



HM TREASURY

Fraud and the Government Internal Auditor

May 2010



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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 fraud-risk management.

1.2 The Government Internal Audit Standards define fraud as any illegal act characterised by deceit, concealment or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organisations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage. Actual gain, benefit or loss to another does not have to occur for an act to be fraud.

1.3 The 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.

1.4 General guidance about fraud can be found in Managing Public Money¹ Annex 4.7 and in Treasury guidance on managing the risk of fraud².

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

² www.hm-treasury.gov.uk/fraud

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What the standards say about fraud

2.1 The Government Internal Audit Standards state 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, non-compliance and other exposures when developing the engagement objectives (**2210.A2 – Engagement Objectives**).

3

Internal audit role in relation to fraud

3.1 It is not a primary role of internal audit to detect fraud. Internal audit's role is to provide an independent opinion based on an objective assessment of the framework of governance, risk management and control. This will include the effectiveness of the processes put in place by management to manage the risk of fraud. In doing so, internal auditors may:

- Review the organisation's risk assessment seeking evidence on which to base an opinion that fraud risks have been properly identified and responded to appropriately (i.e. within the risk appetite).
- Provide an independent opinion on the effectiveness of the fraud prevention and detection processes put in place to reduce the risk of fraud.
- Review new programmes and policies (and changes in existing policies and programmes) seeking evidence that fraud-risk had been considered where appropriate and providing an opinion on the likely effectiveness of controls designed to reduce the risk of fraud.
- Consider the potential for fraud in every audit assignment and identify indicators that fraud might have been committed or control weaknesses that might indicate a vulnerability to fraud.
- Review areas where major fraud has occurred to determine how frauds were perpetrated and make recommendations about strengthening internal controls where appropriate.
- Assist with, or carry out, fraud investigations on management's behalf. Internal auditors should only investigate fraud if they have the appropriate expertise and understanding of relevant laws to allow them to undertake this work effectively. If fraud 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-risk strategy (e.g. fraud policy, fraud response plan, 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.
- Consider whether to report concerns of criminal activity that come to light as a result of audit fieldwork to an appropriate third party such as a fraud or security professional within the organisation.

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Policy on fraud

4.1 The role of internal audit activity in respect of fraud investigations needs to be defined in the internal audit charter. If internal audit accept some form of responsibility for fraud risk management, 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 making clear who has responsibility for fraud issues within the internal audit unit and what steps should be taken and who should be alerted in the event that indicators of fraud are identified during audit fieldwork or where suspicions of fraud 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**).

5

Fraud detected during audit investigations

5.1 If during an audit assignment internal auditors identify control weaknesses that could allow fraud, or find evidence that fraud has been perpetrated or is occurring, the following actions should be taken:

- Refer to local internal audit policy/procedures on handling suspected fraud and/or organisation's fraud response plan;
- Decide whether to extend the audit work and design additional tests directed towards the identification of activities which may be indicators of fraud;
- Consider the rights of any alleged perpetrators;
- Decide whether there is clear evidence of fraud to recommend an investigation;
- Ensure that the extent of the concern is captured and communicated so that implications can be considered in the formation of the HIA's overall assurance; and
- Consider at what point management should be advised of internal audit's concerns, who should be advised and how (e.g. staff with designated anti-fraud responsibilities, Money Laundering Reporting Officer);

5.2 Consider who might be involved in the suspected fraud so as to ensure that alleged perpetrators are not alerted and given an opportunity to tamper with or destroy evidence.

A

Fraud considerations

A.1 The following are examples of questions which internal auditors might consider:

- 1 Does the board and audit committee have clear responsibilities with respect to fraud-risk management?
- 2 Does your organisation set the tone at the top and have a clear anti-fraud strategy including, for example, a fraud 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 fraud (e.g. whistleblowing/fraud hotline)?
- 5 Are regular assessments of attitudes, incentives, pressures and opportunities to commit fraud across the organisation carried out?
- 6 Have the categories of fraud likely to affect your organisation been identified and the exposure arising from each risk assessed? Has this assessment recognised all types of fraud risk including corruption, money laundering and price fixing?
- 7 Has your organisation assessed whether identified fraud 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 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

The NAO role in relation to fraud

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 ISA240 ("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.

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This document can be found in full on our website at:
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