

# *Corruption and Fraud Detection by Supreme Audit Institutions*

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This chapter examines the fraud and corruption issues confronting supreme audit institutions (SAIs) and offers some strategies and ideas for improving SAI performance in detecting fraud and corruption. Some SAIs have already tested some of these strategies, with considerable success. For other SAIs they may be new ideas that can help them contain fraud and corruption in their countries.

The chapter is written for SAIs, with the hope that it will generate debate at the International Congress of Supreme Audit Institutions and cause a change in auditing emphases by SAIs—sooner rather than later. It is also written for government officials and legislators concerned about good governance, accountability, transparency, and probity, particularly in countries where fraud and corruption are well embedded in the local culture. The ideas and strategies expressed in this chapter could be the subject of donor support to countries where fraud and corruption interfere with good governance.

## **The Rise in Fraud and Corruption**

Fraud and corruption have devastating effects, especially on the poorest citizens of developing countries. Corruption has no borders

and has spread worldwide, even to countries once considered “clean.” Public sector bribery, fraud, and corruption have become leading concerns for legislators around the globe, as the diversion of public funds undermines parliamentary control of the public purse. This diversion of public monies robs public policies of resources to do the good they were intended to finance.

Corruption makes no economic distinctions and infects all forms of government. No country can afford to sustain the social, political, or economic costs that corruption entails. Corruption erodes public confidence in political institutions and leads to contempt for the rule of law, it distorts the allocation of resources and undermines competition in the marketplace, and it has a devastating effect on investment, growth, and development. It also exacts a disproportionately high price on the poor by denying them access to vital basic services.

Detailed rules and norms of behavior govern the behavior of civil servants in developing countries. But the process of corruption is so invisible that it leaves little documentary evidence. Despite knowledge of the fact that there is widespread corruption in government departments, state audit has not played any effective role to forestall it, except in a few developing countries, notably China. The cases of corruption that come to light are hardly ever taken serious note of. Partly for this reason, society has gradually become more tolerant of corruption. Responsibility is borne by small fries, with the big fish remaining untouched. This has a demoralizing effect on auditors, who believe that it is pointless to detect or report corruption in a society in which accountability is weak.

In developing countries it is common for SAIs to report unauthorized expenditures, waste of public funds, abuse of procedures resulting in losses to the public treasury, and so forth. These institutions are well respected for their independence and even feared, curbing initiative and encouraging avoidance of decisions. However, audit staff often tend to take a clerical approach, demanding strict compliance with procedures while often missing the objective of the procedures. Minor aberrations and misuse of funds are highlighted, while major systemic failures resulting in large losses to the public treasury go unidentified. Audit officers and staff need training to determine what is significant enough to warrant reporting and training for government officials and staff on public procurement concepts, objectives, processes, and their rationale.

There is an increasing desire among legislators to take the initiative in controlling bribery, fraud, and corruption. This is a difficult challenge, particularly for legislators who lack the institutional support, knowledge, and experience to achieve the conditions necessary to hold their governments to

account. The supreme audit community cannot remain indifferent to the special difficulties faced by legislators laboring within the context of corrupt, and often ruthless, regimes.

In recent years major donors have concluded that strengthening the governance capacity of weak nations is a good strategy to support improved accountability, transparency, and probity. Good governance is a strong antidote to corruption and fraud. Donors can bolster good governance by promoting acceptance of international accounting and auditing standards. Legislators and SAIs should unite in support of international standards for accounting and auditing. These standards, promulgated by the International Accounting Standards Board and the International Federation of Accountants, are now available for the public sector as well as the private sector. The International Organization of Supreme Audit Institutions also provides useful audit and internal control guidance to SAIs.

### **The Need for a Change in Audit Emphasis**

Public sector fraud and corruption thrive when accountability and transparency are absent. Good financial reporting and auditing help reduce the misrepresentation that hides fraudulent operations and misleads the reader. Auditing provides the desirable assurance that audited financial statements can be trusted to represent the economic activities they are intended to portray. SAIs can make a constructive difference by auditing the financial statements of governments and government agencies and making their audit opinions available to legislatures on a timely basis.

There is a gap between stakeholder expectations and audit mandates for SAIs. Traditionally, SAIs have agreed that the primary responsibility for preventing and detecting corruption rests with the administrative authorities, such as the police or anticorruption agencies. SAIs have not seen fraud and corruption busting as their main goal; the approach has been to prevent corruption in the field rather than detecting illegal activities. The public, however, believes that SAIs seek to detect fraud and corruption.

This gap needs to be addressed by the SAIs, which should put more emphasis on detecting fraud and corruption to shrink the expectation gap. They should continue to play an active role in raising awareness of the risks of fraud and corruption and fostering good governance and standards of conduct, but they should go further and focus more on detecting fraud and corruption. This can be done by combining controls audit procedures with financial attest audit procedures.

It is easier to prevent fraud and corruption than to detect it. SAIs have been creating and fostering a preventive environment against fraud and corruption, including strengthening financial management systems, evaluating internal control systems, and identifying and correcting weaknesses. Today there is widespread growth in white-collar crime, including both fraudulent financial reporting and misappropriation of asset schemes. Racketeering and terrorist groups often rely on money laundering schemes to finance and disguise their activities. It is time to consider shifting audit emphasis to audit techniques designed to detect fraud and corruption, as well as prevent this scourge on society. This chapter is not recommending that SAIs go so far as to usurp the role of anticorruption agencies. Within the scope of their audit work, however, they should be more vigilant and capable of detecting fraud and corruption.

When giving an audit opinion on financial statements, it is the custom of SAI auditors to ask the reader of the opinion to assume that all the internal controls are functioning appropriately if nothing specific about controls is mentioned by the auditor. In recent years, auditors have been confronted with new technologies with which to select samples to examine, as well as new rules and regulations on appropriate accounting methods. These requirements have drawn their attention away from the basics of evaluating and testing the functionality of internal controls. Moreover, because there is no requirement in financial attest audit standards to report specifically on the internal controls present, the auditor remains silent and places less emphasis on this important audit area.

It is time for public sector auditors to consider giving an opinion on whether or not the internal controls present are appropriate and sufficient to ensure that the systems support the accuracy and fairness of the financial systems and that fraud and corruption opportunities are minimized. In the conduct of a financial attest audit, public sector auditors could now be providing

- an evaluation of the effectiveness of internal control over financial reporting against a suitable control framework;
- evidence providing reasonable support for the evaluation of the effectiveness of internal control over financial reporting;
- reports of material weaknesses in internal control over financial reporting; and
- an audit of internal control over financial reporting.

Doing so requires a change in the public sector auditors' standard opinion to include a statement that the auditors have examined the internal controls and found them sufficient and functioning appropriately to support the

accuracy of the figures stated in the financial statements and to safeguard the assets of the enterprise. Public sector auditors could opine on matters of internal control present in the enterprise that

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the entity;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with the entity's Generally Acceptable Accounting Principles and that receipts and expenditures of the issuer are being made only in accordance with government rules and regulations; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the issuer's assets that could have a material effect on the annual financial statements or interim financial statements.

SAIs could reasonably take the position that these requirements are those of management, not the external auditor, but that would probably not satisfy the needs of a Public Accounts Committee. (In the private sector, it is up to management to ensure that internal controls are effective.) Some SAIs may resist adding this responsibility to their financial audit reports, as it is not yet required by national or international standard setters. Another reason for not embracing this responsibility is the additional cost. There is no cost to stumbling upon breakdowns; detecting them is time consuming. Very few jurisdictions require an opinion on the state of controls. The United States is one of them.

### What Are Fraud and Corruption?

No precise international legal definition of *fraud* exists because these events are covered by national country acts; no international act exists. The term is used to describe deception, bribery, forgery, extortion, corruption, theft, conspiracy, embezzlement, misappropriation, false representation, concealment of material facts, and collusion. For practical purposes, and for this discussion, fraud may be defined as the use of deception with the intention of obtaining an advantage, avoiding an obligation, or causing loss to another party.

Fraud refers to a deliberate act that usually involves the use of deception to obtain some form of financial benefit or advantage from a position of authority or trust that often results in some form of loss to the organization

defrauded. It refers to dishonesty in the form of an intentional deception or a willful misrepresentation of a material fact.

The word *corruption* comes from the Latin verb *corruptus* (to break); it means “broken object.” Conceptually, corruption is a form of behavior that departs from ethics, morality, tradition, law, and civic virtue. The World Bank and Transparency International treat corruption as the use of one’s public position for illegitimate private gains. Abuse of power and personal gain, however, can occur in both the public and private domains, often through collusion by individuals from both sectors. The Lebanese, therefore, define *corruption* as the “behavior of private individuals or public officials who deviate from set responsibilities and use their position of power in order to serve private ends and secure private gains” (Kulluna Massoul 1999). The United Nations Global Programme against Corruption defines *corruption* as the “abuse of power for private gain” and includes both the public and private sectors.

Although perceived differently from country to country, corruption tends to include fraud, bribery, political corruption, conflict of interest, embezzlement, nepotism, and extortion. Examples of government operations particularly vulnerable to corruption are travel claims; collection of taxes and customs revenues; administration of procurement contracts; concessions of subsidies, permits, and licenses; hiring, administration of personnel, and payroll systems; privatization processes; petty cash abuse; and e-commerce and Internet credit card transactions. Some of the most common forms of corruption include misappropriation of assets, patronage, influence peddling, and bribery.

Transparency International attempts to measure corruption in a country by using an index called the Transparency International Annual Bribe Payers and Corruption Perception Index. This index has some shortcomings in that the number of intelligence-gathering points is not large in some countries. However, it does provide some way of comparing corruption across countries, which can identify countries that should take action sooner rather than later.

The causes of corruption vary from one country to the next. Among the contributing factors are faulty government and development policies, programs that are poorly conceived and managed, failing institutions, inadequate checks and balances, an undeveloped civil society, a weak (corrupt) criminal justice system, inadequate remuneration of civil servants, and a lack of accountability and transparency.

A serious impediment to the success of any anticorruption strategy is a corrupt judiciary. A corrupt judiciary means that the legal and institutional

mechanisms designed to curb corruption, however well targeted, efficient, or honest, remain crippled. Mounting evidence is surfacing of widespread judicial corruption in many parts of the world, a trend that poses a major challenge for SAIs in the future.

### **The International Organization of Supreme Audit Institutions' Interest in Fraud and Corruption**

The International Organization of Supreme Audit Institutions (INTOSAI) is the worldwide federation of SAIs. It hosts an international conference every three years called the International Congress of Supreme Audit Institutions (INCOSAI). The 16th INCOSAI, held in Montevideo, Uruguay, in 1998 was devoted partly to preventing and detecting fraud and corruption. The conference looked at (a) the role and experiences of SAIs in preventing and detecting fraud and corruption and (b) methods and techniques for preventing and detecting fraud and corruption.

The Uruguay INCOSAI agreed that corruption in government wastes resources, reduces economic growth and the quality of life, undermines the credibility of state institutions, and reduces their effectiveness. It noted the strong correlation between corruption and the weakening of state institutions. An understanding emerged that corruption is often linked to the socioeconomic environment of the population (social injustice, poverty, violence) and that a country's traditions, principles, and values influence the nature of corruption. While registering the gravity of the challenge posed by corruption, the INTOSAI community also observed that it is difficult to detect many acts of corruption and to estimate their financial impact, which does not necessarily get reported in financial statements.

The Uruguay INCOSAI adopted the following accords:

SAIs agree that fraud and corruption are significant problems affecting all countries in varying degrees and that the SAIs can and should endeavor to create an environment that is unfavorable to fraud and corruption. As provided in the Lima Declaration adopted by INTOSAI in 1977, SAIs agreed that they should be independent and have adequate mandates that enable them to effectively contribute to the fight against fraud and corruption. It was also agreed that, where possible, SAIs should:

1. seek an adequate level of financial and operative independence and breadth of audit coverage;
2. take a more active role in evaluating the efficiency and effectiveness of financial and internal control systems and aggressively follow up on SAIs recommendations;

3. focus audit strategy more on areas and operations prone to fraud and corruption by developing effective high risk indicators for fraud;
4. establish an effective means for the public dissemination of audit reports and relevant information including establishing a good relationship with the media;
5. produce relevant audit reports that are understandable and user friendly;
6. consider a closer cooperation and appropriate exchange of information with other national and international bodies fighting corruption;
7. intensify the exchange of experiences on fraud and corruption with other SAIs;
8. encourage the establishment of personnel management procedures for the public service that select, retain, and motivate honest, competent employees;
9. encourage the establishment of guidance for financial disclosure by public servants, and monitor compliance as part of the ongoing audit process;
10. use the INTOSAI Code of Ethics to promote higher ethical standards and a code of ethics for the public service;
11. consider the establishment of a well-publicized means to receive and process information from the public on perceived irregularities; and
12. continue work regarding fraud and corruption through INTOSAI's existing committees and working groups; for example, the Auditing Standards Committee will consider these issues as part of developing implementation guidance as part of a broader standard framework (INTOSAI 1998).

While these recommendations may have been appropriate in 1998, it is becoming apparent that more could and should be done to detect fraud and corruption and that SAIs are well positioned to do so, including by opining explicitly on the state of internal controls.

### Anticorruption Policies

Exposure to fraud and corruption can be mitigated if a government has a set of relevant anticorruption policies. SAIs should encourage adoption of anti-corruption policies for government and assist in the development of antifraud programs.

SAIs can audit the implementation of the policy. Such a policy might include features such as the following:

- All losses of money and allegations of offenses, illegal acts against the government, and other improprieties must be fully investigated.
- Suspected offenses should be reported to the responsible law enforcement agency.
- Departments should ensure that employees are aware of and periodically reminded of their personal responsibility to report any knowledge of a

contravention of government laws or its regulations, a contravention of any revenue law, or any fraud against the government.

- Departments should take reasonable measures to protect the identity and reputations of both the people reporting offenses and improprieties and the people against whom allegations are made.
- Departments should establish and ensure that employees are aware of procedures to deal with tips about alleged losses, offenses, improprieties, and improper practices, however obtained or received and whether anonymous or otherwise.
- Managers who fail to take appropriate action or directly or indirectly tolerate or condone improper activity should be personally held to account.

SAIs can test compliance with policies such as these to determine if the government has enabled an appropriate anticorruption and antifraud regime to be set up throughout government and audited by the SAIs.

## Types of Audits

All audits begin with objectives, which determine the type of work to be performed and the auditing standards to be followed. The types of work, as defined by their objectives, are financial audits, compliance audits, controls audits, performance audits, forensic audits, and computer audits.

Audit engagements may have a combination of objectives, which may include more than one type of work or have objectives limited to only some aspects of one type of work. International standards for audit work have been developed by INTOSAI and the International Federation of Accountants (IFAC) and are being rationalized into a common set of standards. Many countries have their own auditing standards, but most are moving toward the IFAC standards, known as the International Standards on Auditing. Public sector auditors should follow the standards that are applicable to the individual objectives of the audit and to the jurisdiction.

## Financial Audits

While financial audits sometimes reveal frauds, they often do not, because they are not designed to do so. It is possible to stumble upon fraud and corruption while examining the financial records for purposes of providing an attest opinion. If auditors find fraud or corruption, they are bound to report on the circumstances, albeit not necessarily in the audit opinion, which might be a clean opinion. The purpose of financial audits is to give assurance that

the financial statements are not misleading and fairly present the economic transactions of the enterprise in accordance with an accounting framework. Detection of fraud is not a primary objective of financial auditing.

### **Compliance Audits**

Fraud and corruption are often identified through compliance audits, which are designed to ensure that laws, rules, and regulations are observed. Compliance audit objectives relate to compliance criteria established by laws, regulations, contract provisions, grant agreements, and other requirements that could affect the acquisition, protection, and use of the entity's resources and the quantity, quality, timeliness, and cost of services the entity produces and delivers.

Nonobservance may indicate a fraudulent transaction, although not all cases of nonobservance are fraudulent. Some transactions identified could reflect breakdowns in internal controls, not fraudulent transactions. Such findings would be reported to management. Tests can be designed to ensure that enterprise financial policies are implemented in accordance with expectations. Deviations would be reported to management. Where a transaction or a series of transactions is revealed to be contrary to the law, such transactions are reported to management and possibly to an enforcement authority.

### **A Priori Audits**

A form of compliance audit popular in Latin countries is the a priori audit, which focuses on the legality of a transaction. Expenditures cannot be processed until an a priori auditor signs off on each document as to its legitimacy, legality, and completeness. In recent years a priori auditing has become synonymous with real-time auditing, in which transactions are examined in real time offline for legitimacy, legality, and completeness. The focus is on transactions, not systems.

### **Controls Audits**

Controls audits are designed to ensure that appropriate controls over systems and software are in place to ensure that internal controls and internal checks are functioning as designed. Controls audits can have features built into them to ensure that fraudulent truncations are flagged or made difficult, if not

impossible, to transact. Controls audits provide assurance that controls are working, but they do not necessarily detect fraud or corruption.

Internal controls audit objectives relate to management's plans, methods, and procedures used to meet the organization's mission, goals, and objectives. Internal control includes planning, organizing, directing, and controlling program operations and the systems put in place to measure, report, and monitor program performance.

### **Performance Audits**

Performance audits aim to provide information and assurance about the quality of the management of public resources. They assess the economy, efficiency, and effectiveness of the management of public sector entities by examining resource use, information systems, delivery of outputs, and outcomes, including performance indicators, monitoring systems, and legal and ethical compliance.

Performance audits are designed to compare operational performance against norms and predetermined criteria. They can therefore be designed to include some references to laws and regulations and to assist in identifying fraud and corruption. Because performance audits focus on operational issues, especially in high-risk areas, it is not uncommon for auditors to notice some activities that are not in accordance with rules and regulations. Thus, although performance audits are not designed to identify fraud and corruption, these issues sometimes surface.

### **Forensic Audits**

Forensic auditing and accounting include providing investigation and litigation support to corporations, government, and law enforcement agencies. They are relatively new in the public sector.

The increased use of computer technology to conduct criminal activities presents new challenges to the forensic accountant. Forensic auditors design their audits to gather evidence to prove the existence of fraud and corruption. The skills required to do this exceed the audit skills necessary to conduct a financial or compliance audit.

Under some circumstances, laws, regulations, or policies require auditors to report indications of certain types of fraud to law enforcement or investigatory authorities before extending audit steps and procedures. Auditors may also be required to withdraw from or defer further work on the engagement

or a portion of the engagement in order not to interfere with an investigation. The follow-on audit work is known as forensic auditing.

### **Computer Audits**

Computer audits are designed to provide assurance that computer-generated financial records are correctly entered so as to comply with the accounting policies and standards of an enterprise. Computer audits explore the risks associated with equipment malfunction, system design errors, calculation correctness, and human error to provide assurance that the computer systems will deliver accurate information. The audits can be designed to test whether laws, rules, and regulations are observed correctly, making a computer audit potentially useful in detecting fraud and corruption.

### **Fraud Audit Standards**

Encouraging auditors to shift emphasis to detecting fraud and corruption does not change the audit standards. Fraud audit standards are very similar to financial attest audit standards, in that they are segregated into general standards of independence: qualifications, due professional care, and professional skepticism. Field standards include planning, knowledge of the entity, management representations, and audit risk. However, fraud audit standards differ when it comes to communications with management and reporting.

### **Detecting Fraud**

Fraud is usually difficult to detect, because collusion occurs and transactions are not recorded. Well-designed internal controls help prevent fraud. Auditors need considerable training to recognize fraud when it does occur.

### **Internal Auditors in Government**

Internal audit is not well developed in many countries in the world; where it is part of the culture, it is often underfunded in government. Internal auditing has thus not played the important role it should have in helping government managers manage better and improve systems of accountability. Seldom do SAIs rely on the work of government internal auditors, whose work has rarely been sufficiently reliable and whose activities are not focused on the same areas as SAI audits.

SAIs can foster the development of internal auditing in government by sharing their training capacity with the internal audit community in government. The SAI can become the intellectual leader for internal auditors, even though they report directly to government departments. SAIs typically have better audit methodologies than internal auditors, which could be shared with the internal audit community.

It would be very desirable to have the internal audit community in government recognized for their expertise in financial management systems and their valuable contributions to management. In Canada the government has recognized that internal audit capacity has not been well maintained. Despite some weakness, internal auditors in the Department of National Defence found a Can\$100 million contract fraud in which services were paid for but not delivered. This good internal audit work, plus the internal audit work done by the internal auditors at the Department of Public Works and Government Services identifying the sponsorship scandal (described below), has educated the government on the value of good internal auditing. It will take some time before the internal audit communities in most governments receive that much recognition.

### ***Internal auditing in North America***

In Canada the Office of the Auditor General revealed a federal sponsorship scandal after two internal audit reports had been ignored by the government (Government of Canada 2003). The media got wind of the problem when one of the internal auditors became a whistle-blower. The government called in the auditor general to investigate in 2002. Her first report was a scathing denunciation of abuse in which financial administration systems and rules were ignored. The explosive report used words such as “scandalous” and “appalling” to describe how the government abused the system.

The auditor general found that Can\$100 million (\$85 million) was paid to a variety of communications agencies in the form of fees and commissions and that the program was designed to generate commissions for these companies rather than to produce any benefit for Canadians. She told the Public Accounts Committee that officials in Canada’s Public Works Department and Government Services “broke just about every rule in the book” when it came to awarding contracts to a marketing agency. She found instances in which the government paid Can\$550,000 (\$440,000) for reports that did not exist.

A year later the auditor general went even further, tracking the flow of funds and assisting the national police. Additional abuses were revealed, and the Public Accounts Committee held inconclusive hearings. The new prime

minister set up a commission to investigate. The televised hearings and the report of the commission engrossed Canadian taxpayers during much of 2005. In the end, several recipients of fraudulent funds pleaded guilty, went to jail, and provided some restitution. Most Canadians believe that the auditor general's report on the scandal played a major role in toppling the government, which fell following these revelations.

Recently, the media reported a large (more than Can\$100 million [\$85 million]) procurement fraud regarding software development in the Department of Defence, in which companies were apparently paid for work not done (Bagnall and McGregor 2006). The fraud occurred despite repeated management letters from the auditor general pointing out weaknesses in the procurement processes.

Neither of the Canadian fraud reports arose from a financial audit. Both were originally identified by internal auditors.

In March 2003, the U.S. General Accounting Office (GAO) reported that the federal government's accounting practices are unreliable and may not meet widely accepted accounting standards. It reported that the information in the consolidated financial statements could not be relied upon to express an "opinion" because of deficiencies in accounting and reporting across the executive branch (GAO 2003).

In August 2005, the GAO (the name was changed to Government Accountability Office on July 7, 2004) faulted a defense contractor's performance in Iraq. The contractor had been awarded more than \$10 billion in contracts. Auditors found significant cost overruns, the overcharging of the Defense Department by \$61 million, illegal kickbacks, failure to police subcontractors' billing, and unauthorized expenses at the Kuwait Hilton Hotel. The GAO found that despite billions of taxpayer dollars spent on reconstruction efforts, oil and electricity production in Iraq remained below prewar levels (GAO 2005).

### ***Internal auditing in Europe***

Britain's National Audit Office reported that the government's innovative individual learning account (ILA) failed because corners were cut, causing an £80 million (\$200 million) training scandal. The ILA program collapsed after ministers rushed the program into place without a business plan, crafted an imperfect contract, and used insecure information technology systems, all of which contributed to fraud and abuse.

The European Union (EU) has suffered a number of highly public fraud and corruption scandals. A recent one involved funding diverted by the Palestinian Authority into the pockets of terrorists. Auditors allege that money intended for use by the Palestinian Authority for legitimate purposes

was siphoned off by corrupt officials to pay the wages of 7,000 nonexistent public servants.

European Court and internal auditors reported fraud in almost all EU institutions and all of its funding programs. Recently, 230 cases were sent to court for filing false expenses, submitting claims for work not done, evading customs duties, misappropriating funds, and padding contracts to suppliers, leading to kickbacks (Mobray 2003).

### ***Internal auditing in China and the Russian Federation***

The Chinese National Audit Office (CNAO), which has targeted fraud and corruption and sought out problems, has uncovered many instances of fraud and corruption that were not picked up by financial attest audits. Almost Y 9.1 billion (\$1.1 billion) was misused in 38 central government departments, through embezzlement and misuse of funds in departments relating to hospitals, universities, water projects, highway construction, and scientific research. CNAO also reported that the lottery division of the national sports body overpaid two of its own companies so much for printing and distributing lottery tickets in 2003 and 2004 that they turned profits of Y 558 million (\$67 million) (*China Daily* 2005).

The Air Traffic Management Bureau of the General Administration of Civil Aviation used Y 207 million (\$25 million) of government money to circumvent national regulations and buy an office building in Beijing. It then paid annual rent of Y 13.5 million (\$1.6 million) to use the building.

According to China's auditor general, "There are holes in the budget management system of some departments. They make use of their funds to improperly make profits for themselves, and he commented that the CNAO audits in 2004 resulted in savings of Y 1 billion [\$120 million]" (Liu Li 2005).

In the Russian Federation, the Audit Chamber has reported fraud and corruption. In 2005 its chair reported that financial offenses uncovered by audit amounted to Rub 77 billion (\$2.7 billion) and that his office had issued remedies that recovered Rub 1.5 billion (\$50 million). The Audit Chamber also exposed contractual underpricing worth \$275 million for sulfur, gas, coal, and petrochemicals exported from the Russian Federation through the Southern Customs Department in 2004–05 (Accounts Chamber of the Russian Federation 2005).

### **Whistle-Blowers**

One of the most useful sources for finding fraud and corruption is information provided by whistle-blowers. Hotlines are being set up in some countries to

**BOX 10.1** The Risks of Whistle-Blowing

Paul van Buitenen, an internal auditor for the European Union, tried to bring his concerns to his superiors at the European Commission. He was demoted for his efforts. He went over the heads of his supervisors, taking his evidence directly to the European Court of Auditors. He was disciplined by his superiors and lost pay. Eventually, his evidence was supported and many senior EU officials resigned (van Buitenen 2000).

Martha Andreasen claimed EU accounts were open to fraud. She found herself facing discipline charges by the European Union. In 2002 she was suspended from her post as chief accountant after publicly declaring that the Commission's accounts were faulty and open to fraud and abuse. According to Andreasen, there was "very little documentation to support contracts," "no check-up on accounting information," "missing progress and final reports," or simply "no contract files" (Sumberg 2002).

Allan S. Cutler, an internal auditor in Canada, became concerned about the blatant abuses of the system for the sponsorship program. He claimed he was threatened with reprisals from his supervisor for having expressed concerns about the integrity of contract management within the sector. Cutler testified that he was ordered to backdate contracts to match the dates appearing on requisitions, that appropriate signing authorities were not adhered to, and that financial authorities had not been received from the client at the time contracts were issued. While Cutler raised issues of contract manipulation and management concerns, he did not allege any illegal activity. He identified that issues were systemic in nature and warranted further examination. After he brought his concerns to the attention of his superiors, his salary was frozen and he was no longer promotable. Eventually, his concerns were reviewed by the auditor general and Cutler was vindicated. He unsuccessfully ran for Parliament in the next election (Cutler 2007).

make whistle-blowing convenient. In the past whistle-blowing was often done by using brown envelopes that could not be traced to the author. In many cases the whistle-blower simply spoke out to authorities. Speaking out has led many whistle-blowers to be punished (box 10.1).

### Ethics Programs and Hotlines

Two effective programs that can advance a fraud prevention agenda are ethics programs and hotlines. An ethics program addresses fraud and corruption in a comprehensive fashion that goes beyond a simple code of conduct. Governments that want to help employees make the correct ethical choices relating

to environmental, legal, and social decisions may consider establishing an ethics program. Through courses, policies, ethics call lines, and other means, such programs help employees align bureaucratic practices with government values and beliefs.

One effective deterrent to fraud is a strong perception of being detected. A complaint or tip hotline can help strengthen the perception of detection, as calls are monitored and acted upon and the results publicized. Available to constituencies both internal and external to the organization, this deterrent is valuable and relatively inexpensive. Outsourcing the phone line to a third-party vendor provides the added benefit of ensuring there is no organizational bias in its operations.

Ensuring that hotlines are not abused is critical. Disgruntled employees can provide information that is damaging to a person who may have caused the caller some distress. To avoid misuse of hotlines, they must be designed in such a way that sorts the wheat from the chaff, so that only legitimate issues are followed up. Much effort has to be made in designing the system to ensure that complaints are not fictitious or frivolous. Psychologically designed questions help auditors focus on legitimate claims.

### **Professional Bodies with Standards and Guidance for Detecting Fraud and Corruption**

Many bodies have promulgated standards and guidance to combat corruption and fraud. These include the INTOSAI, IFAC, the Institute of Internal Auditors, the Institute of Forensic Auditors, and Transparency International. SAIs, which are already members of INTOSAI, should encourage membership in all of these bodies where practical.

### **Government Agencies with Antifraud and Corruption Mandates**

Many governments throughout the world have set up special agencies, in addition to police forces, to combat fraud and corruption. Their main tasks are to find and prosecute companies and individuals engaged in transnational crime, cross-border crime, customs evasion, fraud, counterfeiting, tax evasion, organized crime, and other fraudulent activities. SAIs can be very helpful to these national anticorruption agencies if they have evidence to support criminal charges. SAIs should be very careful in dealing with such evidence, as improper handling may cause the evidence to be declared inadmissible in court.

## Reporting Fraud and Communicating with Management

The reporting standard does not change if auditors put more emphasis on detecting fraud and corruption. Laws, regulations, or policies may require auditors to report promptly to law enforcement or investigatory authorities indications of certain types of fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse. In such circumstances, they should ask those authorities, legal counsel, or both if publicly reporting certain information about the potential fraud would compromise investigative or legal proceedings. Auditors then limit their public reporting to matters that would not compromise those proceedings, such as information that is already part of the public record.

Reporting fraud requires auditors to address the effect that fraud or illegal acts may have on the financial attest audit report. It is important that the Public Accounts Committee or others with equivalent authority and responsibility are adequately informed about fraud or illegal acts. When auditors detect minor, but reportable, violations of provisions of contracts or abuse that is not material from a financial attest perspective, they usually communicate the findings in a management letter to officials of the audited entity. If the auditor's report discloses deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse, auditors should obtain and report their views to responsible officials.

## Recommendations for Improving SAI Anticorruption Performance

SAIs can take many actions to improve their anticorruption and fraud performance. Many progressive SAIs are already doing the following:

- Making more courses and conferences on combating fraud and corruption
- Strengthening investigative powers
- Establishing forensic audit units
- Establishing fraud auditing standards
- Encouraging more professional designation
- Supporting Transparency International
- Supporting and cooperating with national antifraud agencies
- Encouraging ethics and fraud awareness training programs
- Encouraging ministries, departments, and agencies to create fraud control plans

- Encouraging ministries, departments, and agencies to contract-out fraud control (hotlines, fraud risk assessment, fraud training, fraud control plan, and fraud investigation) if resources are unavailable in-house
- Encouraging lawmakers to pass whistle-blower legislation to protect people who provide legitimate information to public control agencies.

Much more can be done in SAIs that have not amended their approaches to fraud and corruption in recent years.

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