Fraud and Corruption Risk Assessment in Projects

World Bank - Preventive Services unit (INT) - GAC in Projects - May 13, 2008
What is the Purpose of This Presentation?

- What Have We Learned About Fraud and Corruption Risk Assessments in PADs?
- **How** Do You Do a Risk Assessment?
- What **Concrete Steps** Should Task Teams Consider?
- How can the **Preventive Services Unit** assist?
Setting the Stage
Sarbanes Oxley Gave Momentum to the Governance Agenda

Highly-publicized frauds at Enron, Tyco and WorldCom exposed significant problems, *inter alia*:

- **Board members** did not exercise their responsibilities, did not have the required expertise, and/or were not truly independent of Management

- **External auditors** performed significant non-audit or consulting work for the companies they audited, at least giving the appearance of conflict of interest

The Sarbanes-Oxley Act of 2002

- Establishes the Public Company Accounting Oversight Board (PCAOB) to oversee, regulate, inspect, and discipline accounting firms in their roles as auditors of public companies

PCAOB Auditing Standard No. 5* Spelled Out Specific Requirements for the External Auditor

- **Perform Fraud Risk Assessment**

- Assess and evaluate **controls** designed to prevent and detect fraud and corruption
Working With Task Teams We Have Learned A Lot About What Can Go Wrong in Project Design

Fraud and corruption risks are underplayed...
- Key risk areas are not mentioned
- Articulation of risks is vague or presented at too high a level
- Past fraud and corruption experiences, incidents, etc. are not referenced

Risk assessment processes provide relatively weak assurances...
- Risk assessment is undertaken too late in the cycle and inadequately resourced
- No diagnostics undertaken in key risk areas
- Critical skills have not always been brought to the team

Mitigation measures (controls) lack specificity and robustness...
- Mitigation measures are not specific in terms of who does what when
- Government and donor accountabilities in risk mitigation not mentioned / explicit
- Mitigation measures are not necessarily linked to risks
- Supervision, prior review thresholds, etc. are not linked to specific threats

Monitoring framework and triggering actions are not clearly spelled out...
- Indicators are not clearly defined
- Triggered Bank action (misprocurement and other remedies) has not been adequately defined and/or agreed with the Borrower
Good News: Task Teams are Uniquely Situated to Assess and Mitigate Risks

- Possess information related to previous Bank-financed projects
- Include **multi-sectoral skills** (country, sector, procurement, fm, etc.)
- Access to **Government** counterparts
- Knowledge of donors, government officials and other **stakeholders**
- Large network of Bank **resource persons**
- Task Teams **know more** about fraud and corruption than they think!
Developing a Risk Control Matrix
1. Identify the Key Threats and Control Weaknesses (Risks) in the Project

**Fraud and Corruption Threats**

- Diversion of road construction and maintenance funds to benefit certain constituencies
- **Pressure on BEC** members to award contracts to favored bidders
- Bribery to steer contracts to favored bidders
- **Collusion** in the bidding of public works contracts
- Scaled-back reports from consultants to fund kickbacks
- **Fraudulent misrepresentation** of work by the contractors

**Control Weaknesses**

- Procurement process lacks integrity
- Assets are not properly registered and protected
- Internal audits fail to identify misstatements
- **Technical audits** provide “clean bill of health” when they shouldn’t
- **Independent Validation and Verification Agents** are bribed and/or extorted to sign-off on work
- **Performance bonds** are not invoked when they clearly should
- Complaint handling system is not in place / producing results
- **Debarment system** is not in place, partially implemented and/or not complied with
- Poor performers keep doing business with the government
Assess the Direct and Indirect Impacts of the Threats to Assets Outlined Above
Risks Can Be Assessed Quantitatively and Prioritized Consistent with the Bank Framework

<table>
<thead>
<tr>
<th>Risk</th>
<th>Impact</th>
<th>Probability</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accountants embezzle project funds by falsifying receipts when paying administrative expenses</td>
<td>4</td>
<td>8</td>
<td>32</td>
</tr>
</tbody>
</table>

The numbers can be used to initiate a discussion of relative risk (they are not necessarily a science)
2. Define the Risk in Question Precisely and Tie Controls to This Risk (NRIMP II Story)

<table>
<thead>
<tr>
<th>Risk</th>
<th>Key Controls (Mitigation Measures)</th>
</tr>
</thead>
</table>
| Elevated bid prices due to collusion by local and int’l bidders in three highway contracts | - **Package contracts** to attract int’l bidders  
- Make **bidding documents** available for on Internet  
- Use **post-bid** qualifications  
- Deploy collusion detection **software**  
- Hire **International Procurement Assessor** who is independent (AusAID financed) and shares reports directly with the Bank  
- Improve quality of **ECE**  
- Enhance **complaint** line use  
- Engage **industry association**  
- **Publish** bid awards and trends  
- Move procurement to **national level** |
INT Investigations Show How Controls Fail to Provide a Defense Against Fraud and Corruption
Determine the Level of Strength Necessary for the Control in Question

<table>
<thead>
<tr>
<th>Level</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1</td>
<td>No specific training requirement exists, so compliance with the requirements is not measured.</td>
</tr>
<tr>
<td>Level 2</td>
<td>Security training requirements exist, and business unit managers record completion of the training, but compliance is not independently verified.</td>
</tr>
<tr>
<td>Level 3</td>
<td>Security training requirements exist, and the business unit managers determine in advance the required percentage of compliance among the individuals involved in that operation. During the periodic risk assessment, a comparison is done to assure compliance with the established percentage.</td>
</tr>
<tr>
<td>Level 4</td>
<td>Same as Level 3.</td>
</tr>
<tr>
<td>Level 5</td>
<td>Security training requirements exist, and the business unit manager is responsible for tracking and verifying that all individuals involved in the operation are compliant.</td>
</tr>
</tbody>
</table>
### 3. Develop Indicators for the Risk and the Controls (and Confirm During Supervision)

<table>
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<tr>
<th>Risk</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>▪ Elevated bid prices due to collusion by local and international bidders in three highway packages</td>
<td>▪ Lowest bid price is significantly higher than the ECE</td>
</tr>
<tr>
<td></td>
<td>▪ Allegations of threat against bidders / cannot purchase bidding doc's</td>
</tr>
<tr>
<td></td>
<td>▪ Similar names of key staff and owners; same address; executed contracts jointly in the past; etc.</td>
</tr>
<tr>
<td></td>
<td>▪ Shell companies (outsourcing major work to local contractor)</td>
</tr>
</tbody>
</table>

<table>
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<th>Controls</th>
<th>Indicators</th>
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<tbody>
<tr>
<td>▪ <strong>Strengthened competition</strong> through ICB and removal of conflicting rules restricting sourcing to domestic contractors</td>
<td>▪ Number of qualified bidders purchasing bid packages / submitting bids</td>
</tr>
<tr>
<td>▪ Deploy collusion detection <strong>software</strong></td>
<td>▪ Number of notable companies not submitting bids</td>
</tr>
<tr>
<td>▪ National rules to restrict domestic sourcing removed</td>
<td>▪ International Advisor to the satisfaction of the Bank is hired</td>
</tr>
<tr>
<td>▪ <strong>International Procurement Advisor</strong> monitors compliance with Bank Procurement Guidelines</td>
<td>▪ Compliance issues identified</td>
</tr>
<tr>
<td>▪ Enhance <strong>complaint line</strong> use</td>
<td>▪ Timely response to issues by the Borrower</td>
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<tr>
<td>▪ <strong>Number of stakeholders showing that they would complain</strong></td>
<td>▪ Number of red flags detected by software</td>
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<tr>
<td>▪ Increase in complaints</td>
<td>▪ Follow-up on red flags</td>
</tr>
<tr>
<td>▪ Redress of key impediments to complaints</td>
<td>▪ Installation, input of data and regular of software</td>
</tr>
</tbody>
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Practical Considerations
Working With Operational Colleagues We Have Jointly Learned A Number of Lessons

1. Undertake a solid **risk identification and assessment** (don’t overlook major risks, fail to take into account existing country/sector lessons, fear to be concise about what is risky and what is not…)

2. Be **strategic and realistic** in devising ways of mitigating risks (be clear about what YOU will and will not do, ensure that your control measures target your risks otherwise they waste resources)

3. Manage **expectations** of the Borrower by discussing up front the Bank’s remedies in case of fraud and corruption (avoid unnecessary tensions in country relations)

4. Explore ways to involve **bilateral donors** in the mitigation of fraud and corruption risks (**other donors** have other funding modalities, can undertake initiatives that fall outside the Bank’s operational scope, and bring to the table additional resources and support)

5. If there is a risk of systemic corruption, ensure **independence of the controls** (**e.g.**, through IPA, project monitor, CSO score cards, etc.)

6. Ensure that the project benefits from country **complaint handling** system and/or embeds a complaint handling component (**e.g.**, central intake of complaints, Bank hotline no. in bidding documents, posters in front of public works, awareness campaign, etc.)

7. Develop a **supervision plan** to get reasonable assurances of the proper working of project controls (**e.g.**, ensure that supervision follows up on risks identified and key controls, that the methodology is robust enough to not be “gamed”, that evidence is gathered that controls indeed are being implemented and are working effectively)

8. Focus on **outcomes** rather than processes - otherwise you won’t “get there” (hence, you may need to improvise or go the extra mile)

9. Advocate that the borrower fully utilize **contractual remedies** in the case of delivery issues (**e.g.**, advocate that the contractor repair, replace or refund and/or that the Borrower call the performance bond, etc.)

10. Promptly **report to INT** any suspicion of fraud and corruption that you may have (when everything else fails…)
Preventive Services Unit

(What We Can Do For You)
Preventive Services Unit Has Three Major Business Lines

- **Advice**
  - Review PADs
  - Review ToR for auditors / fiduciary reviews
  - Participate in design/supervision missions
  - Map country/sector risks
  - **Synthesize Risks in a Control Framework**
  - Troubleshoot specific corruption threats
  - Input to CASs
  - Input to development of indicator frameworks
  - Advice on follow-up to procurement post reviews

- **Training**
  - **Red flags**
  - Case studies (collusion, procurement, FM)
  - Anatomy of fraud and corruption
  - Training for prosecutors / anti-corruption agencies
  - **Fraud and corruption risk assessment and mitigation**
  - **Supervision**

- **Knowledge Products**
  - Complaint Handling
  - Fraud and corruption risk assessment methodology
  - Collusion (in progress)
  - Emergency operations (in progress)
  - Road projects (in progress)
Over the Past Couple of Years INT/PSU Has Worked With 70+ Operational Teams
We Have Built Core Knowledge In Key Sectors

SDN
- Roads
- Energy
- Water

HDN
- Health

(And Have Also Been Engaged with Task Teams in the Design of Social Programs, Rural Development, Forestry, Land Management, CDD, Governance Projects, Emergency Operations, etc.)
The Preventive Services Unit (PSU)

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