



HM TREASURY

Fraud and the Government Internal Auditor

January 2012



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1

Introduction

1.1 The purpose of this guide is to offer advice to central government internal auditors about their role in helping their organisations to manage the risk of fraud and corruption, including bribery, effectively.

1.2 The Government Internal Audit Standards recognise the importance of fraud-risk management and that internal auditors have an important role to play, a role that focuses on assurance. The internal audit role is not to manage fraud-risk on behalf of the organisation but to provide an assurance that risks, including fraud-risk, are being managed effectively.

1.3 General guidance about fraud can be found in Managing Public Money¹ Annex 4.7 and in the Treasury guide “Tackling Internal Fraud”².

¹ http://www.hm-treasury.gov.uk/psr_mpm_index.htm

² www.hm-treasury.gov.uk/fraud

2

What is Fraud?

Introduction

2.1 The term fraud is commonly used to describe a wide variety of dishonest behaviours such as deception, bribery, corruption, forgery, false representation, collusion and concealment of material facts. It is usually used to describe the act of depriving a person of something by deceit, which may involve the misuse of funds or other resources, or the supply of false information. Actual gain, benefit or loss to another does not have to occur for an act to be fraudulent but there does have to be intent to make a gain or cause a loss.

Fraud Act 2006

2.2 The UK Fraud Act 2006 came into force on 15 January 2007. The Act is intended to provide a wide and flexible approach to combating fraud, there is no need to prove that a victim was deceived; it is the misleading intention that counts.

2.3 Fraud has been defined in the Act to require that the fraudster was dishonest in his/her behaviour and that he/she intended to make a gain or cause a loss to another in one of the following ways:

- False representation (section 2);
- Failing to disclose information (section 3);
- Abuse of position (section 4).

2.4 The offence of fraud by abuse of position could include dishonest conduct by agents. If an agent dishonestly abuses their position, with a view to making a gain for themselves or intending to make a loss for another, or to expose the other party to risk of loss, then that agent will have committed an offence. Fraud under this section of the Act may also arise by deliberate omission rather than by dishonest act or acts.

2.5 Separate offences are committed under the Act if a party is in possession of articles for use in fraud. These could range from computer hardware/software to information for the purpose of identity theft. It is a separate offence to make or supply articles for use in fraud. A new offence of obtaining services dishonestly is also introduced by the Act, for example, downloading software dishonestly.

Bribery Act

2.6 The Bribery Act 2010¹ was introduced in the Queen's Speech to Parliament on 18 November 2009. The bill received Royal Assent on 8th April 2010.

2.7 The Act defines four new criminal offences:

- Offering or paying a bribe;

¹ <http://www.legislation.gov.uk/ukpga/2010/23/contents>

- Requesting or receiving a bribe;
- Bribing a foreign public official; and
- A corporate offence of failing to prevent bribery being undertaken on its behalf. Where wrongdoing is uncovered, a corporate entity will automatically be guilty of an offence, unless it can demonstrate that it had “adequate procedures” in place to prevent bribery².

2.8 The act defines “bribery” in wide terms, to capture the differing ways in which bribes are made or received. It sets out several scenarios, or “cases”. The one which is expected to apply to most businesses is the offence of giving a bribe, specifically: “the defendant offers, promises or gives a financial or other advantage intending to induce another person to perform improperly one of their functions in their position of trust and responsibility, or as a reward for improper performance”. In the governance context, officials may be in a position of trust whereby they might be offered a bribe.

² For guidance on the subject of adequate procedures see the MOJ’s guidance at <http://www.justice.gov.uk/downloads/guidance/making-reviewing-law/bribery-act-2010-guidance.pdf>

3

Fraud and Corruption - Internal Audit's Role

3.1 Under GIAS, the Code of Ethics state that internal auditors:

- Shall perform their work with, honesty, diligence and responsibility;
- Shall observe the law and make disclosures expected by the law and the profession;
- Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organisation;
- Shall respect and contribute to the legitimate and ethical objectives of the organisation;
- Shall not accept anything that may impair or be presumed to impair their professional judgement.

3.2 GIAS states that:

- Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organisation, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud (**1210.A2 - Proficiency**);
- Internal auditors must exercise due professional care by considering the probability of significant errors, fraud or non-compliance (**1220.A1 – Due Professional Care**);
- The Head of Internal Audit must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues and other matters needed or requested by senior management and the board (**2060 – Reporting to Senior Management and the Board**);
- The internal audit activity must evaluate the potential for the occurrence of fraud and how the organisation manages fraud risk (**2120.A2 – Risk Management**); and
- Internal auditors must consider the probability of significant errors, fraud, noncompliance and other exposures when developing the engagement objectives (**2210.A2 – Engagement Objectives**).

3.3 It is not a primary role of internal audit to detect fraud and corruption. Internal audit's role is to provide an independent opinion based on an objective assessment of the framework of governance, risk management and control. In doing so, internal auditors may:

- Review the organisation's risk assessment seeking evidence on which to base an opinion that fraud and corruption risks have been properly identified and responded to appropriately (i.e. within the risk appetite).
- Provide an independent opinion on the effectiveness of prevention and detection processes put in place to reduce the risk of fraud and/or corruption.

- Review new programmes and policies (and changes in existing policies and programmes) seeking evidence that the risk of fraud and corruption had been considered where appropriate and providing an opinion on the likely effectiveness of controls designed to reduce the risk.
- Consider the potential for fraud and corruption in every audit assignment and identify indicators that crime might have been committed or control weaknesses that might indicate a vulnerability to fraud or corruption.
- Review areas where major fraud or corruption has occurred to identify any system weaknesses that were exploited or controls that did not function properly and make recommendations about strengthening internal controls where appropriate.
- Assist with, or carry out investigations on management's behalf. Internal auditors should only investigate suspicious or actual cases of fraud or corruption if they have the appropriate expertise and understanding of relevant laws to allow them to undertake this work effectively. If investigation work is undertaken, management should be made aware that the internal auditor is acting outside of the core internal audit remit and of the likely impact on the audit plan.
- Provide an opinion on the likely effectiveness of the organisation's fraud and corruption risk strategy (e.g. policies, response plans, whistleblowing policy, codes of conduct) and if these have been communicated effectively across the organisation. Management has primary responsibility for ensuring that an appropriate strategy is in place and the role of internal audit is to review the effectiveness of the strategy.

3.4 Internal auditors should always report suspicions of criminal activity that come to light as a result of audit fieldwork to an appropriate third party in accordance with the organisation's fraud policy and fraud response plan.

3.5 The Bribery Act does not create any new responsibilities for internal auditors. As with any process, internal audit will provide independent and objective assurance to the AO on the effectiveness of risk management and governance processes. The actions to be taken by internal audit in relation to the Bribery Act will depend on the nature of the organisation's business, the impact that bribery might have on the reputation of the organisation and on anti-corruption policies and practices already in place.

3.6 The Head of Internal Audit should identify, assess and monitor any relevant fraud or corruption risks within the internal audit unit associated with the provision of the internal audit service.

4

Fraud and Corruption - Internal Audit Policy/Strategy

4.1 The role of internal audit activity in respect investigations into cases of fraud or corruption needs to be defined in the internal audit charter. If internal audit accept some form of responsibility for risk management in these areas, this should be defined in the charter making clear that the work is not carried out as part of the internal audit role and identifying how internal audit independence and objectivity is safeguarded.

4.2 The Head of Internal Audit should establish internal audit policy setting out the role of internal audit in relation to fraud and corruption and defining staff responsibilities that are consistent with the organisation's fraud policy and response plan. It should also make clear what steps should be taken and who should be alerted in the event that indicators of fraud or corruption are identified during audit fieldwork or where suspicions have been reported.

4.3 Internal audit policy and strategy may be informed by the considerations highlighted at **Annex A** and in the knowledge of the external audit approach (see NAO fraud role at **Annex B**).

4.4 Annex C outlines the responsibilities of government bodies under the Bribery Act 2010 and could also help inform internal audit policy and strategy. Internal audit will want to consider whether its organisation has carried out an associated assessment and put in place 'adequate procedures' (see paragraph **C.4**).

5

Potential Crimes Detected During Internal Audit Work

5.1 If during an audit assignment internal auditors identify control weaknesses that could lead to fraud or corruption, the auditor should:

- Immediately report the matter to an audit manager or HIA;
- Decide with the audit manager and/or HIA whether to extend audit work to include additional tests directed towards the identification of activities which may indicate that fraud or corruption is occurring, taking care not to alert potential perpetrators or to prejudice any subsequent investigation;
- Make recommendations to management to reduce the risk of fraud or corruption;
- Ensure that the extent of the concern is captured, so that implications can be considered in the formation of the HIA's overall assurance.

5.2 If evidence is discovered that indicates fraud and corruption is occurring, actions to take include:

- Immediately reporting concerns to the audit manager and/or HIA who should follow any guidelines set out in the organisation's fraud policy and response plan;
- Ensuring that appropriate action is taken as part of the organisation's response.

5.3 If internal audit is asked to lead, or participate in, an investigation into a possible fraud or corruption case, it should be made clear to management that any such work is separate to the established internal audit role. The work should only be accepted if specific skills and experience are available to the service and arrangements should be made to ensure that such work is able to be independently audited at a later stage, avoiding any conflicts of interest.

A

Fraud-risk Management

A.1 The following are examples of questions which internal auditors might use to assess the adequacy of fraud-risk management in the organisation:

- 1 Does the board and audit committee have clear responsibilities with respect to fraud and corruption risk management?
- 2 Does your organisation set the tone at the top and have a clear anti-fraud/corruption strategy including, for example, a policy that coordinates on-going activities for the prevention and detection of fraud?
- 3 Does your organisation perform background checks on all potential new employees including agency staff and consultants? Are background checks carried out on staff being promoted into positions of trust?
- 4 Is there a documented process for recording, tracking and responding to all allegations or suspicions of crime (e.g. whistleblowing/fraud hotline)?
- 5 Are regular assessments of attitudes, incentives, pressures and opportunities to commit crime across the organisation carried out?
- 6 Have the categories of fraud and corruption likely to affect your organisation been identified and the exposure arising from each risk assessed? Has this assessment recognised all types of fraud and corruption risk including bribery, money laundering and price fixing?
- 7 Has your organisation assessed whether identified risks are mitigated by existing internal controls and evaluated the design and effectiveness of those controls (e.g. authorisation/approval, segregation of duties)?
- 8 Are there effective channels in place to promote the flow of quality information up, down and across the organisation?
- 9 Is fraud and corruption awareness training provided to all employees (e.g. as part of induction)? Is the training supported with regular updates or other promotional campaigns?
- 10 Are there adequate procedures in place to ensure that, on a regular and continuing basis, senior management considers the effectiveness of the control environment and whether the risk assessment and mitigating controls require amendment or update?

B

NAO's Anti-fraud Role

B.1 The National Audit Office Combating Fraud position statement outlines its approach to tackling fraud risk when carrying out its audit functions. The contents of the position statement include:

- NAO staff may assist clients in tackling the risks posed by fraud through targeted value for money (VFM) studies, other reviews to identify fraud risk, raising awareness in client bodies or by raising control and system weaknesses identified during financial audits.
- The NAO's audit of financial statements is conducted in accordance with International Standards on Auditing and the audit procedures applied are designed to comply with the requirements of ISA 240 ("the auditor's responsibility to consider fraud in an audit of financial statements"). ISA 240 requires that the external auditor makes enquiries of management regarding management's assessment of the risk of fraud, processes for identifying and responding to the risk of fraud, and communications to those charged with governance and with staff in relation to fraud. In addition, it requires that the auditor make inquiries of management, internal audit, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.
- The NAO maintains an attitude of professional scepticism, recognising the possibility that material misstatement due to fraud could exist. For each assignment, a detailed fraud risk assessment conducted in line with ISA240 informs the overall assessment of client risk. Primary responsibility for the prevention and detection of fraud rests with management of the client body. The auditor considers the risk of fraud and plans audit procedures accordingly to give a reasonable prospect of detecting material misstatement in the financial statements arising from fraud. Specific attention is given to risk of fraud that may give rise to irregular expenditure. In reaching an opinion on the regularity of expenditure, the NAO will assess the adequacy of controls that prevent or detect material misstatement in the financial statements arising from fraud.
- Where staff working on the audit of financial statements have knowledge of or suspicion of money laundering, they are personally required, by law, to report their knowledge or suspicion to NAO's Money Laundering Reporting Officer who will decide whether there are grounds for reporting to the Serious and Organised Crime Agency.
- Any knowledge or suspicion of fraud discovered in the course of VFM examination is taken into account when audit findings are evaluated to form an opinion on whether economy, efficiency and effectiveness objectives have been met. The discovery or risk of material fraud is considered when reporting to Parliament.



The Impact of the Bribery Act 2010 on Government Bodies

C.1 The Act applies to central government bodies because:

- Private sector contractors and providers to public sector organisations are covered by the corporate offence, so public sector organisations will need to update their contract documentation to refer to it;
- Individuals employed in public sector organisations may be caught by the individual offences; and
- Some government bodies are commercial organisations.

C.2 Offences under the following sections of the Act that apply to the central government bodies include:

- **Section 1** – the offence of bribing another person (the offence of offering, promising or giving a financial or other advantage to another);
- **Section 2** – the offences relating to being bribed (creates an offence covering a person who requests, agrees to receive or accepts a financial or other advantage;
- **Section 6** – the offences of bribing a foreign public official (the offence is committed where a person offers, promises or gives a financial or other advantage to a foreign public official with the intention of influencing the official in the performance of his or her official functions).

C.3 However, the offence of a commercial organisation failing to prevent bribery set out in Section 7 might also apply to some government bodies. MOJ Guidance states: “so long as the organisation is incorporated (by whatever means), or is a partnership, it does not matter if it pursues primarily charitable or educational aims or purely public functions. The Government considers that that the commercial activities relating to charitable or educational bodies or the commercial activities of public bodies are likely to be caught by the phrase”. In the light of this, it is clear that some central government bodies will fall within the definition set out in section 7. A commercial organisation will have a full defence if it can show that despite a particular case of bribery it nevertheless had adequate procedures in place designed to prevent bribery.

C.4 Adequate procedures are formulated by reference to six principles (which are intended to be flexible and outcome focussed, enabling robust and effective anti-bribery measures to be put in place). They comprise:

- Proportionate procedures – appropriate preventive policies and procedures proportionate to an organisation’s circumstances taking into account its size, structure, complexity and risk exposure.
- Top level commitment to bribery prevention (needs to be reflected and communicated in appropriate policies);
- Risk assessment;

- Due diligence (in respect of persons who perform services for or on behalf of the organisation);
- Communication (e.g. of bribery prevention policies to staff, contractors and other stakeholders);
- Monitoring and review.

C.5 Anti-bribery practices of organisations and institutions should include the following as a minimum:

- Set the tone from the top as one of zero tolerance;
- Assign specific responsibilities to senior managers;
- Ensure appropriate oversight and adherence to policies and processes;
- Introduce and maintain a mechanism for people to report their concerns;
- Develop, communicate and enforce an anti-bribery policy which includes rules on gifts and hospitality, conflicts of interest and a code of ethics;
- Implement appropriate and on-going training;
- Ensure that standards of ethical behaviour expected of all third party agents are included in any contract documentation;
- Conduct regular reviews and audits of relevant business processes to ensure that corruption risk continues to be managed effectively;
- Develop preventive procedures appropriate and proportionate to their circumstances, taking into account their size, structure, complexity and risk exposure.

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This document can be found in full on our website: <http://www.hm-treasury.gov.uk>

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