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*BEATING OCCUPATIONAL FRAUD
THROUGH AWARENESS AND PREVENTION*

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Beating Occupational Fraud through Awareness and Prevention

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BEATING OCCUPATIONAL FRAUD THROUGH AWARENESS AND PREVENTION

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I. INTRODUCTION

Despite the awareness created by high profile fraud cases such as Enron, WorldCom and Parmalat, occupational fraud runs rampant in the business world and poses a significant and growing threat to the operational success of organizations globally. Both the 2004 Fraud Report on Occupational Fraud and Abuse by the Association of Fraud Examiners (ACFE) and the 2005 PricewaterhouseCoopers's (PwC) Global Economic Crime Survey point to this direction.

According to the 2002 report of ACFE, annual fraud losses in the United States (US), not counting the impact of Enron, WorldCom, and other stricken companies, were topping US\$600billion. In the United Kingdom (UK), fraud losses are in excess of £15 Billion per annum, according to Ros Wright, Chairman of the Fraud Advisory Panel in the UK. In the 2004 ACFE fraud report, the figures rose to US\$660 billion in the US while they reached £72 billion in the UK. The collapse of Enron and WorldCom resulted in job and retirement pension losses for a considerable number of employees, while shareholders experienced a loss in market capitalization of some US\$66 billion in the case of Enron and US\$177 billion in the case of WorldCom.

The Enron debacle gave the impression that the not-for-profit sector was unaffected. However, the 2004 ACFE study of 508 occupational fraud cases in the United States indicated that 12.2% of the fraud cases occurred in the not-for-profit sector with a median loss of US\$100,000, 45.8% of which takes place in organizations with fewer than 100 employees. In addition, according to the PwC 2005 Global Economic Crime Survey, nearly half of all organizations worldwide, including US companies, admit having been victims of corporate crime in the past two years. The study revealed that the number of organizations reporting fraud increased from 37 percent to 45 percent since 2003. Asset misappropriation, theft through false pretences, and counterfeiting referred as "tangible frauds" by PwC, cost companies on average US\$1.7 million, resulting in an immediate and direct financial loss.

The PwC survey further reported that companies experienced eight serious incidents of fraud on average. Since 2003, there has been an increase of 71% in the number of

companies reporting cases of corruption and bribery, while the number of those reporting financial misrepresentation rose by 140%.

While occupational fraud is perhaps perpetrated at all levels by staff within an organisation, it is surprising and shocking to note the extent of involvement of senior management in this act. The increase in fraud cases calls for the need to re-evaluate corporate governance processes of organisations. It is interesting to note that even the highly regulated corporate environments in the world are not immune from this vice and are experiencing high profile fraudulent cases on a daily basis.

Organisations exist to satisfy the interest of stakeholders. But where resources are siphoned for personal gain it becomes a matter of public interest that organisations and their employees are held in check to behave ethically for the benefit of the wider society. Organisations that rewarded employees for fraud committed for their benefit might be inherently inciting danger on themselves, as it is often a matter of time before they themselves fall in the trap of similar conducts.

II. WHAT IS FRAUD?

Fraud has no strict legal definition but could be described as a situation where a person appropriates by deception a property belonging to another with the intention of permanently depriving the other of it. It is generally thought of as involving some form of dishonest conduct, whether by act or omission, by making false oral or written statements, and generally with the intention of obtaining property or benefit from another person or entity either for gain per se or to evade a debt or other liability.

The ACFE defines the term “occupational fraud” as the use of one’s occupation for personal enrichment through deliberate misuse or misapplication of the employing organization’s resources or assets. The definition encompasses a wide range of misconducts by employees, managers, and executives, ranging from simple acts such as pilferage of company supplies to more complex and sophisticated financial statement frauds. All occupational fraud schemes have four elements in common. The activity:

- Is clandestine
- Violates the perpetrator’s fiduciary duties to the victim organization
- Is committed for the purpose of direct or indirect financial benefit to the perpetrator; and
- costs the employing organization assets, revenue, or reserves.

(a) Occupational Fraud

The ACFE identified three major categories of occupational fraud:

- **Asset misappropriation**, involving theft or misuse of an organization's assets, such as skimming revenues, stealing inventory or committing payroll fraud;

- **Corruption**, where fraudsters wrongfully use their influence in a business transaction to procure some benefit for themselves or another person(s), contradicting their duty to their employer or the rights of another, for instance by accepting kickbacks or engaging in conflicts of interest; and
- **Fraudulent financial statements**, which typically involve falsification of an organization's financial statements. Examples include overstating assets and revenues, or understating liabilities or expenses to achieve personal gain.

(b) Fraud Committed by Employees

Some common examples of fraud perpetrated by employees are:

- Extortion and acceptance of bribes or kickbacks.
- Embezzlement by misappropriating funds and falsifying financial records to conceal the act.
- Diverting assets to an outsider or an employee that would normally generate income for the organization.
- Stealing of any kind (e.g., cash, supplies, equipment, tools, data, etc.).
- Pocketing payments on customers' accounts and issuing receipts on self-designed receipt books.
- Keeping terminated employees on payroll and pocketing the paychecks.
- Paying for personal expenses with organization funds with or without authority and failing to reimburse the funds.

(c) Management Fraud

Some examples of frauds committed by the management include:

- Illegal kickbacks.
- Intentional failure to disclose significant information in order to improve the financial picture of the organization to outside parties to gain performance bonuses or contract renewal
- Intentional, improper representation or valuation of transactions, assets, liabilities or income
- Prohibited business activities such as those who violate government statutes, rules and regulations.
- Complex financial transactions and creation of Special Purpose Entities.
- Intentional, improper related-party transactions in which one party receives some benefit not obtainable in an arm's length transaction
- Conflict of interest with the purpose of enriching oneself.
- Use of confidential and insider information to appropriate a personal benefit

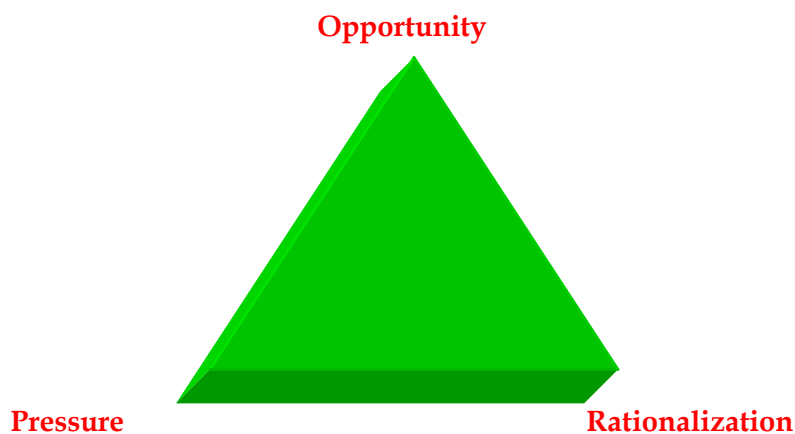
Persons from outside as well as from within the organization can perpetrate fraud for the benefit or to the detriment of the organization. Fraud designed to benefit the organization generally produces such benefit by exploiting an unfair or dishonest advantage, which might also deceive an outside party. Perpetrators of usually benefit indirectly as their personal gains are correlated with the benefits derived from the fraud by the organization.)

Fraud perpetrated to the detriment of the organization benefits generally directly or indirectly an employee, an outside individual, or another firm. Such instances include:

- Acceptance of bribes or kickbacks.
- Diversion to an employee or outsider of a potentially profitable transaction, which would normally generate profits for the organization.
- Embezzlement, as typified by the misappropriation of money, property, and falsification of financial records to cover up the act, thus making detection difficult.
- Intentional concealment or misrepresentation of events or data.
- Claims submitted for services or goods not actually provided to the organization.

(d) The Fraud Triangle

The Fraud Triangle can be used to illustrate the phases of fraud. Employees commit fraud because of opportunity, pressure, and rationalization.



Opportunity is generally provided as a result of weaknesses in the internal control systems, such as inadequate or lack of policies and procedures, easy access to information, lack of supervision and review, failure to segregate financial duties, inadequate management approval and ineffective monitoring of controls.

Pressure

Over 90 percent of all known employee frauds involved some form of a vice- or financial-related pressure, which may result from job dissatisfaction or ego. Pressure

may also arise from personal financial problems, vices such as gambling, drugs, extensive debt, etc. or may be related to rapid personal gains or material.

In a corporate setting, the pressure can be intensified by imposing unrealistic financial targets on management. Improved earnings and higher share prices were the causes of the WorldCom and Enron scandals. Other sources of financial pressure include incentive compensation plans and the cases of "cooking the books" to minimize tax payments by reducing income levels.

Rationalization occurs when the individual develops a justification for his/her fraudulent activities. It allows the perpetrator to reconcile unethical actions with own values and neutralize the guilt of in his or her mind. For example:

- "I really need this money and I'll put it back when I get my paycheck"
- "I have been working hard but received no adequate compensation; it is not a bad idea if I reward myself".

Whether policies and procedures for the prevention and detection of fraud are in place, it is important for management and employees in general to be aware of situations that give credence to the risk of fraud. These warning signs known as "red flags" are meant to draw attention to circumstances that might potentially lead to fraudulent activity.

Fraud "Red Flags" for employees include:

- Borrowing money from co-workers
- Creditors or collectors appearing at the workplace
- Gambling beyond the ability to stand the loss
- Excessive drinking or other negative personal vices
- Easily annoyed at reasonable questioning
- Providing unreasonable responses to questions
- Refusing vacations even when obviously overworked or promotions for fear of detection
- Bragging about significant new purchases
- Carrying unusually large sums of money
- Rewriting records under the guise of neatness in presentation

Other dangerous fraud signals **in terms of** systems and processes are as follows:

- High personnel turnover
- Low employee morale
- Inadequate segregation of duties especially in the finance and procurement function
- Management dominated by one person (or small group) without effective oversight of Board
- Management overriding internal controls
- Lack of supporting documentation for adjusting entries
- Incomplete or untimely bank and other key accounts reconciliation statements
- Increased customer complaints
- Write-offs of inventory shortages without attempting to identify the causes
- Unrealistic performance expectations

- Rumors of conflicts of interest
- Frequent changes of auditors, legal and other professional advisors.
- Financial results inconsistent with the rest of the industry
- Lack of transparency in financial transactions and information

(e) **Highlights of Recent Fraud Statistics using the ACFE 2004 Fraud Report on the United States**

Position in the organization: The 2004 ACFE Fraud Report concludes that managers or executives steal the most in terms of value. Although not often involved, they steal a considerable amount since they have easy access to the organization's cash. They have the ability to manipulate the accounting system and the auditors, as well as to circumvent the internal accounting control system. Employees commit a higher number of fraud but their monetary earnings are much less. More specifically, owner/executives are involved 12 percent of the time with an average theft amounting to US\$900,000 per incident. Managers are involved 34 percent of the time, with an average theft of US\$140,000 per incident, while employees are involved 67 percent of the time, with an average theft of US\$62,000 per incident.

Gender: Men are more involved in fraud than women, but this trend is changing rapidly. Up until recently, not many women had reached the executive level, hence did not have the opportunity to steal as much as the men. Men account for 53 percent of thefts, stealing an average of US\$160,000 as against an average of US\$60,000 for women.

Age: Perpetrators are young people but usually are over 35 years of age and committing 63 percent of the frauds, which provide them with more than US\$100,000 on average.

Education: A college degree positively correlates with high position in the organization, therefore the statistics for the losses follow a similar trend: the higher the educational level, the higher the loss. Thefts involve people having at least an undergraduate degree as in the case of 49% of the time, and stealing an average amount of US\$150,000 per incident. The 51% remaining cases involve people with no undergraduate degree and where the average theft stands at US\$50,000 per incident.

Tenure of Perpetrator: The length of time a perpetrator had been employed with a victim organization is directly correlated to the size of the loss in the fraud scheme. The reason is that the longer an employee works for an organization, the more likely he or she is to advance to higher levels of authority, and enjoy a greater degree of trust from superiors and co-workers.

Number of Perpetrators: Most fraud cases involve a single perpetrator. But when more than one person conspire to commit a fraud, the resulting loss is tremendous, as it is easier to circumvent anti-fraud controls in the case of multiple perpetrators.

Prior Criminal history: Most of the perpetrators of fraud are first-time offenders. This finding is consistent with other studies, particularly with the research of the late

criminologist Donald Cressey who developed the Fraud Triangle Theory, which suggests that most occupational fraudsters are not career criminals.

III. FRAUD DETECTION AND DETERRENCE

(a) Responsibility in Deterring Fraud

Management is responsible for examining and evaluating the adequacy and the effectiveness of actions taken to fulfill this obligation. Deterrence consists of actions taken to discourage fraud and limit resulting financial losses. The major mechanism for deterring occupational fraud is the set up of strong internal control systems. Organizations with strong internal control systems are less vulnerable to fraud. However, it becomes more problematic when management itself is involved in the act. It is important that chief executives, chief financial officers and audit committees ensure strong internal financial controls and related risk-management procedures in order to reduce the risk of distortion of accounting numbers by management.

Corporate financial scandals namely WorldCom and Enron have served as a wake-up call for the investing public, accountancy bodies, regulators and government. Techniques of “aggressive earnings management”, such as – complex accounting, over-hyped market expectations, and management remuneration based on short-term performance are still a serious threat.

The Enron scandal led to the passing of the Sarbanes-Oxley Act in the USA in 2002. The Sarbanes-Oxley Act has dramatic and far-reaching implications for corporate ethics and information disclosure. Alongside the stock exchange listing requirements, the law mandates that companies re-examine and, where necessary, enhance their corporate ethics initiatives. Effective corporate ethics and compliance is fast becoming an integral part of good corporate governance.

The answer to the question as to whether swift legislation with sweeping powers brought about the desired behavioural change is no. According to Sherron Watkins the former Enron Vice-President who blew the whistle on her own bosses, legislation such as Sarbanes-Oxley has improved corporate governance but “behaviour has not got much better”. The recent financial statement fraud in the business world proves that despite tough regulations, management that is committed to fraud can still get away with it as a result of weak corporate governance and the failure of the external auditors to exercise caution while performing their duties.

Fraud prevention and deterrence require a holistic approach, such as stronger internal audit and control systems, more assertive audit committees, more aggressive external audits, closer scrutiny of complex financial structures and transactions by the investment community, regulators and the auditors. This calls for a greater ethical responsibility throughout corporate organizations, which combined with strong internal controls, is the best defense against internal management conspiracies that were the hallmark of the corporate scandals of Enrons and Parmalats.

Greater emphasis should be placed on corporate ethics, which have become the burning issue in recent years in the USA and Europe. However, the issue is yet to be addressed in Africa as fighting public corruption is currently the focus of attention and efforts. Nonetheless, urgent measures need to be taken in order to tackle the issues of business ethics and occupational fraud globally.

(b) Responsibility in Detecting Fraud

The most disturbing fact as noted in the PwC report is that the majority of crimes are detected by accident. More than one-third (34%) of these frauds were discovered by accident, making "chance" the most common fraud-detection tool. Companies become aware of the frauds from calls to hotlines or whistle-blowers, as in the case of Internal audit which detected over 30 percent of the reported cases in North America, while 26 percent of the cases are reported globally. The ACFE report supports the requirement for audit committees to establish confidential reporting mechanisms as recommended by the study. Occupational frauds are more likely to be detected through a tip rather than through other means such as internal audits, external audits, and internal controls.

The issue of where the responsibility lies in detecting fraud remains a controversy between accountants and their legal counterparts. The issue of reasonable assurance is being questioned. After the major corporate scandals, the public outcry has grown increasingly louder regarding the failure of to detect fraud and irregularities. With the collapse of Enron and Parmalat, there is increasing doubt as to whether the auditing profession (and even the largest and most prestigious accountancy firms in the world) will survive in its present form.

As the world trade relies on the fundamental principle of independent oversight, the accounting profession may have to undergo changes to accommodate public requests. External auditors are required to demonstrate professional skepticism. Strong support from the corporate audit committee is also essential. The detection and deterrence of frauds require a shift in auditing procedures, which should give a greater attention to the "cooks of the books" rather than the "books" themselves. However, audit procedures alone, even when carried out with due professional care, do not guarantee the detection of fraud. A concerted effort from the management, external auditors and all employees is needed to combat fraud. Corporate governance procedures play a major role not only in maintaining auditors' independence but also in deterring behavior such as earnings management. Membership on corporate boards should not be a function of celebrity or cronyism but should rather be based on productive contribution from board members to the corporate governance process.

(c) Responsibility in Reporting Suspected or Actual Fraud

Anyone within the organization who has reasonable suspicions of an alleged fraud or actual evidence of a fraud is responsible for reporting suspected or actual fraud. All

employees have the obligation to ensure their organization is free from wrongdoings or criminal activities. All information related to the fraud should be treated as confidential in order to protect the personal security of those who report corporate wrongdoings. There have been instances where whistleblowers had died under mysterious circumstances to prevent them from testifying. A particular situation is notified to management or regulatory bodies in order to facilitate a full investigation that would establish the fact, and to ensure that reporting itself is not considered as established fact.

The following cautious approach should be adopted when reporting corporate wrongdoings:

- Ensuring that the situation involves an imminent threat to society or to the business.
- Documenting all allegations
- Examining internal whistle-blowing mechanisms
- Exploring anonymous ways of reporting
- Seeking advice or expert opinion
- Searching for other employment opportunities if management is involved

(d) Role of whistle-blowing in combating fraud

Whistle-blowing has become an increasingly important tool worldwide to combat corruption and corporate misconduct. Whistle-blowing designates employees' decision to disclose unethical, immoral or illegal action at work to an authority figure (supervisor, media or regulatory bodies). Yet, whistle-blowing is one of the least developed global business practices. Organisations often face significant challenges in their efforts to promote whistle-blowing internally.

(e) Impediments to Whistle-blowing

Employees, in particular, can refrain from blowing the whistle for various reasons. Cultural norms, for example, may influence employees, resulting in divided employees' loyalties among family, authority and the organization. There is also the dilemma of whistle-blowing, which attempts to weigh the disclosure of wrongdoings against the option to remain silent.

Employees fail to speak out against others in the organization for fear of being perceived as violating confidentiality and loyalty. They could be singled out and considered as threats to the organization. They could as well face retaliation of being fired, listed for redundancy, transferred to undesirable locations, physically abused, received death threats, and even murdered. Legislations to protect whistle-blowers are essential to encourage reporting of corporate misconduct.

IV. PREVENTION OF CORPORATE FRAUD

Despite the seemingly rampant corporate misconduct, organizations can take the following practical steps to prevent fraud:

- a. Set the ethical tone from the top: Create and maintain the culture of honesty and high ethics that is supported by all, from top to bottom. Every employee, regardless of his/her position, should be held accountable for his/her actions. Ethics should represent the intrinsic cultural values of an organisation as well as the behaviour exhibited by the organisation to all its stakeholders.
- b. Implement a strong system of control and internal audit with skilled personnel to detect and investigate fraud. These measures are designed to ensure effectiveness and efficiency of operations, compliance to laws and regulations, safeguarding of assets, and accurate financial reporting. Internal controls and related fraud risk management strategies will help reduce opportunities for committing fraud.
- c. Devise an appropriate fraud and ethics policy for the organization.
- d. Undertake a serious examination of fraud tips and conduct investigations to identify the fact.
- e. Create an anonymous system for employees to report witnessed or suspected illegal or unethical actions with the set up of a confidential fraud hotline.
- f. Provide regular education to employees about illegal and unethical behaviour to foster the culture of ethics.
- g. Conduct background check for past incidents during the recruitment of new staff
- h. Involve suppliers and customers in the organization's fraud prevention efforts, as they can be a valuable source of information.

(a) Devising Appropriate Fraud and Ethics policy

Fraud is a behavioral and ethical issue. The prevention of fraud requires the development of policies and practices that address the following three factors:

1. Reducing incentives for committing fraud crimes
2. Limiting opportunities by making the crime more difficult to commit; and
3. Creating an environment where integrity is of utmost importance.

A fraud and ethics policy should include at least the following aspects:

- ◆ Scope of policy
- ◆ Policy statement
- ◆ Actions constituting fraud
- ◆ Other ethical issues such as conflict of interest, gift and entertainment, and insider and confidential information
- ◆ Fraud reporting procedures
- ◆ Confidentiality of the process
- ◆ Investigating responsibility
- ◆ Authority to investigate suspected fraud
- ◆ Disciplinary/legal action

(b) Specificity of Fraud

- ◆ It is prevalent and pervasive
- ◆ It has no boundaries: any company, organisation, or country is vulnerable to fraud
- ◆ It employs various schemes ranging from simple to complex, from “accidental” to carefully planned and executed
- ◆ It has no classic perpetrator with specific characteristics such as age, marital status, education level
- ◆ It is committed by perpetrators who are often trusted and are long-term employees

(c) Role of Good Corporate Governance in Fraud Prevention

Management of fraud is an integral component of effective corporate governance. The elements listed below contribute towards the prevention of fraud both at individual and corporate level.

- ◆ Robust stock exchange rules and compliance regime
- ◆ Strong securities and exchange commissions
- ◆ Effective and acceptable auditing and accounting practices
- ◆ Adoption of best business practices
- ◆ Ethical business culture
- ◆ Proactive management, board and executive stances
- ◆ More assertive audit committees
- ◆ Strong internal audit and controls

Capacity building, alongside the establishment of collaborative networks and enhanced cooperation amongst countries, is crucial to stimulate and facilitate the adoption, promotion and implementation of the highest standards of Corporate Governance globally. Programs that promote best corporate governance practices and strengthen private sector regulatory and governance frameworks should be put in place in order to attract and retain Foreign Direct Investment (FDI), especially in emerging markets.

V. CONCLUSION

According to the OECD, a good corporate governance regime provides the assurance that companies use their capital efficiently. Good corporate governance also ensures that organizations take into account the interests of a wide range of constituencies, and those of the communities within which they operate. The boards are held accountable to the company and its shareholders, thereby ensuring that corporations operate for the benefit of the society. In addition, good corporate governance helps maintain the confidence of

investors - both foreign and domestic - and attract more "patient" long-term capital. (OECD, 1999, pg. 7).

Indeed, occupational fraud poses enormous challenge to economic development. Growing corporate collapse of businesses and fraudulent appropriation of developmental resources deprive the majority of world citizens from the maximum benefits of wealth creation. The revision of corporate governance processes and business ethics will prove to be useful to build trust and attract investment.

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THE ACBF WORKING PAPER SERIES

Overview: The ACBF Working Paper Series (AWPS) was launched in October 2004 as one of the instruments for disseminating findings of ongoing research and policy analysis works designed to stimulate discussion and elicit comments on issues relating to capacity building and development management in Africa. A product of the Knowledge Management and Program Support Department of the African Capacity Building Foundation, a Working Paper very often ends up as an Occasional Paper, a book or some other form of publication produced by the Foundation after a thorough review of its contents. It offers a means by which the Foundation seeks to highlight lessons of experience, best practices, pitfalls and new thinking in strategies, policies and programs in the field of capacity building based on its operations and those of other institutions with capacity building mandates. AWPS also addresses substantive development issues that fall within the remit of the Foundation's six core competence areas as well as the role and contribution of knowledge management in the development process.

Objectives: AWPS is published with a view to achieving a couple of objectives. Fundamental among these are the following:

- To bridge knowledge gaps in the field of capacity building and development management within the African context.
- To provide analytical rigor and experiential content to issues in capacity building and the management of development in Africa.
- To highlight best practices and document pitfalls in capacity building, the design, implementation and management of development policies and programs in Africa.
- To systematically review, critique and add value to strategies, policies and programs for national and regional economic development, bringing to the fore pressing development issues and exploring means for resolving them.

Focus: AWPS focuses on capacity building and development management issues. These are in the following areas:

- Capacity building issues in the following six core competence areas and their relevance to development management in Africa:
 - Economic Policy Analysis and Development Management.
 - Financial Management and Accountability.
 - Enhancement and Monitoring of National Statistics.
 - Public Administration and Management.
 - Strengthening of Policy Analysis Capacity of National Parliaments.
 - Professionalization of the Voices of the Private Sector and Civil Society.
- Engendering of development
- Development challenges, which include issues in poverty reduction, HIV/AIDS, governance, conflict prevention and management, human capital flight, private sector development, trade, regional corporation and integration, external debt management, and globalization, among others.

Orientation: Papers published by the Series are expected to be analytical and policy-oriented with concrete guide to strategies, policies, programs and instruments for strengthening the capacity building process and enhancing growth and development. In line with the objectives of the Series, such papers are expected to share experiences, information, and knowledge, disseminate best practices and highlight pitfalls in capacity building processes and/or the management of development policies and programs.

Contributions: AWPS welcomes contributions from policy analysts, development practitioners, policymakers, capacity building specialists, academics and researchers all over the world, but with a focus on the African context.