

GUIDES TO GOOD GOVERN- ANCE

No. 05

Managing the risks of real estate corruption and fraud in the defence sector



CENTRE FOR INTEGRITY
IN THE DEFENCE SECTOR



Norwegian Ministry
of Defence

CENTRE FOR INTEGRITY IN THE DEFENCE SECTOR

The Centre for Integrity in the Defence Sector (CIDS) is promoting integrity, anti-corruption measures and good governance in the defence sector. Working with Norwegian and international partners, the centre seeks to build competence, raise awareness and provide practical means to reduce risks of corruption. CIDS was established by the Norwegian Ministry of Defence in 2012.

ABOUT THE AUTHOR

This guide is written by the Internal Audit department (IA) of the Norwegian Ministry of Defence. The guide is produced as a part of IA's engagement in the Anti-Corruption cluster of the Nordic-Baltic Assistance Programme (NBAP). The role of IA is to provide independent assurance that risk management, governance and internal control processes in the Norwegian defence sector are operating effectively. IA reports to the Secretary General and works in accordance with the international standards of The Institute of Internal Auditors.

FOREWORD

CIDS is publishing the fifth booklet of the series Guides to Good Governance. Our objective with this series is to present key issues within the area of good governance to a wide audience in a concise and reader-friendly format.

Real estate is an area within the defence sector that normally is exposed to major corruption and fraud risks. Real estate corruption and fraud schemes can have significant negative impact on personnel's health and safety and organisations' financial situation, reputation and internal culture.

IA's objective with this guide is to provide sound and specific guidance on how organisations can reduce their exposure to real estate corruption and fraud risks.

I would like to thank the authors for their efforts and for letting us benefit from their expertise and practical experience.

We hope that managers, control functions, auditors and other interested parties within and outside the defence sector can utilize this contribution to good governance. The successful fight against corruption and fraud requires extensive and systematic work over time. CIDS is happy to receive any feedback on this guide.

Oslo, 20 June 2017



Per Christensen
Director

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Introduction

Several definitions of *corruption* and *fraud* exist. In this guide, we use the definitions provided in *Managing the Business Risk of Fraud: A Practical Guide*¹. Corruption is operationally defined as *the misuse of entrusted power for private gain*. Fraud is defined as *any intentional act or omission designed to deceive others, resulting in the victim suffering a loss and/or the perpetrator achieving a gain*.

The defence sector is subject to substantial corruption and fraud risks. Transparency International, a reputable multinational organisation focused on anti-corruption and transparency in government and business, estimates that at least USD 20 billion is lost to corruption in the sector every year². In addition, billions of USD are lost due to other fraudulent acts. The consequences of defence corruption and fraud are severe. Transparency International states³: “*What is wasted on defence corruption could be spent in improving schools, healthcare or infrastructure. Corruption destroys trust in military institutions and the armed forces, risking lives in the process. When leaders buy arms because they have been bribed or received favours, it is the soldiers in the field who are left with shoddy guns or inadequate protection. Soldiers exist to protect citizens, but governments have a duty to protect their soldiers, and they buy*

from defence companies to do so. Corruption, on the other hand, protects only the corrupt.” The defence sector normally owns, controls and/or manages vast real estate assets in the form of land plots, buildings and construction projects. Typically, many high-value transactions such as acquisition/sale, rental agreements, construction- and maintenance projects are carried out every year. The high economic values involved attract groups and individuals seeking unjust personal gain. A broad set of effective controls are necessary to manage real estate corruption and fraud risks in the defence sector.

This guide recommends ways in which defence sector management and internal auditors can fight real estate corruption and fraud. The framework outlined in this guide can be summarised in the following process model:

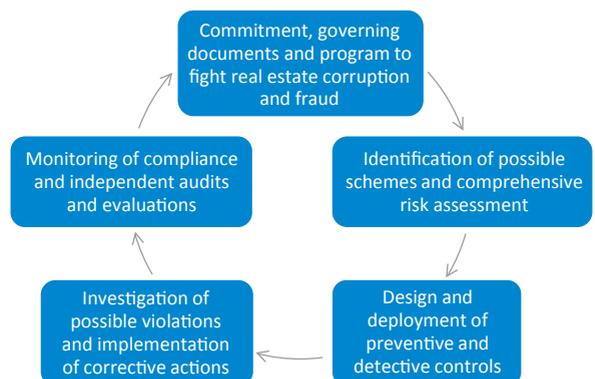
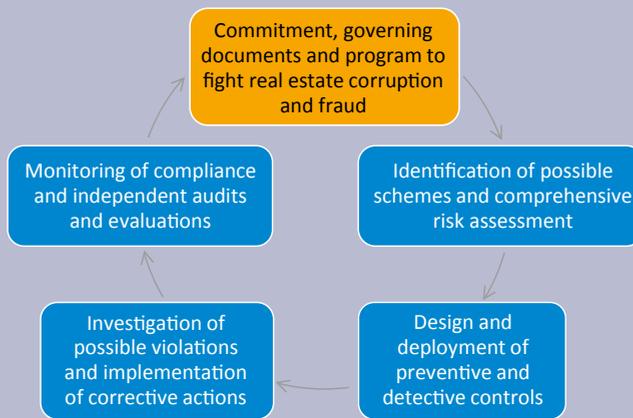


Figure 1 Process model

1 Published by The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners

2 https://www.transparency.org/topic/detail/defence_security/

3 https://www.transparency.org/topic/detail/defence_security/



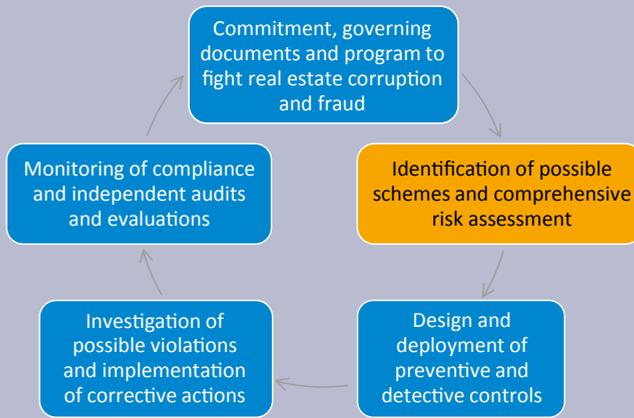
Commitment, governing documents and program

Clear rules including written process descriptions and senior management’s commitment are prerequisites for effective fighting of corruption and fraud. The ethical standard of the organisation should be articulated in a formal governing document such as a code of ethics or similar. Organisations exposed to real estate corruption and fraud risks should consider addressing this risk area specifically in their code of ethics. An adequate code of ethics influences how we think about our actions and what we should and should not do. Every employee shall have an understanding of how the code of ethics influences his or her daily work, and the ways to act accordingly. Senior management needs to communicate their commitment to fight corruption and fraud. It is crucial that managers act as good role models and demonstrate actual adherence to the code of ethics. Moreover, managers need to under-

stand their own role in implementing, overseeing, assessing and following-up that an ethical atmosphere is created consistent with the requirements of the code of ethics. Management needs to create a culture through words and actions where it is clear that fraud is not tolerated, that any such behaviour is dealt with swiftly and decisively, and that whistleblowers will not suffer retribution⁴. It is good practice to require every new member of an organisation to acknowledge with signature that he or she has read and understood the code of ethics.

For organisations exposed to a broader set of corruption and fraud risks it is beneficial to formalise the different risk mitigating elements in an overall program, such as an anti-corruption program, fraud management program or integrity program.

⁴ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners



Real estate corruption and fraud risk assessment

The first step in fighting real estate corruption and fraud is to identify and assess specific potential schemes and events that the organisation needs to mitigate. The risk exposure should be assessed periodically and the assessment should be carried out in a structured and systematic manner. The organisation can identify and assess real estate corruption and fraud risks in conjunction with an overall entity risk assessment or on a stand-alone basis. The assessment shall identify where real estate corruption and fraud may occur and who the perpetrators might be. Accordingly, control activities should always consider both the real estate corruption and fraud scheme and the individuals within and outside the organisation who could be the perpetrators of each scheme. If the scheme is collusive⁵, preventive controls should be augmented by detective controls, as collusion negates the control effectiveness of segregation of duties.⁶

ELEMENTS OF THE RISK ASSESSMENT

Corruption and fraud are intentional acts that the perpetrators normally wish to remain undetected. Thus, the corruption and fraud assessment team needs to engage in reasoning to anticipate the behaviour of potential perpetrators. Such reasoning requires a sceptical mindset and is also important in designing corruption and fraud detection procedures that a perpetrator may not expect. The reasoning involves asking questions such as:

- How might the corrupt person or fraudster exploit his/her position and/or authority for unjust enrichment?
- How might the perpetrator exploit vulnerabilities in the safeguarding of assets or system of controls?
- How could a perpetrator override or circumvent controls?
- What could a perpetrator do to conceal the corrupt or fraudulent act?

With this in mind, a real estate corruption and fraud risk assessment generally includes the following key elements:

⁵ A collusive scheme is one performed by two or more individuals working together.

⁶ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners

- *Identify inherent real estate corruption and fraud risk* – Collect data and use the assessment team’s collective insight, observations and imagination to articulate the population of real estate corruption and fraud risks that could apply to the organisation. Included in this process is the consideration of all types of real estate corruption and fraud schemes and scenarios: methods, incentives and opportunities to commit corrupt or fraudulent acts.
- *Assess the opportunity/vulnerability* expressed in ability, incentives and existence of control weaknesses to commit the corrupt or fraudulent act. *Assess the personal safety, financial, reputational and internal cultural consequences* if the corruption or fraud scheme occurs.
- *Prioritise the identified schemes* based on outcome of the assessment and *decide re-*

sponse based on priority and cost-benefit analysis of relevant mitigating actions.

RISK ASSESSMENT FRAMEWORK

The organisation should apply a framework to document their real estate corruption and fraud risk assessment. The framework below is an adjusted version of a framework developed by the Office of the Auditor General of Norway. It illustrates how the elements of risk identification, assessment, and response can be applied in a systematic and structured approach.

The framework consists of two sheets: the sub sheet and the main sheet.

Step 1: List all identified real estate corruption and fraud risks and schemes in the sub sheet

Step 2: Assess the risks and schemes with respect to opportunity/vulnerability. The following five-point weighting scale may be applied:

Opportunity/vulnerability		Score
VERY HIGH	Opportunity/vulnerability for the real estate corruption or fraud scheme in the organisation is very high	5
HIGH	Opportunity/vulnerability for the real estate corruption or fraud scheme in the organisation is high	4
MODERATE	Opportunity/vulnerability for the real estate corruption or fraud scheme in the organisation is moderate	3
LOW	Opportunity/vulnerability for the real estate corruption or fraud scheme in the organisation is low	2
VERY LOW	Opportunity/vulnerability for the real estate corruption or fraud scheme in the organisation is very low	1

Figure 2 Opportunity/vulnerability scale

Step 3: Assess the personal safety, financial, reputational and internal culture consequences if the scheme occurs. Explanation of the different types of consequences:

Personal safety: assessment of safety hazards if the scheme occurs. To what extent will the corrupt or fraudulent act put health and safety of personnel at risk?

Finance: assessment of the financial losses if the scheme occurs. To what extent will the corrupt or fraudulent act reduce effectiveness or efficiency? Will the scheme have adverse impact on quality of deliveries (e.g. construction work)?

Reputation: assessment of the consequences for the organisation in case the corrupt or

fraudulent act becomes publicly known. To what extent will the scheme have adverse impact on public trust in the organisation?

among employees? To what extent will it have adverse impact on the general moral or ethical standard in the organisation?

Internal culture: will the corrupt or fraudulent act create dissatisfaction, fear and/or conflicts

The following five-point weighting scale may be applied when assessing consequences:

Consequence		Score
VERY SIGNIFICANT	The scheme will have very significant negative impact on personnel's health and safety and/or the organisation's financial situation, reputation and/or internal culture. The extent of damage will be very high.	5
SIGNIFICANT	The scheme will have significant negative impact on personnel's health and safety and/or the organisation's financial situation, reputation and/or internal culture. The extent of damage will be high.	4
MODERATE	The scheme will have negative impact on personnel's health and safety and/or the organisation's financial situation, reputation and/or internal culture. The extent of damage will be moderate.	3
LOW	The scheme will have negative impact on personnel's health and safety and/or the organisation's financial situation, reputation and/or internal culture. The extent of damage will be low.	2
INSIGNIFICANT	The scheme will have little impact on personnel's health and safety and/or the organisation's financial situation, reputation and/or internal culture. The extent of damage will be insignificant.	1

Figure 3 Consequence scale

Step 4 – Rank the schemes by multiplying the score for opportunity/vulnerability with the highest score among the four types of consequences:

Total ranking (prioritisation) = O*C (highest score among the four consequence dimensions is selected)

In summary, the sub sheet will look like this:

Sum after weighting and calculation	Real estate corruption or fraud scheme	Opportunity/vulnerability	Consequence			
			Personal safety	Finance	Reputation	Internal culture
25	EXAMPLE A decision-maker in the Ministry of Defence is offered and accepts compensation in the form cash, goods, services or job offer from a private construction firm in order to influence the award of the contract regarding the construction of a new office building for the armed forces	5	3	4	5	4
16	[Description of Scheme Y]	4	2	4	4	3
6	[Description of Scheme Z]	2	2	3	3	3

Figure 4 Sub sheet

After completing the sub sheet, the schemes/risks are transferred to the main sheet. When prioritizing the schemes/risks in the main sheet,

solely classification as “high priority” or “low priority” is used. The classification is based on the ranking in the sub sheet and it is necessary to

decide which sum (from the column «Sum after weighting and calculation») qualifying for *high* or *low* priority. The main sheet including the example (we assume in this example exercise that all schemes with sum higher than 15 are given high priority) scheme provided in the sub sheet above has this form and content:

REAL ESTATE CORRUPTION AND FRAUD SCHEMES

Several real estate corruption and fraud schemes within the defence sector can be anticipated. Obviously, risk exposure will vary between organisations and nations. For awareness and learning purposes, we provide a list of some common schemes and scenarios:

- Scheme 1 – A key decision-maker in the defence sector uses his/her position to acquire a land plot sold by an entity within the defence sector at a price significantly below real market value.
- Scheme 2 – A decision-maker in the defence sector owns a land plot at a suitable location for military units. An entity in the defence sector needs a land plot in connection with the establishment of a new military base. The decision-maker influences the acquisition process so that his/her land plot is acquired by the entity in the defence sector at a price significantly above normal market price.
- Scheme 3 - Decision-makers in the defence sector are *offered and accept* compensation

Corruption/fraud risk - WHAT	Scheme WHO/HOW	Red flags	Management actions
EXPLANATION Short description of the risk. One shall try to put the risk/scheme in a suitable category (e.g. "bribery").	Detailed description of the scheme including method and who is involved. Explain how the scheme might occur.	Description of characteristics or "symptoms" of the scheme including signs to look for in order to detect it.	Descriptions of controls/ actions already in place or need to be implemented to mitigate the risk.
Real estate process			
1 Construction of new buildings			
Bribery of public official	EXAMPLE A decision-maker in the Ministry of Defence is offered and accepts compensation in the form of cash, goods, services or job offer from a private construction firm in order to influence the award of the contract regarding the construction of a new office building for the armed forces.	Discrepancy between salary and lifestyle. Sudden change in work pattern or behaviour. "Surprising" career move. Sudden change in the behaviour of the supplier.	Whistle blower hotline is operative. Training program on integrity and ethics is being implemented. Improved routines for reporting breaches to the police is necessary.
[Risk name and category of scheme Y]	[Description of scheme Y]	[Red flags related to scheme Y]	[Red flags related to scheme Y]
[Risk name and category of scheme Z]	[Description of scheme Z]	[Red flags related to scheme Z]	[Red flags related to scheme Z]

Figure 5 Main sheet

in the form of cash, goods, services and/or job offer from private construction firms in order to influence the award of contracts regarding the construction or demolition of buildings for entities in the defence sector.

- Scheme 4 - Decision-makers in the defence sector *request and are given* compensation in the form of cash, goods, services (e.g. construction services at the private houses of the decision-makers) and/or job offer from private construction firms in order to influence the award of contracts regarding the construction or demolition of buildings for entities in the defence sector.
- Scheme 5 - Decision-makers in the defence sector are *offered and accept* compensation

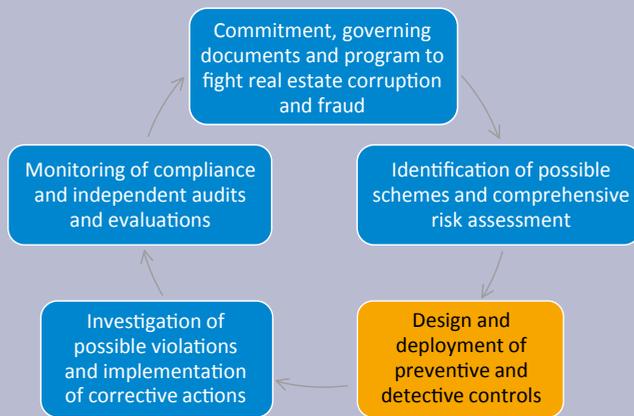
in the form of cash, goods, services and/or job offer from private service providers in order to influence the award of contracts regarding maintenance and/or other facility management services rendered to entities in the defence sector.

- Scheme 6 - Decision-makers in the defence sector *request and are given* compensation in the form of cash, goods, services and/or job offer from private service providers in order to influence the award of contracts regarding maintenance and/or other facility management services rendered to entities in the defence sector.
- Scheme 7 - Personnel involved in the allocation of housing to military personnel

Priority	Opportunity/vulnerability	Consequences for the organisation	Audit procedures
Priority high/low is set based on assessment and ranking in the sub sheet.	Outline and explain assessment done in sub sheet.	Description based on assessment in sub sheet. Comment the major consequences.	Outline audit procedures that might be relevant in case of internal audit.
High	Several officials in the Ministry of Defence have extensive Powers of Attorney to enter into profitable contracts with construction firms. Current lack of detective and corrective controls.	Financial losses as the armed forces probably will pay more than necessary for the building. Taxpayers' trust in the Ministry of Defence will be reduced. Employee motivation is expected to suffer.	Review of segregation of duties. Mapping of relations between construction firms and key decision makers in the Ministry of Defence. Discreet examination of lifestyle of key decision makers in the Ministry of Defence.
High	[Assessment of opportunity/vulnerability scheme Y]	[Consequences if scheme Y occurs]	[Relevant audit procedures related to scheme Z]
Low	[Assessment of opportunity/vulnerability scheme Z]	[Consequences if scheme Z occurs]	[Relevant audit procedures related to scheme Z]

requests and receives compensation in the form of cash, goods or favours for granting attractive or scarce flats/houses to specific individuals.

- Scheme 8 - A small group of decision-makers involved in the procurement of construction or other real estate- related services enters into contracts with firms for which they in reality are the ultimate owners.
- Scheme 9 – Employees (e.g. in procurement or accounting) misappropriate assets by
 - Creation of, and payments to, fictitious vendors of construction and/or other real estate – related services or
 - Payment of inflated or fictitious invoices for real estate-related services or
 - Payment of invoices for real estate – related services not performed.
- Scheme 10 – Decision-makers/employees *in collusion* with vendors or third parties misappropriate assets by
 - Payment of inflated or fictitious invoices for real estate-related services or
 - Payment of invoices for real estate – related services not performed or
 - Using buildings or land owned by the defence sector for personal gain (e.g. renting a warehouse owned by the defence sector to a private company and keeping all or parts of the revenues).
- Scheme 11- Employees with access to classified information about defence sector buildings etc. sell such information to foreign authorities or other parties.
- Scheme 12- An employee involved in construction projects is compensated by an external construction firm for allowing the firm to use the construction project as part of money laundering activities.



Controls to prevent, detect and correct real estate corruption and fraud

RESPONSE TO REAL ESTATE CORRUPTION AND FRAUD RISKS

Risk tolerance varies from organisation to organisation. Leading organisations exposed to real estate corruption and fraud risks normally want to have a robust corruption and fraud response program. This means designing and performing controls that mitigate applicable risks in an effective and efficient manner. It does not mean putting every possible control in place. The goal is a targeted and structured approach – not an unstructured or haphazard approach- and efficient controls that deliver the most benefit for the cost of resources⁷. The overall objective is to have the benefit of controls exceed their cost⁸. Generally, internal controls are composed of policies, procedures, practices and organisational structures that are implemented to reduce risk to the organisation. Internal controls are typically classified as preventive, detective or corrective in nature. In our context, prevention encompasses policies, procedures, training, and communication that stop real estate corruption and fraud from occurring, whereas detection focuses

on activities and techniques that detect and report the occurrence of a corrupt or fraudulent act. Correction encompasses measures to minimise the impact of a detected corrupt or fraudulent act, to identify how the event could happen and how future occurrences can be avoided.

PREVENTION

Prevention is the most proactive measure to fight corruption and fraud. Among the many elements in prevention are conflict disclosure, Human Resources Procedures, public access to unclassified information, integrity due diligence of vendors and partners, segregation of duties and authority limits and various transaction-level procedures.

CONFLICT DISCLOSURE

Conflicts of interests may lead to decisions that are not in the best interest of the organisation as personal considerations may affect judgment and decision making. Although the intentions may be legitimate, the appearance of a conflict may be perceived as improper. Various conflicts of interest are typically among the major real estate fraud risks. Thus, a process for managers, employees and contractors to self-disclose potential or actual

⁷ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners

⁸ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners

conflicts of interest is important. Once conflicts are internally disclosed, the legal department or any other qualified and objective function should assess each conflict. There are several decision paths:

- Conclude that there is in fact, a conflict and require the individual to terminate the activity or leave the organization.
- Accept the internal disclosure and determine that there is no conflict of interest in the situation described.
- Decide that there is a potential for conflict of interest and impose certain constraints on the individual to manage the identified risk and to ensure there is no opportunity for a conflict to arise.

HUMAN RESOURCES PROCEDURES

The following procedures to prevent corruption and fraud should be an integral part of the organisation's Human Resources processes.

■ **Performing background checks**

A key corruption and fraud risk in any organisation lies in the people hired and promoted into positions of trust and authority. For that reason, it is important to be aware of any issues of personal integrity that may affect their suitability for the position. Education, work experience, professional skills, ethical standard and reasons for leaving former jobs should be verified.

■ **Anti-corruption and anti-fraud training and awareness building**

Experience indicates that it takes both time and efforts to build sufficient awareness with respect to an organisation's anti-corruption and anti-fraud agenda. Conse-

quently, recurring training and awareness activities are necessary to ensure that the commitment against corruption and fraud is known and lived throughout the organisation. Personnel involved in real estate needs tailored information and training so that they understand the ethical standard expected from them and as well as types of real estate corruption and fraud that could occur. Furthermore, it is necessary to provide guidance on how to solve ethical dilemmas. A brief handbook to assist personnel in navigating challenges related to interaction with suppliers etc. is useful.

■ **Employee dialogue and performance evaluation**

Performance management involves the evaluation of employee behaviour and performance as well as work-related competence. Normally, people want recognition of competence and reward for positive performance and success. Regular and fair assessment of employee performance with timely and constructive feedback are important in preventing problems. Employees who are not recognized for what they do and what they have accomplished, especially those who may have been bypassed for promotion, may feel their inappropriate and fraudulent conduct is justified⁹. Employee dialogue can also include an organisation wide employee survey.

■ **Conducting exit interviews**

A practice of conducting exit interviews of terminated employees or those who have resigned can help in both prevention and detection efforts. These interviews may reveal issues regarding management's in-

⁹ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners

tegrity and other problematic culture and practice in the organisation.

PUBLIC ACCESS TO UNCLASSIFIED INFORMATION

Public announcement of defence sector real estate assets for sale is an important preventive measure for reducing the risk for inappropriately low transaction prices and less bidders that possible.

INTEGRITY DUE DILIGENCE OF VENDORS AND PARTNERS

The real estate sector across Europe attracts a relatively high number of players with low ethical standard. Thus, due care is required when selecting sellers and buyers of land plots and vendors of construction and other real estate – related services. Integrity Due Diligence (“IDD”) is the gathering of information to gain an understanding of the integrity and corruption risks associated with a third party.

SEGREGATION OF DUTIES AND AUTHORITY LIMITS

Segregation of duties is a basic internal control that prevents and detects irregularities by assigning to separate individuals the responsibility for initiating and recording transactions and for the custody of assets. Duties within real estate that should be segregated include:

- Custody of assets (management of buildings etc.)
- Authorisation/approval (of contract awards, payments etc. and valuation of assets)
- Recording transactions (execution of payments, accounting etc.)

Fraud is less likely when an individual’s level of authority is commensurate with his or her

level of responsibility. A misalignment between authority and responsibility, particularly in the absence of control activities and segregation of duties, can lead to fraud¹⁰.

TRANSACTION-LEVEL PROCEDURES

Reviews of certain types of transactions can also help prevent corruption and fraud. Because corruption and fraud schemes often involve the use of third-party entities/individuals, checks should be made before new employees, vendors and customers (in our context buyers of land/buildings and renters) are registered in accounting systems and similar. Furthermore, transactions with parties where possible conflicts of interest have been disclosed should be reviewed. Some control questions:

- Do we have sufficient documentation to conclude that the new employee or vendor is real and not fictitious?
- Is any of the master data (e.g. address and/or bank account) of a new vendor or a new customer identical with master data of an existing employee?
- Is the transaction with the related party (disclosed in the interest register) determined to be acceptable?
- Is delivery address similar to the address of an employee?
- Does the vendor request payments to a bank account in a tax haven?

¹⁰ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners

DETECTION

Having effective detective controls in place and visible is one of the strongest deterrents to corrupt and fraudulent behaviour. The objective of detective controls is to identify whether corruption and fraud is occurring or has occurred. The types of detective controls implemented should reflect schemes and risks identified for the organisation. Detection techniques should be flexible, adaptable, and continuously changing to meet the dynamic nature of risks. Important detection methods include an anonymous reporting mechanism (whistleblower hotline), process controls, and proactive detection procedures specifically designed to identify corrupt and fraudulent activity.

WHISTLEBLOWER HOTLINES

We know that tip is by far the most common detection method in fraud cases, accounting for 39% of cases according to the 2016 global fraud study¹¹. However, this is not the case for all organisations. The study shows that in organisations with a reporting hotline, 47.3% of fraud schemes was detected by tip. By comparison, organisations without a reporting hotline detected 28% of the cases by tip. This indicates that a whistleblower hotline can be an effective mean to detect fraud schemes. The figure below shows that whistleblowers use various reporting mechanisms, and that organisations can benefit from having multiple channels for reporting corruption and fraud:

¹¹ Association of Certified Fraud Examiners (ACFE) report to the nations on occupational fraud and abuse.

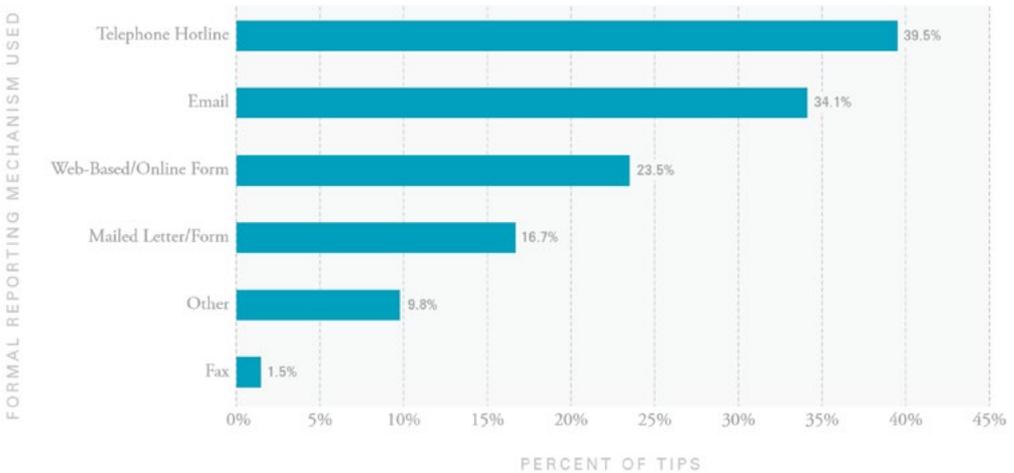


Figure 6: Formal reporting mechanism used by whistle-blowers (ACFE Global fraud survey 2016)

To be effective, the employees must have trust in the reporting process. Whistleblower reports should be treated confidentially and with great professionalism. Furthermore, the reporting mechanism should be accessible and transparent, with information about how the reports are handled, by whom, and how whis-

tleblowers are protected from retaliation. The hotline should be managed by employees with training and experience from handling such cases, and with an independent position in the organisation. Finally, the reporting mechanisms should facilitate anonymous reporting.

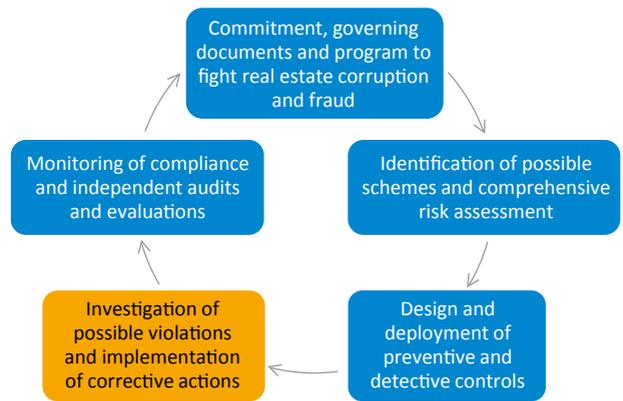
PROCESS CONTROLS

Process controls specifically designed to detect corrupt and fraudulent activity, as well as errors, include reconciliations, independent reviews, physical inspections/counts, analyses, and audits. Applied in a real estate context, the most relevant process controls are as follows:

- *Reconciliations*: agree sales/acquisition contracts of land plots and buildings to independent valuations/appraisals, agree invoices for acquisition, sales, rental and purchasing of goods and services to contracts, agree invoices for construction and maintenance services to actual work progress/work performed
- *Independent reviews*: calculation of market value of land plots, buildings and rent by independent experts, condition evaluation of buildings by independent experts, evaluation of budgets for construction projects by independent experts
- *Physical inspections/counts*: asset count of buildings including technical installations and interior, inspection of progress in construction and maintenance work, inspection of quality of construction and maintenance work
- *Analyses*: structured analysis of development in property prices, rents and costs of construction and maintenance services for different locations
- *Audits*: please refer to section 5 in this guide for details

PROACTIVE DETECTION PROCEDURES

In addition to detective process controls, organisations may be able to use data analysis, continuous auditing techniques, and other technology tools effectively to detect corrupt and fraudulent activity. A prerequisite for applying these procedures is high degree of digitalization of purchasing- and accounting processes.



INVESTIGATION AND CORRECTIVE ACTION

It is essential that any violations, deviations, or other breaches of applicable laws, the code of ethics or controls, regardless of where in the organization, or by whom, they are committed, be reported and dealt with in a timely manner. Appropriate punishment must be imposed, and suitable remediation completed.

INVESTIGATION

We can define investigation as a systematic fact finding and reporting process, normally based on allegations or suspicions of fraud, misconduct or other illegal activity¹². The purpose of an investigation is to establish facts and course of events. The investigation shall analyse causes and assess whether unfortunate aspects of the case can be traced back to human error, poor work or intentional acts for personal gain. Ultimately, the aim of the investigation is to assess whether the allegations or suspicions are correct or not. The investigation should be neutral in its design and search for sufficient evidence to draw a valid conclusion. Although an internal investigation is not bound by the same regulations as a police investigation or a trial, one should strive to follow some of the same principles. The European Convention on Human Rights provides directions that are relevant when conducting an investigation¹³ :

1. *The right to a fair trial* (article 6): although an investigation is not a trial, one should ensure that the process is in line with some of the elements from a fair trial:
 - a. Independence and impartiality of the members of the investigation team and decision makers
 - b. The presumption of innocence: the European Convention on Human Rights states that “everyone charged with a criminal offence shall be presumed innocent until proved guilty according to law”. This implies that an investigation should not state that anyone is guilty of a criminal offence before the case is tried in court, and that the mandate for the in-

vestigation should not go longer than to request an assessment of whether criminal offenses may have been committed

- c. *The right to defend oneself* (contradiction): The principle of contradiction implies that the person concerned is acquainted with and able to comment and respond to arguments that could be used against him/her.

2. *The right to respect for private and family life* (article 8) protects individuals from having to answer questions of personal character, and sets restrictions for which information that might be published (/publicly known).

CORRECTIVE ACTIONS

After it has been verified that corruption or fraud has occurred, the organisation needs to determine what action to take. Any action taken should be appropriate under the circumstances, applied consistently to all levels of employees, including senior management, and should be taken only after consultation with individuals responsible for such decisions.

Possible actions include one or more of the following:

- *Criminal referral* - cases involving possible criminal offence shall normally be referred to law enforcement. The police/military police has access to additional information and resources that may aid the case. Referrals for criminal prosecution may increase the deterrent effect of the organisation’s efforts to fight corruption and fraud.
- *Civil action* - the organisation may wish to pursue its own civil action against the perpetrators to recover funds.

¹² *An introduction to theory, practice and career development for public and private investigators*, Whitney D. Gunter and Christopher A. Hertig, 2005

¹³ NOU 2009:9 Lov om offentlige undersøkelseskommisjoner

- *Disciplinary action* – internal disciplinary action may include, termination, suspension (with or without pay), demotion, or warnings.
- *Extended investigation* – conducting a root cause analysis and performing an extended investigation may identify similar misconduct elsewhere in the organisation.
- *Process improvement* – the organisation may be able to re-engineer its processes

cost-effectively to reduce or remove the opportunity for similar acts in the future

Internal control remediation – improvement of certain internal controls to reduce the risk of similar corrupt or fraudulent acts occurring in the future. The organisation should consider the potential impact of its response and the message that it may send to the public, stakeholders, and others¹⁴.

¹⁴ Managing the Business Risk of Fraud: A Practical Guide, The Institute of Internal Auditors, The American Institute of Certified Public Accountants and Association of Certified Fraud Examiners



Effective audits addressing real estate corruption and fraud risks

Typically, laws, policies, anti-corruption and anti-fraud programs and controls will not be consistently followed unless compliance is monitored. Audits are normally the most comprehensive and effective means for testing the effectiveness and efficiency of anti-corruption and anti-fraud measures. Audits act as a powerful motivator to promote compliance with legal, policy and/or program requirements, as well as detect and deter potential improper activity. Knowing that someone is looking and you might be caught doing something is clearly a deterrent, just as the lack of monitoring could provide incentive or opportunity. Conducting anti-corruption and anti-fraud audits send a powerful message that management means what it says and is committed to fight fraud and corruption. The audits shall raise awareness, provide feedback as to how the controls are working and often uncover new risks not previously seen. Providing remedial action in response to audit findings is a cru-

cial aspect of keeping anti-corruption and anti-fraud efforts fresh and evolving as the operations and its risks evolve. A prerequisite for effective anti-corruption and anti-fraud audits is management's support and ability to implement corrective actions derived from the audits. There are two main points of focus when auditing real estate corruption and fraud risks:

- Test for compliance with the various elements of a defined framework and/or program to prevent, detect and correct corruption and fraud in the real estate area
- Substantive compliance testing of potential violations or red flags.

In the following, general real estate audit procedures as well as relevant procedures when auditing the various sub-processes within the real estate area are outlined.

GENERAL REAL ESTATE AUDIT PROCEDURES

Fieldwork procedures generally involve:

- *Analysis and walk-through of the framework and/or program to prevent, detect and correct corruption and fraud in the real estate area* – this means testing the effectiveness of current efforts through interviews with relevant personnel, surveys among all or groups of employees, inspection of documentation and observation of control performance. The internal auditor shall develop an understanding whether applicable risks have been adequately assessed and responded to. To achieve this, the internal auditor needs to evaluate whether the controls in place provide reasonable assurance that real estate corruption and fraud will be prevented or detected and corrected. Depending on the requirements defined by the organisation, the internal auditor will cover a broad range of risk mitigating measures as outlined in section 4 above.
- *Detailed review of selected transactions* – this means gathering evidence to evaluate the integrity of individual real estate transactions such as acquisition, divestment, construction, demolition and leasing. Unless the number of real estate transactions is quite limited, the internal auditor will test a selection of transactions based on perceived risk and magnitude. Samples of transactions to be tested are selected on a judgmental basis.
- *Additional sample testing and/or follow-up of any potential corruption and fraud red flags or other areas of potential concern* – if the review of selected transactions identifies red flags, the internal auditor should examine these further and consider expanding the sample. Any indications of corrupt or fraudulent acts identified in the course of the audit should be referred to the internal body responsible for the handling of such matters.

RELEVANT PROCEDURES WHEN AUDITING ACQUISITION AND/OR DIVESTMENT OF LAND PLOTS AND BUILDINGS

Key procedures when reviewing the acquisition and divestment of land plots and buildings include:

- Walkthrough and assessment of segregation of duties between custody of real estate assets, authorization of the transaction and accounting of the transaction
- Verification that the transaction is approved in accordance with valid power of attorney
- Verification that fair value of the land plot and/or the building has been calculated by an independent and objective expert
- For buildings: verification that a condition analysis has been worked out by an independent and objective expert
- For acquisition of land plots and buildings: verification that the acquisition is based on actual need and that acquisition price corresponds with the fair value calculated by independent expert
- For acquisition of land plots and buildings: (if the seller is a company) verification of the ultimate and real ownership of the selling company
- For divestment of land plots and buildings: verification that the divestment team has obtained (or at least made a real try to obtain) competitive bids from several potential buyers and verification that the transaction price corresponds with the fair value calculated by independent expert
- For divestment of land plots and buildings: (if the buyer is a company) verification of the ultimate and real ownership of the acquiring company
- Mapping of any relationships between defence sector personnel involved in the transaction and the external transaction party and assessment of any conflicts of interest
- To be considered for key decision makers involved in high-value real estate transactions in the defence sector: mapping of private assets and private consumption/lifestyle
- Verification that actual payments correspond with transaction price in final and approved contract

RELEVANT PROCEDURES WHEN AUDITING CONSTRUCTION AND MAINTENANCE PROJECTS

Key procedures when reviewing construction and maintenance projects include:

- Walkthrough and assessment of segregation of duties between internal “owner” of the building(s), unit awarding contract(s) to construction companies/service providers and accounting of the transaction
- Verification that contracts are approved in accordance with valid power of attorney
- Walkthrough and assessment of vendor selection and contract award processes with a particular emphasis on the competitive bidding process
- For major vendors: verification that adequate Integrity Due Diligence has been carried out
- Verification of real/ultimate ownership of vendors that were awarded contracts
- Comparison of contract prices with common market prices for similar services at the same or comparable location
- To be considered for key decision makers involved in high-value construction and/or maintenance projects in the defence sector: mapping of private assets and private consumption/lifestyle
- Mapping of any relationships between defence sector personnel involved in the transaction and the external transaction party and assessment of any conflicts of interest
- Verification that invoices are based on actual progress in construction and/or maintenance work
- Verification that quality of construction and/or maintenance work is in accordance with industry standard and standard agreed in contracts

RELEVANT PROCEDURES WHEN AUDITING LEASE/RENTAL AGREEMENTS

Key procedures when reviewing lease/rental agreements include:

- Walkthrough and assessment of the selection of properties for leasing/rental and the contract award processes
- Review of contracts and assess whether there are deviations from the standard conditions
- Mapping of and comparison with general market conditions for similar agreements
- Mapping of involved employees and ownership in rental companies

RELEVANT PROCEDURES WHEN AUDITING ALLOCATION OF HOUSING TO MILITARY PERSONNEL

Key procedures when reviewing allocation of housing to military personnel include:

- Walkthrough and assessment of whether the allocation process is in line with internal guidelines and best practises for internal control, including
 - Assessment of whether the allocation process, including the selection process, is documented (necessary written regulations)
 - Assessment of whether the criteria for allocation are objective, relevant and in line with internal guidelines
 - Sample testing to verify compliance with criteria for the allocation of housing
 - Verification that all military and civilian personnel requesting accommodation have complete and valid documentation proving their right to free accommodation
 - Verification that the public has access to results from allocation of housing

CONCLUDING COMMENTS

Although complete elimination of all real estate corruption and fraud risks is most likely unachievable or uneconomical, organisations can take positive and constructive steps to reduce their exposure. The combination of awareness of possible real estate corruption and fraud schemes, a thorough risk assessment, strong prevention and detection (including specific anti-corruption and anti-fraud control processes), as well as coordinated and timely investigations and corrective actions, can significantly mitigate risks. Internal Auditing can add significant value by providing

objective assurance that the controls in place are sufficient for identified risks and ensure that the controls are functioning effectively. A prerequisite for conducting effective audits in this area is having auditors with the right mindset and skills. High personal integrity and courage to challenge key decision-makers are necessary attributes. Core skills to have on the audit team include in-depth knowledge about possible schemes, ability to select the most relevant transactions for testing and to recognize red flags.

Guides to Good Governance series



Guides to Good Governance is a series of small booklets each of which discusses a particular topic of importance to good governance in the defence sector. The guides can be read by individuals with an interest in learning more about one or several topics of direct relevance to good governance in the defence sector – or the public sector more generally – and they can be used for educational purposes.

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