Metals and Mining – Fraud and corruption
Ernst & Young Fraud Investigation & Dispute Services perspective
A recovery in metal prices in recent times has encouraged metals and mining players to reactivate capital projects and exploration activity. However, this is being conducted in a less controlled environment following cost reductions stemming from the global financial slowdown. Such circumstances heighten fraud risk. Often, in the quest for expanded production and increased returns, projects are conducted in countries more prone to corruption, thereby posing the corruption risks.

This dynamic environment provides a complex challenge around monitoring exposure to fraud and corruption, especially for those most responsible for an organization’s governance – the Board of Directors.

Industry insight*

- India accounts for 7.5% of the value of the Asia-Pacific region’s metals and mining industry
- A global decline in commodity prices in 2009 significantly affected the Indian metals and mining industry, causing it to shrink by 9.5% in 2009 to reach a value of US$83,608.6 million
- The outlook for the industry continues to be positive. Industry analysts estimate that in 2014, the Indian metals and mining industry will be valued at US$196,539.8 million, an increase of 135.1% since 2009
- Iron and steel is the largest segment within the Indian metals and mining industry, accounting for 71.3% of the industry’s value. Iron and steel sales proved the most lucrative for the Indian metals and mining market in 2009, contributing revenues of US$59.6 billion

Market analysis*

The aluminum, iron and steel, precious metals and minerals, coal and base metal markets constitute the metals and mining industry. In comparison, sales of coal generated revenues of US$20 billion in 2009, equating to 23.9% of the market’s aggregate revenues. The market’s performance is forecast to accelerate, with an anticipated CAGR of 18.6% between 2009 and 2014.

* Source: Datamonitor report, Industry profile: Metals and Mining in India (August 2010)
Key drivers of fraud and corruption in metals and mining

- High-level government regulations
- Large volume of materials
- Operational risks in remote locations
- Labor-intensive operations
- Hedging and forwards trading
- High-value commodities
- Expenditure in remote locations
- Dependence on local communities
- Local compensation and contract awards
- Disposal of scrap
- High cost of raw materials
- Environmental impact
- Requirement for large capital investments
- Operating in countries with endemic corruption
- Largest source of local economic activity
- Merger and acquisition activity
- Involvement of third-party and contractors
- Large royalty and tax payments
Cost of fraud and corruption

Investors and shareholders penalize a company if they think risk management is insufficient or if they suspect fraudulent activities are taking place in a company. Further, credit rating agencies now include a score for enterprise risk management in the evaluation process, which has the potential to result in a change in a company’s rating by as much as 70–80 points. These result in:

- Financial costs
- Impact on reputation
- Impact on shareholder value
- Personal liability

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

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

Ernst & Young’s 11th Global Fraud Survey, 2010
Fraud and disputes: risks and challenges in the metals and mining sector

The key drivers compounded with the challenging business environment have resulted in the generation of several risks which have become endemic to the industry. Some of the key fraud risks confronting the industry are:

**Procurement**

In the mining and metal business, the material-to-sales ratio is typically high due to the high cost of raw material from primary to secondary metal producers. Therefore, procurement is a critical area, ridden with fraud risks in the metals sector due to the sheer size of expenditure and the large volume of raw material. The biggest challenge in detecting procurement fraud and corruption is that the act, such as collusion or a corrupt practice, will not go through the company’s books, as the monies or other benefits will flow directly from the supplier to the employee. These bribes or benefits will be reflected in the books of the company in the form of inflated material prices, substandard materials, variations to the original contract, etc.
“Government agencies wield a great deal of power over mining companies and their ability to effectively explore and operate in these countries. Navigating these agencies effectively without the pitfall of fraud and corruption takes a lot of local knowledge and strong prevention strategies.”

John Smart, Partner, Fraud Investigation & Dispute Services, Ernst & Young LLP

Scrap sales can offer ample avenues for unfair practices through the abuse of authority. This scrap, if not adequately controlled and accounted, may also be misused by unscrupulous elements to substitute the misappropriation of good material and also misuse the standard input and output norms (SION) to cover for the deficit. Some scrap is also hazardous in nature and may pose ethical, regulatory and economic challenges in the course of their treatment and disposal.

Apart from the standard regulatory compliances of direct or indirect tax laws as well as labor, corporate and industrial laws, a company needs to comply with stipulations under mining and environmental regulations. For instance, failure to afforest mined areas could result in the cancellation of the mining permit. The mining and metals industry is also fraught with several safety and operational hazards. Thus, from a regulatory and a reputation risk perspective, it becomes critical for a company to monitor third parties to ensure compliance with regulatory requirements.
The metals and mining industry continues to struggle with the challenge of licenses and permits. The government licensing and tendering business has been traditionally conducted by involving agents, third parties or middle men. Generally, contracts with these agents do not include clauses pertaining to anti-bribery and compliance. Transactions with such parties may not be conducted at arm’s length or at a benchmark price potentially exposing the company to non-compliance. With the enforcement of laws such as the Foreign Corrupt Practices Act (FCPA) in the US and the Anti-Bribery Act in the UK, the enforcement of regulation over corrupt practices is no longer limited to business conducted within the geographical boundaries of any regulator.

The metal industry primarily works by hedging almost all future transaction considering volatile price movement in the sector. Usually, companies have an in-house treasury department, which caters to the need of such hedging and forwards transaction. The department is susceptible to high fraud-risk factors such as an employee indulging in unauthorized futures transactions or buying non-standard derivative products that may lead to high-value losses.

Considering the exponential cost of transporting material around the world for such an industry, it has been observed that employees and vendors have regularly abused logistics expenditure for personal gain ranging from employees receiving kickbacks for appointing a specific transporter to vendors, inflating costs by inflating trips or invoices in collusion with employees etc.
Other fraud and corruption risks in the metals and mining industry:

- **Theft of assets**, such as equipment, consumables or supplies, cash, information, intellectual property and workers’ compensation reimbursements
- **Unauthorized or illegal use of assets**, information or services for private purposes, including computers (including email and the internet), motor vehicles, clerical and other support, confidential information, equipment such as photocopiers, telephones and fax machines
- **Abuse of position and power for personal gain**, such as seeking and obtaining bribes or other gifts in exchange for favorable treatment and nepotism in staff appointments
- **Manipulation and misuse of account payments**, such as fictitious employees on the payroll and favoring suppliers whose costs or products are not as competitive as other suppliers
- **Falsification of records**, including timesheets, travel claims, purchase orders, and petty cash vouchers
- **Manipulation of computer programs for improper purposes**, such as unauthorized approval to pay, diversion of proceeds and writing off debts
- **Usage of child labor** in contravention of existing regulations
- **Weak record retention** and personal data-protection policies
- **Employee collusion** with a specific buyer for a greater share of sales volume
How can we help?

At Ernst & Young, FIDS is well-positioned to support clients in addressing various risks:

- **Arbitration support**
- **Expert witness**
- **Quantum assessment**
- **SION validation**
- **Evaluate SION vs actual consumption**
- **Evaluate potential material leakages**
- **Level 1 background check:** On information available in the public domain.
- **Level 2 background check:** Site visits and interviews
- **Level 3 background check:** A full-fledged investigation
- **Fraud awareness training**
- **Whistleblower program**
- **Forensic data analytics**
- **Special site reviews**
- **Investigation response**
- **Anti-bribery and anti-corruption assistance**
- **Monitor compliance with global anti-corruption and operating guidelines.**
- **Perform forensic due diligence on target companies and business partners**
- **Conduct whistleblower allegation investigations and reporting**
- **Manage an ethics hotline for reporting concerns**

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**How can we help?**

**Opportunity**
- Create a code of ethics by centralizing responsibility at the board level
- Conduct regulatory compliance reviews
- Provide solutions on records risk management

**Internal controls**
- Fraud awareness training
- Whistleblower program
- Forensic data analytics
- Special site reviews
- Investigation response

**Ethical culture**
- Tone from the top
- Fraud control plan

**Motivation**
- Create an anti-fraud policy and a fraud-response plan
- Conduct fraud-risk assessments of the current state of vulnerable processes
- Develop a continuous monitoring mechanism for high risk processes and transactions

**Suitable target**
- SION validation
- Evaluate SION vs actual consumption
- Evaluate potential material leakages

**Fraud risk-vulnerability assessment**
- Level 1 background check: On information available in the public domain.
- Level 2 background check: Site visits and interviews
- Level 3 background check: A full-fledged investigation

**Regulatory compliance assistance**
- Anti-bribery and anti-corruption program assistance
- Monitor compliance with global anti-corruption and operating guidelines.
- Perform forensic due diligence on target companies and business partners

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**Investigations**
- Conduct whistleblower allegation investigations and reporting
- Manage an ethics hotline for reporting concerns

**Dispute advisory services**
- Arbitration support
- Expert witness
- Quantum assessment

**SION validation**
- SION validation
- Evaluate SION vs actual consumption
- Evaluate potential material leakages
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