Fraud and corruption in mining and metals

Focus on business ethics

2010
The global financial crisis has weakened mining and metals companies’ defences against fraud.

To meet rising metals demand, mining and metals companies are operating in territories that provide increased exposure to corruption.

This report draws on our experience “at the coalface” and will assist those responsible for governance to update their understanding of the rapidly changing fraud and corruption risk environment.
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Introduction

The recovery in metal prices has encouraged mining and metals companies to reactivate capital projects and exploration activities. This increased level of activity is being undertaken with slimmed down control environments by virtue of the cost reductions of the recent global financial crisis. These circumstances provide greater fraud risk. Often in the quest for expanded production and higher returns, these projects are being conducted in countries more prone to corruption, and hence provide a greater corruption risk.

This dynamic environment is providing a complex challenge around monitoring exposure to fraud and corruption, for those most responsible for governance of the organization – the Board of Directors.

This report draws upon our experience ‘at the coalface’ and will assist those responsible for governance to:

- Update their understanding of the rapidly changing fraud and corruption risk environment
- Make a high level assessment of your company’s changing exposure
- Gain insights into how to combat fraudulent and corrupt practices.

The mining and metals sector has received significant bad press over alleged fraud and corruption in the sector. A major iron ore producer has had media attention for China, a global diversified for Cambodia, and a global copper and gold producer for the Democratic Republic of Congo. The sector is an easy target for fraud and corruption given the nature of mining operations.

Certain characteristics predispose miners to fraud and corruption risks including:

- Labour-intense operations
- High-value commodities
- Dependency on local communities
- Highly regulated activities
- Largest source of local economic activity
- Large royalty and tax takes
- Remoteness of operations
- Operating in countries with endemic corruption
- The requirement for large capital investments
- Environmental impact
- Frequency of merger and acquisition activity

Fraud and corruption are typically covert events that can go undetected for years, or altogether. This is because the people committing these acts understand the weaknesses either in the processes or systems and exploit them. They also improve their skills as they continue to perpetuate these activities, effectively learning on the job, making them harder to detect.

Whether one is referring to a lapse in safety standards, a bribe paid overseas to retain an existing contract, or a senior executive acting for personal gain, the speed of the reaction of regulators, law enforcement and the financial markets can quickly overwhelm management and Boards of Directors alike. The effects of such activity are broad ranging and can be fundamental to an organization’s ability to operate; and include the impact to: its bottom line; its social licence to operate; its ability to access new projects; the return of value to shareholders; and the reputation of the organization.

“One sign that Boards are aware of fraud and corruption issues is the concern (76%) that Directors now have about their own personal liability”

11th Global Fraud Survey, Ernst & Young, 2010
Management of potential fraud and corruption in the mining and metals sector is critical for the following reasons:

- Provides tangible evidence of a culture of integrity
- Helps to minimize fraud and facilitates early detection
- Limits unpleasant surprises that can distract management
- Addresses concerns of external auditor and Board of Directors
- Limits potential for class action lawsuits
- Safeguards the assets and reputation of the company on behalf of investors

Ultimately, fraud and corruption risk is related to corporate governance, business ethics and crisis management. And like crisis management, the time to develop your plans and procedures is not when the world is at your door looking for answers. Addressing the need for ethical business conduct and how your organization will deal with any lapses is of paramount importance.

These plans and procedures need to be developed through an understanding of how fraud and corruption is committed and the personal and business indicators of that behavior. As the people involved in the commission of these types of offences do not want to get caught, and want to keep what they have taken, they will exploit their knowledge of your controls and processes to continue to commit their crimes. To combat this, it is necessary to increase the perception and reality of detection through clever tactics and solutions, aimed at preventing and detecting.

To give you a better understanding of your level of risk, we have included a short survey that will give you a preliminary understanding of your level of exposure to fraud and corruption in your organization. The survey can be found on page 16 and 17.

Fraud: “...an intentional act...involving the use of deception to obtain an unjust or illegal advantage.”

Fraud is typically seen as theft of cash, misappropriation of assets or falsification of accounts in order to achieve an unjust or illegal advantage or to cause some disadvantage.

Corruption: “Dishonest activity in which an employee...of an entity acts contrary to the interests of the entity...in order to achieve some personal gain...”

Corruption is a subset of fraud and involves the offer or making of some benefit (typically financial) to another party to provide an advantage to an individual/entity.

1 ASA240 auditing standard on The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Report, 2006
2 AS 8001-2008 Fraud and Corruption Control
The cost of fraud and corruption

Media often focuses on the level of fines that have been paid as a result of fraud and corruption. Fines are the tip of the iceberg in penalties and costs for businesses. On top of this, there is the impact on reputation in terms of shareholder value, including the personal liability for actions carried out by the company. Mining and metals companies need to demonstrate that they are making a valuable economic and social contribution to the countries in which they are operating. When the local community sees the distribution of wealth as unjust, they are likely to protest, causing damage to reputation and potential loss of social license to operate.

Impact on shareholder value
Investors will apply a penalty if they think risk management is insufficient - an Ernst & Young Survey\(^3\) identified that 61% of respondents had avoided investing in a company due to insufficient risk management, and 48% had divested for the same reason. It is not just investors that have a keen eye on risk management. Standard & Poor's debt rating now includes a score for enterprise risk management in the evaluation process, which has the potential to result in a change in a company's credit rating by as much as 70-80 points. Moody's and Fitch are also beginning to evaluate an organization's risk competency as one of the evaluation elements for determining credit ratings. To manage and maintain shareholder value, Boards need to demand greater detail and accountability than ever before.

Personal liability
In Ernst & Young's 11th Global Fraud Survey, 76% of respondents were concerned about personal liability for actions carried out by the company. However, many who oversee corporate governance do not seem to be operating in a way that would increase their own protection. Half of the Chief Financial Officers (CFOs) interviewed as part of the survey said that the Board needs to have a better understanding of the enterprise-wide exposure to be an effective safeguard against fraud and corruption.

Worryingly, it appears that the Board is doing little to educate itself. Only 28% of our CFOs had been asked for a fraud risk assessment and 40% for a review of anti-fraud, bribery and corruption internal controls.

With the increased oversight and accountability for risk management placed on the Board, it is imperative that the Board can attest that risk and controls are being managed effectively. Understanding of risk tolerances and how risk management affects daily decisions should be consistent from the Board down to line-level managers. The greater the potential exposure, the more active the Board of Directors needs to be.

The fraud triangle outlines the three factors that are in play when fraud occurs:

- **Motivation**
  In any crime there will always be a motive. Some examples of personal motive might be addiction to gambling or drugs, maintaining lifestyle, personal debt or, indeed, revenge. It is often assumed that fraud is undertaken for personal financial gain - this is often the case, but other motivating factors could be pressure from above (to demonstrate economic recovery to shareholders for example). During the global financial crisis, whilst companies were reducing workforces, those still in employment may have felt pressure to commit fraud to make up for future loss (of salary or job security).

- **Suitable target**
  A motivated person will not hesitate to exploit knowledge of a company's systems and processes in order to commit acts of fraud and corruption. Typically, and unfortunately, they will test the internal controls and learn 'on the job', becoming better fraudsters over time.

- **Rationalization**
  Internal controls

- **Ethical culture**

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\(^3\) Mining and metals risk survey, Ernst & Young, 2006
“Dealing with complex issues of fraud, regulatory compliance and business disputes can detract from efforts to achieve a company’s potential. Better management of fraud risk and compliance exposure is a critical business priority, no matter what the industry sector and geographical location.”

The guide to investigating business fraud, Ernst & Young, as published by AICPA, 2009

Rationalization
A motivated person will typically rationalize their behavior by, for example, believing that they will return the money the following month, or that the contractor (who is a friend) is good and should get the work. As a consequence, and through this rationalization process, people continue to commit crimes over an extended period.

Suitable target
Inside any business there are areas that are attractive in terms of being able to commit fraud or corruption (e.g., procurement). The people who know these areas are typically those who know which areas are vulnerable, where the opportunities lie and will create the opportunity to over-ride or circumvent controls.

What protects the targets of fraud and corruption are internal controls and the ethical culture of the organization. The internal controls are often predictable and known to the fraudster and they will not hesitate to exploit friendship and the trust of their colleagues in their fraudulent and/or corrupt activities. Understanding this drives the need to reinforce internal controls to create an environment of less predictability around the controls, and a perception of detection in the mind of the fraudster.

In addition to this, the ethical culture of the organization needs to become one where each member understands they have a role in protecting the organization and that they see themselves as organizational guardians. This enhancement of the ethical culture needs to be driven from the top with a zero tolerance for fraud and corruption.

The new UK Bribery Act, April 2010, creates a more effective legal framework for combating bribery. It goes further than the FCPA in the following respect:

- It introduces a new corporate offense for failing to prevent bribery
- It draws no distinction between public and private sector bribery, bringing into its remit business-to-business bribery
- There is no exemption for facilitation or ‘grease’ payments

* Business Briefing: The Bribery Act, Ernst & Young, 2010
Key drivers of fraud and corruption risk

The potential exposure to fraud and corruption can occur across all phases of the lifecycle of the mine. The following are the most common areas of fraud and corruption risk for mining and metals companies:

1. Where there are high levels of government regulation
2. Operational risks are in remote locations
3. The area of procurement
4. Expenditure in remote locations
5. Local compensation and contract awards

1. High levels of government regulation

The mining and metals sector is one of the most regulated around the world. Regulation licenses and approvals need to be sought from government officials for the exploration, development, construction and operation of a mine. Typically, the government also owns the infrastructure such as ports and railway which means that companies and their agents are constantly dealing with governments and government bodies to get their products to market. The government is also responsible for reviewing environmental and social impact assessments; planning for local and regional development; upholding health and safety standards; and investing and distributing revenues from mineral development. As a result, officials who have the power to block, delay or frustrate a project may attempt to solicit bribes for the benign exercise of that power.

Mining and metals companies are also often involved in joint ventures or production-sharing agreements with foreign governments or state-owned enterprises in high risk countries. Through these arrangements, local governments may appoint an official to be on the Board of Directors to protect the interest of the local government. Any change in government policy affecting the industry will be scrutinized by the international market. It is often a perceived conflict of interest that is created through such arrangements that impacts a company’s reputation.

We often find, particularly in developing countries, that most employees, including senior managers, have very little understanding of the Foreign and Corrupt Practices Act (FCPA), and even less so of the UK Bribery Act. Given the nature of mining activities, they have frequent contact with government officials, some of whom might be seeking financial assistance, payments or other benefits. Employees should understand that they might be targeted by foreign officials or others seeking to compromise them. Employees should be alerted to this risk and provided with appropriate training to identify, resist and report.

“Doing business in new geographies ... may bring particular fraud, bribery and corruption risks. Establishing a robust compliance environment to mitigate these risks requires real investment – in leadership time, people, technology and training. Demonstrating that all of this effort is making a difference – that the firm itself is committed to ethical growth – is a critical business imperative.”

David L. Stulb, Global Leader, Fraud Investigation & Dispute Services
The 2008 Bribe Payers Index\(^6\) shows that mining ranks fourth (out of 19) as the most likely sector to bribe a public official and third most likely to use political donations as a means of influence. With this in mind, mining and metals companies need to understand the ‘in-country’ risks relevant to specific locations through research from external agencies such as Transparency International and the Extractive Industries Transparency Initiative (EITI), as well as their own corporate and industry knowledge. Once the threats are understood, prevention strategies can be developed to mitigate the risk of fraud and corruption.

EITI seeks to build country-level reporting systems whereby there is regular reconciliation and publication of what extractive industry companies are saying they have paid to governments with what governments say they have received from them. Currently 46 of the world’s largest oil, gas and mining companies support and actively participate in the EITI process. Benefits for companies supporting this process include improved stakeholder and community relations, better risk management, lower capital costs, and improved company reputation and staff satisfaction. Companies become a supporter by declaring their support publicly and promoting the initiative internationally and in countries where they operate. Being a supporter of the EITI does not require any reporting or disclosure requirements in addition to those for all companies operating in the relevant sectors in countries implementing the EITI.

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“You need to have a very strong risk and fraud control framework which doesn’t live in a cupboard; that is embraced from the Board to the tea lady.”

Chief Operating Officer respondent, Ernst & Young’s 10th Global Fraud Survey

2. Operational risks in remote locations

Across most commodities, the number of world-class deposits in ‘safe’ countries has diminished. As a result, mining and metals companies are increasingly exploring, developing and operating in more remote ‘frontier countries’ where there is a perceived high risk of corruption. Countries like Mongolia, Russia, the Democratic Republic of Congo, Pakistan, Indonesia, Iran and China are now being considered as promising mining locations. Many of these countries are inherently risky due to their political or socio-economic situation, and also as they often represent new business environments.

The Transparency International Corruption Perception Index (CPI) measures the perceived levels of public sector corruption in 180 countries and territories. A composite index, the CPI, is based on 13 different expert and business surveys with the highest possible rating being 10. The year’s best ranked country in 2009 (i.e., perceived to be less corrupt) was New Zealand, with a rating of 9.4. The frontier countries rate poorly on this scale.

In Ernst & Young’s 10th Global Fraud Survey, 47% of mining respondents said that corrupt practices were prevalent within the sector – the highest of the sector survey respondents. This is not surprising. If you map the top producing countries by commodity to CPI, it is evident that mining companies are operating in countries perceived to be exposed to the greatest level of corruption. Of the top ten bauxite producing countries, only one ranks above five on a 10 point scale (Australia is at 8.7). The other nine top bauxite producing countries rank below four, reflecting a high risk operating environment. This is a consistent story for all of the other major commodity groups.

The Corruption Perceptions Index (CPI) measures the perceived levels of public sector corruption in 180 countries and territories.
There is an apparent correlation between the mining and metals sector and high levels of corruption. This is clearly due to the fact that operations are in poorer, remote countries where the need and opportunity is high and fraud and corruption opportunities are exploited. The mining and metals sector has characteristics that heighten this risk:

- **Large capital expenditure** - The mining and metals sector has to commit huge sums of money to develop mines; often a disproportionate amount to the wealth of that country. Available funds for government in terms of royalties and taxes present great opportunities for government officials wanting their part of the prize. Where a regime is short on governance and transparency, there is less likelihood of these officials getting caught.

- **Extensive regulation** - As previously mentioned, governments need to regulate the sector as it has a widespread impact both socially and environmentally, whilst utilizing energy and transport infrastructure. If those issuing permits and concessions have wide powers of discretion, including delaying tactics, they are potentially open to taking a bribe.

- **Fixed locations** - Other sectors have the choice of where to invest and may feel that some of these perceived highly corrupt countries are too risky for their profile. The mining and metals sector has less choice - they need to operate where the minerals are and are increasingly moving into the new frontier countries. When the stakes are this high, officials can be in a strong position to ask for bribes.

The resource rich countries often perversely suffer from lower economic growth rates, which is referred to as the ‘resource curse’. Corruption is a cause as it undermines the economic incentives to break this “curse” and therefore leaves corrupt countries with less money to invest in national capital stock and social welfare. These countries and regions are also generally politically unstable, which, combined with corruption, makes commercial activity more difficult and expensive.

### Cultural divide

A constant problem for mining companies operating in different countries is what has been described as the cultural divide. This cultural divide often provides a challenge for companies who find it difficult to apply the same business processes, policies and procedures across countries with differing cultures. A challenge facing mining and metals companies operating in remote locations is their lack of local knowledge and the ‘rules of the game’. Because of this, they often rely on a local partner or an intermediary who has the necessary contacts to ‘get things done’. Even when they are committed not to indulge in bribery, mining and metals companies may lack the necessary control and information over their local partner’s behavior, background and connections. This combination of factors is likely to have a direct impact on levels and forms of corruption in the mining and metals sector. For example, bribes can be demanded and paid to favor a request for a mining concession, get a permit or approval, speed up bureaucratic processes or secure favorable contract conditions.

In-country employees often operate on the premise that “this is the way we need to do business here” and, as a consequence, modify existing controls to enable the procurement of goods and services to proceed. This in itself creates an opportunity for fraud and corruption. In-country management will often explain the need to adapt business operations to the prevailing culture. Ernst & Young has found in many of the investigations that we have conducted that in-country management have often gone too far in adapting to the local culture, breaking down existing controls in the process. What can happen is that the local culture begins to dominate organizational behavior. We believe the opposite should apply - the company cognisant of the existing culture should insist that “this is the way the company will do business” and the local culture will need to adapt to the company’s requirements.

### What Boards can do to reduce their exposure to these risks

- Boards need to ensure that the firms’ cultures are upheld regardless of pressure from in-country management to compromise this
- The firms’ cultures need to be embedded from the top down, insisting that ‘this is the way the company will do business’ rather than accepting the prevailing culture is key
The crucial test for process controls arises when under pressure, which normally originates from two sources – time and budget. Mining is a risky, time-consuming and capital intensive industry that requires massive up-front investment before mining companies start making profits. Within such a context, companies operate under considerable time pressure to make their investment profitable and repay their investment loan. Often, one of the major key performance indicators for mine managers is speed to market and to deliver projects on time. By bypassing controls in a pressured environment, mining and metals companies may be able to deliver projects on time, but the potential negative impact on a company’s reputation and continued operations may far outweigh the benefits, and may have a long-lasting effect on relationships with other suppliers.

Acquiring assets in remote locations
An area that mining and metals companies need to consider is the fraud and corruption risk gained through acquisitions. To date, more than half of the US FCPA prosecutions have arisen in the context of a merger or acquisition.\(^6\)

Those responsible for merger and acquisition activity should understand that identifying fraud and corruption risk is not an automatic ‘deal breaker’ in every context. However, it is always preferable to know as much as you can about exposure prior to closing the deal. Highly effective due diligence processes identify the broad risk areas, allow management to assess their tolerance for the risk, and then, if necessary, build decisive remedial action into a post-deal integration plan.

The following example illustrates why a thorough due diligence review is critical to companies in the mining and metals sector. A junior mining company performed the exploration and paid a bribe to obtain the concession. This company then farmed out to a larger company who took over operatorship. Whilst the farm-in party was not involved in the bribe, they will be expected to have done sufficient due diligence on the transaction and to have reported any transgressions discovered.

The post-deal integration plan should include a detailed follow-through on any unresolved issues identified pre-acquisition and to explore any areas that were abbreviated due to time pressure or other constraints. Should issues subsequently have to be disclosed to regulators, a timely and thorough vetting of the potential risks in the due diligence process pre- and post-acquisition will strengthen the argument for leniency. Turning a blind eye is not acceptable – accountability is the key.

Unauthorized use of confidential information – case study
Ernst & Young investigated a matter where an employee was targeted by an individual who had a business of providing corporate intelligence to companies. In this instance, the businessman approached a number of bidders for a multimillion dollar contract and told them that he would be able to gain insider information on their bid as it progressed through the technical and commercial evaluations, and then be in a position to influence the decision-making in terms of the awarding of the contract.

Information on the progress of the bids was solicited from an employee whilst socializing at a local club. In the interests of maintaining the friendship, the employee would ask his manager about how the bids were progressing. The information would then be sold on to the various competing bidders.

When the contract was awarded, the successful bidder paid a success fee in the hundreds of thousands of dollars to the individual.

It should be noted that the information the employee was providing, although confidential, was not critical to the success of the various bids. However, the perception that an insider had been corrupted had a serious impact upon the reputation of our client and the perceived integrity of the bidding process.

\(^6\) 11th Global Fraud Survey, Ernst & Young, 2010
3. Procurement

A critical area of fraud risk in the mining and metals sector is in procurement due to the sheer size of expenditure\(^7\). IBIS estimates that procurement constitutes around 20% of the operating costs for mining and metals companies in Australia and it constitutes over 80% of capital project expenditure. There is mounting evidence that even organizations with robust controls constantly underestimate their exposure to procurement fraud.

The procurement function plays a pivotal role in all the stages of the mining lifecycle. At each stage, the objectives differ, and, from a strategic procurement perspective, it is crucial that the procurement function is aligned to enable companies to achieve the different objectives. The biggest challenge in detecting procurement fraud and corruption is that the actual event, such as the payment of a bribe, will not go through the books of the company, as the monies or other benefit will flow directly from the supplier to the employee. The manner in which this bribe or benefit is facilitated or financed will be reflected in the books of the company in various forms, including:

- Inflated prices
- Goods paid for but not delivered
- Inferior goods delivered
- Unauthorized extension of contracts
- Variations to original contract

**Fraud in the tender process**

For many large value purchases, the tender process is the start of a long-lasting relationship with a supplier that, through the delivery of goods, a service or a project, will assist mining and metals companies in achieving their corporate strategies and return value to shareholders. At least that is the objective. Traditionally, the tender process is seen by fraudsters as an area of opportunity, given the large number of people involved, limited knowledge of market conditions, time pressure to procure, and the lack of proper vetting.

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\(^7\) *Mining in Australia IBISWorld Industry Report, IBISWorld, 17 February 2010*

\(^8\) *Guarding your business: Fraud and corruption in the procurement process, Ernst & Young, November 2009*
4. Expenditure in remote locations

It is increasingly common for mining and metals companies to operate in remote locations. These operating locations often combine difficult communication, challenging physical access, poor banking, insecure supply routes and predominantly cash-based local economies. Mining and metals companies often value the management team of these locations using their initiative to achieve outcomes despite the constraints of remoteness. However, this increases the risk of misappropriation and theft if internal controls are relaxed to accommodate remoteness.

Misappropriation of cash

Improper classification of costs is a particular problem for mine sites where there are typically a large number of capital projects, and hence these costs are easy to hide. There are a number of instances where projects have been undertaken and the costs have been improperly allocated to other projects.

A powerful example of this was a mine site in Africa, where the mine manager developed a golf course on site and allocated the costs for development of the course to other capital project codes, including mining operations. The fraud was detected when company officials visited the site and noticed the golf course, having previously declined the application to build it by the mine manager. In another instance, a bar had been constructed on site, with the costs of manufacture again being allocated to other codes and mine operations.

Employee expense extortion

Due to the large number of expatriate employees (expats) many miners have working for them, extortion of expenses becomes a real risk. Expats are given living away from home allowances which include food and entertainment budgets. Because of the broad interpretation around the definition of these expenses, it can be easy for expats to take advantage of the system.

Indicators of fraud would include the employee’s lifestyle and personal assets being inconsistent with their income, and close relationships with contractors or suppliers.

This extortion can also extend to simple expense claims which are an area used frequently to pay bribes or misappropriate money. Ernst & Young has investigated one particular group of employees who, through their expense claims, were able to fund fishing trips and weekend activities all under the guise of legitimate business expenses. They covered up their activities by approving each other’s expenses.

Theft from site

Assets on a mine site can be highly valuable in remote locations. Obvious theft from site may cause the perception by the local community that corruption is rampant and to be exploited. An example of this is where the black market sale in fuel and diesel is evident on every major road into site. Where did it come from? We suggest this is just the visible tip of the iceberg.

The impact of theft is sometimes beyond the financial loss incurred. Theft can have a detrimental impact on health and safety aspects, which ultimately puts mineworkers’ lives at risk. Theft can also result in operational outages. The theft of electrical cables, for example, resulting in smelters being switched off, will cause millions of dollars in lost production revenue.

Misappropriation of cash — case study

Accounting practices can be manipulated to accommodate corrupt payments to third parties in order to maintain operations in an area. Ernst & Young visited a client location in a frontier country where there was evidence of stock theft. Ernst & Young visited the site to gather information about the number of employees on site and methods for payment of the various levels of employees who were described as permanent employees, part-time employees and casuals.

According to company records, there should have been 45 casuals working across two shifts. However, there were only three casuals working at the time of inspection, and three were expected during the next shift. We established that the payments were made to an agent, and that the money which was allegedly paid to the casuals was in fact a bribe payment to a faction of the local community to allow continued operation. In this instance, remote management had created a local solution which involved false accounting and corrupt payment, believing that they would never be detected, and the end justified the means.
5. Local compensation and contract awards

Compensation payments
As part of their social obligations, mining and metals companies will typically need to make compensation payments to those impacted by project development and operations (such as landowners and other users of infrastructure). The payment of compensation can present a critical risk of fraud and corruption. A complicating factor in developing countries is the potential for more wily community members and employees to exploit other community members. The company has a social liability to ensure that the compensation gets back to the impacted parties.

Beyond financial loss, if not dealt with appropriately, this has the potential to impact on the reputation of the organization and influence its real and social licence to operate.

Steps companies can take to respond to the risk of misappropriation and theft
The use of technology, such as forensic data analytics, can be used by management to get a better understanding of the operations, and reporting can be tailored to include an assessment of fraud indicators.
For example:
- Unusual stock movements
- Abnormal usage of consumables, such as fuel
- Abnormal behavior of external parties visiting the site, such as visits outside normal hours or high frequency of a supplier visiting the site without the supplier being contracted to do any current work
- Implementation of security systems and services in high risk areas

Awarding of local contracts
There is a requirement in many countries that contracts should be awarded to nationals where possible. Contracts of this type typically involve canteen facilities, transport, security and the supplies of other goods and services which are able to be sourced in-country. This presents an area vulnerable to fraud and corruption, especially through remote employees seeking to award contracts to themselves, friends, associates or companies with which they are associated.

The financial implication is the perception in the wider national community that there is widespread corruption in the mining organization. The belief is also that the local community is being exploited by the mine and a privileged few.

Engaging nationals in accordance with a licence to operate
Local sourcing is an important part of mining and metals companies’ commitment to the development of the local economy, and companies may have no alternative but to source goods and services locally due to remoteness.

The sustainability of long-term relationships with local suppliers is a priority for mining and metals companies. The challenge lies in the ability to cultivate a culture of joint ownership, where local suppliers understand the contribution by mining and metals companies to local communities, and the role they play in achieving those objectives.

What Boards can do to reduce their exposure to these risks
The responsibility of the management of mines is to ensure the right corporate message about responsibility and transparency is communicated and demonstrated in all aspects of the mining operation.

“Management fears the unknown. You can have policies and procedures in place but often have very little idea of what is going on in remote parts of your business.”
CFO, United States, 11th Global Fraud Survey, Ernst & Young, 2010
It is unlikely that any new types of fraud and corruption activities will be invented - they have all been committed with only subtle variations over time.

Similarly, the methods of committing the crimes will remain constant. With an understanding of these activities, we have developed ‘red flags’ which will be valuable in indicating what organizations need to look out for. It should be remembered that it is not just one or two of these indicators, but more likely a combination of the indicators, plus your knowledge of the business or person, which will form the basis for suspicion.

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<thead>
<tr>
<th>Business</th>
<th>Personal</th>
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<td>Failure to take leave or only taking leave when others take leave, e.g., Christmas</td>
<td>Lifestyle not consistent with income</td>
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<td>Unusually close relationships with customers or suppliers</td>
<td>Working unusual hours for no apparent reason or benefit</td>
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<td>Lack of accurate reporting or delay in reporting for no apparent reason</td>
<td>Withdrawn changes in behavior patterns</td>
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<td>Secrecy around business operations</td>
<td>Personal assets not consistent with income</td>
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<td>Projects consistently run over budget</td>
<td>Unusual behavior patterns around gambling</td>
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<td>Consistently paying premium prices</td>
<td>Unusual expense claims from expats</td>
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<td>Favorable payment terms</td>
<td>Leave approval requirements left to the last minute</td>
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<td>Presenting invoices for payment when immediate supervisor is not about</td>
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<td>Poor morale, high staff turnover</td>
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<td>Pushing projects through in order to circumvent existing controls</td>
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Please note, if you are suspicious, then given your knowledge of the business and persons, the suspicion is worth acting upon.
Better practices – the tone from the top

Fraud and corruption are covert crimes which are very difficult to detect through traditional controls and processes. In order to detect and prevent such activity, an organization needs to boost the perception and reality of detection by reinforcing existing controls and engraining it in the existing corporate culture.

Strategic response to the risk of fraud and corruption
The Association of Certified Fraud Examiners (ACFE) found that the most powerful preventative strategies in relation to fraud and corruption are:

Fraud awareness training – Provides advice on what fraud and corruption look like, trains the workforce in detection, and outlines their role in protecting the organization.

Special site reviews – This is typically conducted by an auditor and investigator and is focused on identifying existing or potential fraud and corruption. This special review involves the use of advanced interview techniques aimed at gathering information from parties in a non-confrontational manner.

A whistleblower program – The whistleblower program enables the workforce to confidentially escalate their suspicions properly based on the information provided to them through the fraud awareness training. This produces an element of unpredictability into the controls which makes it harder for the fraudsters to go undetected.

According to the ACFE, organizations which have these programs and strategies in place are likely to detect fraud and corruption twice as quickly as those without them, and reduce losses by half.

Other better practices we are seeing in the sector include:

Detection strategies – Companies should develop a repository of knowledge around fraud and corruption events. The information for the knowledge repository can be drawn from the whistleblower hotline and internal and external audit, actual fraud and corruption events in the mining and minerals sector, and specific events in the business itself. This knowledge can then be used to drive detection strategies around site visits and forensic data analysis.

Investigation response – Companies should ensure that a standard investigating response procedure exists. If a fraud or corruption event occurs, this response procedure looks to ensure key stakeholders are informed and clearly understand their role in the process. In addition to this, it will enable a proper investigation to be conducted in the interests of all stakeholders with all information gathered on how the fraud or corruption event occurred. This information can then be used to inform the decision-making process on the final resolution of the matter and to form part of the knowledge repository.

Risk assessments – Companies should seek to undertake regular fraud and corruption risk assessments. Important to conducting a fraud and corruption risk assessment is an initial information session on what fraud and corruption is, what are the business and personal indicators to look out for, and case studies on related fraud and corruption events in the sector. Once this knowledge is established with the participants they are then involved in a brainstorming vulnerability review to determine where the organization might be at critical risk. Once these critical risk areas are identified strategies are then developed to covertly look for evidence of fraud and corruption in these areas.

Ethical culture
Organizations need to drive a culture of zero tolerance from the top, ensuring the code of ethics reflects this. By training all employees in the risk of fraud and corruption and their role in protecting the organization, you are in effect creating guardians for the company.

These responses reinforce existing controls and reinforce the existing culture.

The ACFE found that the most powerful preventative strategies in relation to fraud and corruption are fraud awareness training, special site reviews and a whistleblower program. According to the ACFE, organizations which have these programs in place are likely to detect fraud and corruption twice as quickly as those without the programs and strategies and reduce losses by half.
Understanding your level of risk

Complete this section of questions and collate the number responses for a preliminary understanding of your level of exposure to fraud and corruption in your organization.

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
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</thead>
<tbody>
<tr>
<td>Are any of the following applicable to you or your organization?</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Are there areas in your business where you have particular concern about its high exposure to the risk of fraud and corruption?</td>
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<tr>
<td>2. Have you observed any business or personal indicators that might support this concern?</td>
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<tr>
<td>3. Are there areas of the business that are not performing to expected levels for no apparent business reason, or are the reasons you are being given not satisfactory?</td>
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<tr>
<td>4. Are there areas of your business where suspicions or minor events of fraud and corruption have occurred or are occurring?</td>
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<tr>
<td>5. Do you operate in remote locations?</td>
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<tr>
<td>6. Are the remote locations you operate in included in high risk areas on the Transparency International Index?</td>
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<tr>
<td>7. Are you concerned about the number of sole source contracts you may have in operation across the business?</td>
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<tr>
<td>8. Are you concerned that the level of oversight around the performance of contract works once a contract is awarded may not be adequate?</td>
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<tr>
<td>9. Do you have a high number of expats operating in your business?</td>
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<tr>
<td>10. Are you concerned about the limited knowledge your organization has of emerging economies and cultures in which you operate?</td>
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</tr>
</tbody>
</table>

If you have answered “Yes” to four or more of the questions above, it may be an indication that your organization is at heightened risk of being a victim of fraud or corruption. Reliance on management representations would generally not prove sufficient defence for directors. It is important that you assess and understand the potential impact of fraud and corruption risk, and to develop the correct strategies to deal with these issues.
Complete this section of questions and collate the number responses for a preliminary understanding of how you stack up against better practices in the mining and metals sector.

<table>
<thead>
<tr>
<th>Question</th>
<th>Yes</th>
<th>No</th>
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<tbody>
<tr>
<td><strong>What is the tone at the top?</strong></td>
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<tr>
<td>1. Do you have a corporate ethics code for employees prohibiting conduct that would amount to fraud or corruption?</td>
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<tr>
<td>2. Do you have a formal training program for all employees specifically addressing fraud and corruption risks?</td>
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<tr>
<td>3. Is there a requirement for all employees/agents to certify that they have read and complied with the ethics code on an annual basis? (Records should be kept to ensure that annual certifications are returned by employees.)</td>
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<tr>
<td>4. Is there an ongoing assessment and analysis of the effectiveness of detection strategies followed by your organization?</td>
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<tr>
<td>5. Do you have a whistleblower policy and effective channels for employees to report suspicious behavior?</td>
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<tr>
<td>6. Do you believe your employees have confidence in the whistleblower program?</td>
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<tr>
<td>7. Do you have a standing response protocol in place in relation to the investigation of matters of fraud or misconduct?</td>
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<tr>
<td><strong>Detection strategies</strong></td>
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<tr>
<td>8. Do you perform due diligence reviews and vetting on new business partners, including suppliers, vendors, distributors, and agents?</td>
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<tr>
<td>9. Do you employ specific methods to detect any unauthorized or improper payments to customers and government officials, such as forensic data analytics?</td>
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<tr>
<td>10. Do you have a formal process whereby employees, on an annual basis, declare any potential conflicts of interests?</td>
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<tr>
<td>11. Do you conduct special site reviews focused on the detection of fraud and corruption?</td>
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<tr>
<td>12. Do you conduct an annual risk assessment of fraud and corruption risks involving a cross-section of your business?</td>
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</tbody>
</table>

If you have answered “No” to four or more of the questions above, we would recommend that you revisit / challenge the adequacy of your anti-fraud strategy.
How can Ernst & Young help

The global mining and metals Fraud Investigation & Dispute Services team is located in all of the major mining hubs. We have a number of services to help with fraud prevention and detection:

**Anti-fraud and Corruption Framework**
We work with organizations to develop a strategy aimed at minimizing the risk of fraud and corruption and increasing the detection capability within the company. These programs are developed and tailored according to the culture and areas of operation of the business.

**Fraud Awareness Training**
We conduct training sessions which educate an organization's workforce in the detection and prevention of fraud and corruption. It creates a powerful team approach to the prevention and detection of fraud and corruption.

**Site visits**
Site visits are undertaken to review critical areas of fraud risk and conduct an indepth review of these areas, both on and off site, creating a strong deterrent for potential fraudsters. These strategies are focused on reinforcing the existing controls and increasing ‘the perception of detection’.

**Fraud and corruption response protocol**
In the event of fraud and corruption activity, Ernst & Young can work with an organization to develop a planned 24/7 response aimed at the protection of evidence, safeguarding the rights and interests of all parties, and providing relevant information to enable informed decision-making on future civil or criminal action.

For further information, contact one of our authors, or your local Ernst & Young contact.

**Authors**
Paul Fontanot  
*Fraud Investigation & Dispute Services*  
paul.fontanot@au.ey.com

Robert Cockerell  
*Fraud Investigation & Dispute Services*  
robert.cockerell@au.ey.com

TJ Koekemoer  
*Fraud Investigation & Dispute Services*  
tj.koekemoer@au.ey.com
The Ernst & Young Fraud Investigation & Dispute Services practice has global reach. See below for a list of our country/territory leaders. For more information, visit www.ey.com/fids.

<table>
<thead>
<tr>
<th>Local contact</th>
<th>Name</th>
<th>Telephone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global Leader</td>
<td>Managing Partner</td>
<td>+44 20 7951 2456</td>
</tr>
<tr>
<td></td>
<td>David Stulb</td>
<td>+1 212 773 8515</td>
</tr>
<tr>
<td>Afghanistan/Pakistan</td>
<td>Shariq Zaidi</td>
<td>+92 21 3568 6866</td>
</tr>
<tr>
<td>Australia/Oceania</td>
<td>Paul Fontanot</td>
<td>+61 2 8295 6819</td>
</tr>
<tr>
<td>Austria</td>
<td>Martin Schwarzbartl</td>
<td>+43 1 21170 1405</td>
</tr>
<tr>
<td>Baltic States</td>
<td>Linas Dicpetris</td>
<td>+370 5 274 2344</td>
</tr>
<tr>
<td>Brazil</td>
<td>Jose Compaglio</td>
<td>+55 11 2573 3215</td>
</tr>
<tr>
<td>Canada</td>
<td>Mike Savage</td>
<td>+1 416 943 2076</td>
</tr>
<tr>
<td>CESSA (Czech Republic/Hungary/Slovakia/Slovenia/Croatia)</td>
<td>Markus Lohmeier</td>
<td>+420 225 335 173</td>
</tr>
<tr>
<td>China</td>
<td>John Auerbach</td>
<td>+86 21 2228 2642</td>
</tr>
<tr>
<td>France</td>
<td>Philippe Hontarrede</td>
<td>+33 1 46 93 62 10</td>
</tr>
<tr>
<td>Germany</td>
<td>Stefan Heißner</td>
<td>+49 211 9352 11397</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>Chris Fordham</td>
<td>+852 2846 9008</td>
</tr>
<tr>
<td>India</td>
<td>Arpinder Singh</td>
<td>+91 22 6665 5590</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Fariaty Lionardi</td>
<td>+62 21 5289 4004</td>
</tr>
<tr>
<td>Ireland</td>
<td>Julie Fenton</td>
<td>+353 1 221 2321</td>
</tr>
<tr>
<td>Italy</td>
<td>Paolo Marcon</td>
<td>+39 02 7221 2955</td>
</tr>
<tr>
<td>Japan</td>
<td>William Stewart</td>
<td>+81 3 3503 2832</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Philip Rao</td>
<td>+60 374 958 763</td>
</tr>
<tr>
<td>Mexico</td>
<td>Jose Treviño</td>
<td>+52 55 5283 1450</td>
</tr>
<tr>
<td>Middle East</td>
<td>Bob Chandler</td>
<td>+973 1751 4873</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>Angélique Keijers</td>
<td>+31 88 40 71812</td>
</tr>
<tr>
<td>Norway</td>
<td>Dag Eidsvik</td>
<td>+47 2400 2648</td>
</tr>
<tr>
<td>Philippines</td>
<td>Roderick Vega</td>
<td>+632 894 8342</td>
</tr>
<tr>
<td>Poland</td>
<td>Mariusz Witalis</td>
<td>+48 225 577 950</td>
</tr>
<tr>
<td>Romania/Bulgaria</td>
<td>David Smith</td>
<td>+40 214 028 485</td>
</tr>
<tr>
<td>Russia/Commonwealth of Independent States</td>
<td>Ivan Ryutov</td>
<td>+7 495 755 9738</td>
</tr>
<tr>
<td>Singapore</td>
<td>Lawrance Lai</td>
<td>+65 6309 8848</td>
</tr>
<tr>
<td>South Africa</td>
<td>Stuart Waymark</td>
<td>+27 31 576 8050</td>
</tr>
<tr>
<td>Southeast Europe (Turkey/Greece)</td>
<td>Dilek Çilingir</td>
<td>+90 212 368 5172</td>
</tr>
<tr>
<td>South Korea</td>
<td>TS Jung</td>
<td>+82 2 3787 6823</td>
</tr>
<tr>
<td>Spain</td>
<td>Ricardo Noreña</td>
<td>+34 91 572 5097</td>
</tr>
<tr>
<td>Sweden</td>
<td>Kenneth Johansson</td>
<td>+46 8 5205 9620</td>
</tr>
<tr>
<td>Switzerland</td>
<td>Michael Faske</td>
<td>+41 58 286 3292</td>
</tr>
<tr>
<td>UK</td>
<td>John Smart</td>
<td>+44 20 7951 3401</td>
</tr>
<tr>
<td>US</td>
<td>Jeff Taylor</td>
<td>+1 202 327 7239</td>
</tr>
</tbody>
</table>
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Ernst & Young’s Global Mining & Metals Center

With volatile metals prices, ongoing uncertainty about demand and restricted capital markets, the global mining and metals industry is facing a new era of both challenges and opportunities.

Ernst & Young’s Global Mining & Metals Center brings together a worldwide team of professionals to help you achieve your potential—a team with deep technical experience in providing assurance, tax, transaction and advisory services.

The Center works to anticipate market trends identify the implications and develop points of view on relevant industry issues. Ultimately it enables us to help you meet your goals and compete more effectively. It’s how Ernst & Young makes a difference.

Global Mining & Metals Leader, and Oceania
Mike Elliott
Tel: +61 2 9248 4588
michael.elliott@au.ey.com

China
Peter Markey
Tel: +86 21 2228 2616
peter.markey@cn.ey.com

Canada
Tom Whelan
Tel: +1 604 891 8381
tom.s.whelan@ca.ey.com

United States
Andy Miller
Tel: +1 314 290 1205
andy.miller@ey.com

South America
Carlos Assis
Tel: +55 21 2109 1606
carlos.assis@br.ey.com

Europe, Middle East and India and Africa
Michael Lynch-Bell
Tel: +44 20 7951 3064
mlynchbell@uk.ey.com

United Kingdom
Lee Downham
Tel: +44 20 7951 2178
ldownham@uk.ey.com

Africa
Adrian Macartney
Tel: +27 11 772 3052
adrian.macartney@za.ey.com

France and Luxemburg
Christian Mion
Tel: +33 1 3041 2182
christian.mion@fr.ey.com

Commonwealth of Independent States
Evgeni Krustalev
Tel: +7 495 648 9624
evgeni.krustalev@ru.ey.com

India
Navin Vohra
Tel: +91 124 464 4470
navin.vohra@in.ey.com

Ernst & Young
Assurance | Tax | Transactions | Advisory

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Dealing with complex issues of fraud, regulatory compliance and business disputes can detract from efforts to achieve your company’s potential. Better management of fraud risk and compliance exposure is a critical business priority—no matter the industry sector. With our more than 1,000 fraud investigation and dispute professionals around the world, we assemble the right multidisciplinary and culturally aligned team to work with you and your legal advisors. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It’s how Ernst & Young makes a difference.

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