, a manager may approve the expenses of an employee who is also a personal friend in order to maintain that friendship, even if the expenses are inaccurate.

**Corruption was involved in around 43% of all frauds with a median loss of US\$ 200,000**

Bribery is when money (or something else of value) is offered in order to influence a situation.

Extortion is the opposite of bribery, and happens when money is demanded (rather than offered) in order to secure a particular outcome.

This type of fraud is more costly than asset misappropriation but less costly than financial statements fraud.

According to the ACFE's Report to the Nations 2020, 55% of the corruption cases investigated during Jan 2018 to Sep 2019 were perpetrated by someone in a position of authority (35% manager and 20% owner / executive) where as remaining 41 % by employees and 3 % by others. The median loss incase of owner/ executives was US\$ 600,000 where as that of managers was US\$ 150,000 and of employees US\$ 100,000.

## Asset-misappropriation

By far the most common frauds are those involving asset misappropriation, and there are many different types of fraud which fall into this category. According to the ACFE's Report to the Nations 2020, misappropriation happens in over 86% of fraud schemes with a median loss of US\$ 100,000. But in terms of losses, it is the least expensive per median loss among the three categories. The common feature is the theft of cash or other assets from the company, for example:

**Misappropriation happens in over 86% of fraud schemes with a median loss of US\$ 100,000**

Cash theft – the stealing of physical cash, for example petty cash, from the premises of a company.

Fraudulent disbursements – company funds being used to make fraudulent payments. Common examples include billing schemes, where payments are made to a fictitious supplier, and payroll schemes, where payments are made to fictitious employees (often known as 'ghost employees').

Inventory frauds – the theft of inventory from the company.

Misuse of assets – employees using company assets for their own personal interest.

## Financial statement fraud

This is the least common type of fraud amongst the three. According to the ACFE's Report to the Nations 2020, it occurred in only 10 % of all fraud cases investigated during Jan 2018 to Sep 2019 with a median loss of US\$ 954,000. However it is the most expensive. Average financial cost to a company is very high. This is also known as fraudulent financial reporting, and is a type of fraud that causes a material misstatement in the financial statements. It can include deliberate falsification of accounting records; omission of transactions, balances or disclosures from the financial statements; or the misapplication of financial reporting standards. This is often carried out with the intention of presenting the financial statements with a particular bias, for example concealing liabilities in order to improve any analysis of liquidity and gearing.

**Financial Statement Fraud occurred in only 10 % of all fraud cases with a median loss of US\$ 954,000**

## IV. FRAUD CONCEALMENT

An act of fraud typically involves not only the commission of the scheme itself, but also efforts to conceal the misdeeds. Understanding the methods fraudsters use to cover their crimes can help organizations better design prevention mechanisms and detect the warning signs of fraud.

According to the ACFE's Report to the Nations 2020, the top 4 concealment methods used by fraudsters included:

- Create fraudulent physical documents (40%)
- Altered physical documents (36%)
- Altered electronic documents or files (27%)
- Created fraudulent electronic documents or files (26%)

## V. FRAUD DETECTION

### Recognizing Fraud — Types of Red Flags for Fraud

When dealing with red flags for fraud, it helps tremendously to organize them into various categories. Many company policies already do this, as it is a step toward training management and employees to be familiar with how fraud patterns work. Categories can include:

#### General Red Flags for Fraud

- Missing documents
- Excess purchases
- Use of business funds for personal reasons
- Conflicting statements (especially with fraud involving disclosure)
- Stifling of reporting mechanisms

#### Behavioral Red Flags

- Lifestyle changes, such as drug or alcohol use, or gambling
- Significant personal debt or credit problems
- Financial pressures such as medical debt, family problems, divorce, etc.
- Refusing to take sick or vacation leave

#### Management and Director Red Flags

- Disproportionate compensation schemes
- Disregard for regulatory agencies or rules
- Weak/non-existing internal controls
- Frequent changes in external auditors, banking contacts, or bank accounts
- Significant amount of downsizing in a healthy market environment
- Sale of company assets under market value

#### Accounting Red Flags

- Excessive or unaccounted for cash transactions
- Unreconciled bank account statements
- Unusual amount of expense items, supplies, or employee reimbursements
- Sudden activity in inactive accounts

As per the ACFE's Report to the Nations 2020, in corruption cases investigated during Jan 2018 to Sep 2019, the top red flags were:

Living beyond means	42%
Financial Difficulties	26%
Unusually close relationship with vendor / customer	19%
Control issues, unwillingness to share duties	15%
Irritability, Suspiciousness or defensiveness	13%
Wheeler - Dealer attitude	13%

Divorce, Family Problems	12%
Addiction problems	9%
Complained about inadequate pay	8%
Refusal to take vacations	7%
Excessive pressure from within organization	7%

As per the ACFE's Report to the Nations 2020, all occupational frauds investigated during Jan 2018 to Sep 2019 were committed by these departments:

Operations	15%
Accounting	14%
Executives/Upper management	12%
Sales	11%
Customer Service	9%
Administrative Support	6%
Finance	5%
Purchase	5%

These are just some of the possible categories and corresponding red flags to keep an eye out for. The important thing is to train team members to be cognizant of red flags, and to learn what options they have for internal and external reporting. The success of the company can depend on such vigilance and willingness to take steps toward preventing fraud.

## Green Flags

Green flags are in many ways the converse of Red Flags. These indicators are just too good to be true. Some examples are:

- Unusually high returns provided by an investment
- High Profit margins for a company which are way above the industry average
- Specific companies performing very well when the industry is in a slump

## Acting on Fraud Red Flags

The costs and negative consequences of fraud can be massive; beyond company lost profits, fraud can also result in:

- Loss of shareholder confidence
- Deterring of potential shareholders from investing
- Legal consequences for violations
- Lowered public opinion and perception of the company

Thus, it is important for companies and funds to have workable mechanisms in place for reporting fraud. Ideally, anti-fraud mechanisms should be built into company operating procedures.

Perhaps the most concerning consequence of fraud is that each incident or occurrence serves to perpetuate a culture of dishonesty and misrepresentation in corporate settings. It is especially important to be able to identify patterns of fraud in upper management levels and at the policy-making levels, as these can then filter down into more day-to-day operations. In this regard, the cooperation and participation of whistleblowers is extremely valuable in the identification and reporting of corporate fraud.

## General Methods for Fraud Detection

Methods can be developed for frauds in general, or specific groups of frauds (e.g., a category), or even individual schemes. Some methods that could be used for general detection, regardless of the scheme, are:

- Internal audit function actively engaged in proactive antifraud activities
- Sarbanes-Oxley Act (SOX) section 404 results can lead to identification of weaknesses in internal controls that can cause a higher risk for fraud in that area or business process
- Horizontal and vertical analysis of financial reports, especially when comparisons are made between business units and their data
- Ratio analysis, especially trends over several years, and by business unit compared to other units and the entity as a whole
- Surprise audits and/or cash counts
- Anonymous tips and complaints system to which employees, vendors, and customers have access; comfortable, convenient, easy to use
- Data mining for applicable red flags using Computer-Assisted Auditing Tools (CAAT)

According to the ACFE's Report to the Nations 2020, the most common detection methods for occupational frauds investigated during Jan 2018 to Sep 2019 were as below:

• Tip	43%
• Internal Audit	15%
• Management Review	12%
• Other	6%
• By Accident	5%
• Account Reconciliation	4%
• External Audit	4%
• Document Examination	3%
• Surveillance / monitoring	3%
• Notified by law enforcement	2%
• IT Controls	2%
• Confession	1%

## Anti-Fraud Controls at the Victim Organization

The presence of a robust system of anti-fraud controls can be a powerful deterrent, as well as a proactive prevention and detection mechanism, in the fight against fraud. As per the Report to the Nations 2020, 81% of the victim organizations had a code of conduct and 83% underwent external financial statement audits, while 74% had internal audit departments, and 73% had company management certify the financial statements. On the other end of the spectrum, 23% of organizations had policies requiring job rotation or mandatory vacation, and only 13% provided rewards for whistleblowers.

## VI. FRAUD PREVENTION

Though fraud cannot be completely prevented, still it can be significantly reduced if we implement certain preventive majors effectively.

- Proper Segregation of duties among employees.
- Establishing a fraud hotline. (to offer employees an anonymous , confidential method to report

suspected fraud)

- Creating Stronger and effective internal controls in the organization.
- Carrying out regular audit of vulnerable areas of the organization.
- Stronger corporate governance in the organization to stop upper management fraud. (Some measures include: independent oversight of management and operations by the board, inclusion of financially literate members in the audit committee etc.)
- Anti-fraud education in the organization.

## VII.NEPALESE SCENARIO

### Legal Provisions

Some of the legal provisions dealing with the fraudulent activities in Nepal have been summarized below:

#### Provisions in the Penal Code 2017

Several provisions have been incorporated in the Penal Code to cover the fraudulent activities, some of the key sections are:

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Section 33. Prohibition of criminal conspiracy:

Section 241. Prohibition of theft:

Section 249. Prohibition of cheating:

Section 251. Prohibition of criminal misappropriation of property:

Section 252 Prohibition of criminal breach of trust:

Section 276. Prohibition of forgery:

Section 277. Prohibition of possessing or using as genuine a forged document:

Section 278. Prohibition of making instrument for making forged document:

Section 279. Prohibition of committing fraud:

Section 280 and 281. Punishment for Fraud

#### Provisions in Civil Code 2017

Section 151. Fraud on Guardianship

Section 336 (2). Fraud in Trust Property

Section 518 (2) (c). Contractual Fraud

#### Banking Offence and Punishment Act, 2064

The Act has mentioned following activities as banking offences:

- open an account or demand cash payment in an unauthorized manner
- obtain or issue cheques, cheque-books or bank statements in an unauthorized manner:
- make unauthorized withdrawals or payments:

- obtain or make payment by way of abuse or unauthorized use of electronic means
- avail or provide loans in an unauthorized manner
- misuse of credit
- misuse of banking resources, means and assets:
- acquire assets or open account by borrower who has over dues:
- make loss by making alteration in the account or ledger or by committing forgery or fraud
- derive excess, low or false valuation
- carry out and cause to carry out irregular economic or financial transactions:

## Companies Act of Nepal

Section 115 of the Companies Act requires the auditor to report (in addition to other matters) :

- Whether the books of account as required by this Act have been properly maintained by the company in a manner to reflect the real affairs of its business;
- Whether the balance sheet, profit and loss account and cash flow statements received have been prepared in compliance with the accounting standards prescribed under the prevailing law and whether such statements are in agreement with the books of account maintained by the company;
- Whether the board of directors or any representative or any employee has acted contrary to law or misappropriated any property of the company or caused any loss or damage to the company or not;
- Whether any accounting fraud has been committed in the company

However the Act has not defined the term accounting fraud.

Section 160 of the Companies Act provides certain provisions relating to fraudulent activities. Some of the activities covered by the section to be punishable includes:

- Where any director or officer of a company has caused any loss or damage to the company or any person by mentioning any false matter in any document of the Company, with mala fide intention or malicious recklessness, such director or employee;
- Where any director or officer or employee fails to hand over the documents, accounts, cash goods in –kind in this charge on the termination of his/her office or on receipt of a order to liquidate the company, to the successor or where the successor fails to take over them pursuant to this Act, such director, officer and employee who do not hand over or take over them;
- Any director or officer who issues the prospectus of a company prior to its being registered with the Office who gives false details in the prospectus;
- Where any act is done beyond the jurisdiction of the board of directors or beyond the scope of work of the company, any director or officer who does or orders to do such act;
- Any director or officer or employee who misappropriates or embezzles cash or goods in-kind of the company or uses the cash or goods in-kind of the company for his/her personal use without the approval of the board of directors or the general meeting or does not settle advances according to the rules of the company or does not abide by any order issued by the Office or fails to submit any returns of the company;
- Any director or substantial shareholder or company who receive or give any loan facility or remuneration from the company in a manner to be contrary to the provisions contained in this Act;

## Nepal Standards on Auditing

NSA 700 requires the auditors to form an opinion on the financial statements as below:

- The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

- In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error

NSA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. An auditor conducting an audit in accordance with NSAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the NSAs.

## Fraud Incidents in Nepal

As disclosed in the Financial Fraud Conference held on 7th may 2018 in Kathmandu, "178 financial crimes worth NPR 36 billion have been registered in Nepal in the last eight years."

According to data maintained by the Nepal Police Headquarters, police recorded 368 cases related to fraud across the country in the fiscal year 2016/17. The number of cases rose to 542 in the fiscal year 2017/18. In the fiscal year 2018/19, police registered 627 cases related to fraud.

<https://kathmandupost.com/national/2019/12/04/police-arrest-two-persons-for-alleged-online-fraud>

## VIII. CONCLUSION

In summary, Fraud is an activity that takes place in a social setting and has severe consequences for the economy, corporations, and individuals. It is an opportunistic infection that bursts forth when greed meets the possibility of deception. Individuals commit white-collar crime by embezzling funds, manipulating accounts, receiving bribes, or committing other schemes through their place of business. What they all have in common, however, is the intent to deceive.

Methods used to detect fraud includes: internal audit function actively engaged in proactive antifraud activities, Sarbanes-Oxley Act (SOX) section 404 results can lead to identification of weaknesses in internal controls that can cause a higher risk for fraud in that area or business process, Horizontal and vertical analysis of financial reports, Ratio analysis, Surprise audits and/or cash counts, Anonymous tips and complaints system to; Data mining for applicable red flags using Computer-Assisted Auditing Tools. etc.

Internal Audit, SOX Compliance check, CAAT tools are some of the means to detect fraud

Fraud incidents are increasing day-by-day worldwide including Nepal so a proactive measure is the best possible way to minimize the loss due to the Occupational Frauds.

## IX. REFERENCES

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4. Nepal Penal Code 2017
5. Companies Act of Nepal
6. Companies Act of India
7. Banking Offence and Punishment Act, 2064 (Nepal)
8. Nepal Standards on Auditing



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