

Combating Fraud and Corruption in the Public Sector

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Foreword

Why do we have auditors? Peter Jones is to be congratulated for addressing this elusive question in his very readable book.

A question for the experts, many experts will reply. Maybe, but no service provider ever gets the last word about what sort of service is to be provided. Even mediaeval bishops found out the hard way that they could not altogether ignore public opinion. Defenestration was a popular remedy during the Thirty Years War for bishops who failed to respond. Brain surgeons, police chiefs and flight controllers have all had to defer to the market. How can auditors expect to buck this trend?

One factor which has so far given them a bit of undeserved privacy to order their own priorities is that people of good taste never want to put into words what auditors are for. This is obvious from the euphemisms so often used by their technical literature. This often says 'ensure that' when it means 'see if', conjuring up the scenario that everything is really all right, but that auditees just need the auditor to say so. Needless to say no auditor worth the name proceeds on this assumption. The truth needs stating, however, and it is that the public is willing to pay for auditors only if they are looking for something which the public thinks may be wrong.

In the long run discussing professional objectives is the only way for professionals to retain credibility with society. Too many people for comfort are now questioning whether auditors are succeeding. Ministers for their part lose no opportunity to press auditors to widen their repertoires. The sceptics have coined their own word for their doubts – the expectation gap.

Most members of the public would be astounded to hear auditors saying that preventing fraud and corruption are the responsibility of management. Managers are by definition responsible for almost everything which happens

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on their manors, but it is precisely because managers are responsible for fraud prevention that they feel the need for a regular audit.

I am therefore delighted that Peter Jones has tried to spell out what auditors can do to detect fraud and corruption. It is harder to find books which tell you how to do fraud auditing than how to tickle trout. Some auditors are sure to disagree with the techniques and tests which he describes, but he need not be too put out about this. If the critics can suggest something better, great. A necessary debate will have been opened up.

Will Werry
Chairman of the Competition Joint Committee, freelance
consultant and former district auditor.

Preface

This book explores the circumstances and implications surrounding fraud and corruption in the public sector. In the public sector corporate objectives and regulations are immensely varied and can change frequently, depending upon political initiatives. Public sector bodies are responsible to politicians and, in a democracy, to the electorate. At one extreme organizations may be required to attain a precise level of statutory 'profit' or return on capital employed, while at the other they may be directly funded from taxation with, apparently, little regard for performance.

An underlying theme of this work is the special position and additional responsibilities of public officials who must be seen to be above suspicion of fraud and corruption. The public sector accounts for approximately 40% of the nation's gross national product and financial malpractice can have very serious implications, directly and indirectly, for all its citizens. Two crucial roles are considered, those of auditors and those of managers. When it comes to combating fraud and corruption managers often rely on the assistance and advice of auditors, though the responsibility to prevent malpractice nearly always rests with management. This book attempts to set out some of the objectives and the necessary measures that are, usually, common to both parties and to clarify some of the confusion that can arise. It examines a wide range of financial and organizational wrongdoing and provides detailed case studies which, without intending any comparison with people or organizations current or past, attempt to introduce an element of realism into the explanation of events.

Although investigation and reporting aspects are considered in detail, the book is aimed more at prevention than cure. A great many simple and cost-

effective measures can be taken to minimize the risk of fraud and corruption. In a regularly audited and well-managed organization a number of these measures are already likely to be in place. But all too often the underlying significance of such measures is not appreciated by managers, or even auditors. This lack of appreciation can be damaging, particularly during periods of change or when simplistic 'cost-cutting' exercises are undertaken.

Since 1980 all public sector activities have faced increased financial pressures. There have been many different responses often resulting in traumatic organizational changes. After virtually uninterrupted growth for most of the past century, involving an ever expanding controlling and providing role, the public sector now faces contraction and reversion to a more regulatory and enabling role.

It is not the intention of this book to adopt a political stance. The problems of fraud and corruption are more likely than most to be readily transferrable across political boundaries. But any period of fundamental change and realignment offers additional temptations and risks. The detailed effects of change are often unpredicted by their, usually ardent, supporters. Attempts to introduce a more business-like environment with greater competition requires careful forethought. Activities which cause little concern in the private sector will raise many problems if the public sector is allowed merely to 'ape' such activities.

As Chapter 2 explains, historically, many public sector bodies arose to satisfy a demand for goods and services that had not been adequately provided by the market mechanism. Defence is the most obvious example: mercenaries are notoriously fickle. Among important issues involving organizational changes is that of maintaining a strong separation of duties between the public sector client and its contractors which, though always important, was more academic in the past. Today with more and more competitive contracts being awarded, maintaining this separation is a crucial factor in avoiding corruption. Unlike a private entrepreneur a public official should never be able to award valuable contracts on the basis, say, of family or workplace connections. The official must be seen to be above suspicion of favour, even when an arm of the official's own organization is one of the contractors.

Many of the topics covered have been approached from the standpoint of auditors, accountants and financial managers. These professions, particularly auditors, have in recent years been forced to confront the problems caused by fraud and corruption. After several decades of appearing to hope the issue would fade from prominence, the professional bodies, particularly the accounting professions, have started to issue new professional guidance and Parliament has been forced to consider the role of auditors. From occupying a prominent though rarely pre-eminent position until the late 1960s and early 1970s, the influence of fraud and corruption upon the objectives of

auditors, both internal and external, has steadily decreased. This has been particularly true of external auditors whose objectives have required them to express increasingly less challengeable opinions over this period. The dramatic reversal of this trend in the 1990s has brought the auditors' role in relation to fraud back to the forefront of debate.

Until the 1948 Companies Act, the external audit of companies required the auditor to attest to the 'truth and correctness' of accounts rather than the current 'true and fair' view. Though impossible actually to fulfil, it was the duty of the National Audit Office to attest to the 'correctness' of accounts until as recently as 1985! But long before this it became accepted by auditors and their clients that, in the main, responsibility for preventing and detecting fraud, lay with management rather than auditors. Well-publicized events in the public and private sectors involving recent fraud and widespread corruption have called into question the independence of auditors and the steps they should take to guard against and report cases of fraud.

The internal auditor, who is generally expected to be of service to management as well as maintaining an independent stance – a position of some invidiousness at times – has tended to be more involved in preventing, detecting and even investigating fraud and corruption than his external counterpart, though the internal auditor in no way compensates for management's own responsibilities.

Throughout this book the examples and case studies are an essential part of understanding the issues and techniques outlined in the main text. Audit, like management, is primarily a vocational rather than theoretical subject, which can be understood and appreciated best by practice and experience. Readers who are unfamiliar with public sector accounting terms may find the appendices of Chapter 9 helpful.

If the techniques and controls discussed in this book are implemented auditors and managers can hope to keep the destructive experiences of fraud and corruption to a minimum for themselves, their colleagues and clients.

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My wife Pam, my family, close friends and colleagues deserve my grateful thanks for putting up with my inconsiderate behaviour and general rattiness while writing this book.

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Peter Jones
Faversham

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Characteristics of fraud and corruption

Introduction

This chapter explains what is meant by fraud and corruption; terms that are often misunderstood. Straightforward descriptions of the basic conditions that give rise to fraud and corruption are given and the special requirements of the public sector are emphasized.

The bulk of this chapter deals with legal and professional requirements and the basic regulatory framework that applies to most public bodies. Key aspects of regulatory control are explained in detail. The chapter emphasizes the importance of achieving a regulatory framework relevant to operational rather than to strategic considerations. Operational regulations can be particularly useful to the manager by helping to prevent fraud and corruption from becoming established in the workplace.

The chapter finishes with a detailed case study outlining the effects of a poor reporting structure and inadequate internal regulation on one key part of an organization. The general conclusions which are drawn can be widely applied.

Basic conditions surrounding fraud and corruption

Fraud and corruption occur when the two following basic conditions exist.

2 Characteristics of fraud and corruption

Intent

There must be intent in the mind of the perpetrator. Intent may arise from a great variety of causes and whether these originate from within the person or from the person’s environment makes no practical difference in most situations.

Opportunity

There must be opportunity to perpetrate a corrupt or fraudulent act. An opportunity may be created after being planned and contrived at great length, or it may arise from a chance taken in a passing moment.

Intent

Intent is given relatively limited attention throughout this book. This is because intent is more the specialist realm of the criminologist and criminal psychologist than the auditor, accountant or manager. However, behind intentions lie motivations which can, if recognized in time, indicate the likelihood of fraud and perhaps prevent it occurring.

Table 1.1 Motivations towards fraud and corruption

<i>Personal financial problems:</i> particularly indebtedness, family and gambling-related problems. This category is often the most complex and difficult to recognize. Circumstances that are completely beyond the tolerance of one individual may be considered quite a minor problem by others.
<i>A corporate ethos conducive to corruption:</i> the ‘everyone-else-is-doing-it’ syndrome. This category may be relatively easy to recognize – overtime ‘fiddles’, petty pilfering and so on – but is often very difficult to correct. In general corrective action must be firmly taken from the top down.
<i>Disgruntlement and malice:</i> all but the smallest organization will have rivalries and ‘co-operation’ problems. These can get out of hand and bureaucratic point-scoring can become personal. Officers who feel they have been wronged may try to get even. Also in this category come a wide variety of the under-rewarded pay and ‘perks’ motivations, particularly if these have persisted for long periods of time.
<i>Ego</i> beating the system by perpetrating fraud can represent a challenge, particularly in the area of computer-related fraud discussed in Chapter 5.
<i>Peer pressure:</i> this is effectively part of the corporate culture category. But with peer groups the pressures are usually more intensive and restricted to parts of an organization.
<i>Ideological:</i> these include political, even religious motivations. Also in this category (and possibly partly under ‘Ego’) can be placed ‘Robin Hood’ motivations of fraud to redistribute wealth from the rich to the poor, usually including the perpetrator.

Motivations can be extremely complex and because of this they are usually easier to recognize with hindsight than before the event. Nevertheless, because they can provide a useful warning signal, they are worth considering in broad outline.

Table 1.1 outlines some of the more commonly mentioned motivations. Each one is a genuine cause of concern whether or not it becomes the cause of intent to perpetrate fraud or corruption. Most auditors and senior managers would take notice of these motivations and try, informally at least, to bring them to the attention of other senior managers, or trained counselling staff. Often the manager or auditor will be able to discuss his or her concerns directly with the officers affected. If this is done in time, managers may be able to 'cure' these adverse motivating factors which, after all, is no more than sound management practice.

These motivations or causes of intent could be subdivided and reclassified to seemingly unlimited extents. Beyond this the matter of intent becomes a moral issue outside the scope of this work.

Opportunity

Opportunity, unlike intent, is very much the concern of this book. In particular many of the techniques outlined and cases discussed seek to enable the auditor and more often the manager to minimize opportunity for fraud and corruption.

Opportunities can arise from almost any conditions. Long-term stability can lead to complacency – 'Joe always uses the same route to the bank... the same computer password... the same firm of contractors... etc.' Change can also lead to opportunities, often arising from confusion – 'No one told us who was actually responsible for the bank reconciliation of the new accounts... what exemption would apply to religious orders under the new benefit rules... etc.' Changes in personnel, changes in location, account codes, indeed almost any change of a manual or computerized nature can present opportunities that previously were absent. The regulations, system controls, relationships, attitudes and awareness needed to minimize these opportunities are explained in this book.

Corruption is usually less tangible than fraud. It is a state of mind or ethos that can spread among individuals that make up an organization. Corruption can lead to fraud which is but one of the effects caused by corruption. From an audit viewpoint corruption is more complex than fraud.

Evidence

The conditions surrounding fraud can be complex but in most cases recorded evidence of a fraud exists. For the fraud to remain undetected evidence must be hidden directly by concealment, or indirectly by falsifying records and even the appearance of physical artifacts. For example:

- accounts may contain false entries or be left uncompleted;
- reconciliations may be 'faked';
- stock records may remain unchecked or contain false entries;
- inferior items may be substituted for genuine articles;
- crucial documents may 'go missing'.

Evidence, and how it has been concealed or falsified, will form much of the discussion in later case studies. The recurring question that must be addressed is whether managers can make the evidence of actions and the effects they cause available and 'visible'? For the auditor availability ensures an 'audit trail' and for the manager it ensures responsibility and accountability for the work undertaken.

Such a trail of responsibility shown by written authorizations, well-defined duties, allocation of performance targets, computer passwords or other means, usually enhances quality of output and service. Poor quality is often, but not always, indicative of lax control which may in turn provide opportunity for fraud.

The greater complexity surrounding corruption arises because whereas an effective fraudster may conceal evidence, corruption can occur without generating evidence in the first place. This makes detection during routine audit almost impossible.

The quantifiable extent of fraud is sometimes estimated by writers who refer to types of fraud (e.g. computer fraud) or to geographical areas (e.g. USA, UK, the city of London). Examples include the Audit Commission survey of computer fraud which is done approximately every three years (see Bibliography). Occasionally fraud crime statistics are published on an industrial sector basis. By contrast no one has yet made a realistic attempt to quantify the extent of corruption by reference to value or frequency of occurrence. The most that can be assumed is that the known cases of fraud form but part of the total illegal or unjust actions of corrupt individuals. Favouritism is one of the main manifestations of corruption that goes unrecorded, even at times unnoticed.

Recruitment, promotion, redundancy (or remission therefrom) are oft cited activities where favouritism can play a determining part. Beyond these lie the generally more serious examples involving the awarding of major contracts.

Favouritism often goes hand in hand with bribery, also largely unrecorded, though favouritism may arise from family or social connections in which the pecuniary interest is often difficult to ascertain.

Corruption and the funding of public bodies

Corruption in a public sector body may not be seen as such in the private sector. Who could call a father corrupt for favouring the employment of, or awarding of contracts to, his son or daughter in the context of a family business? Such is generally acceptable custom in society. The critical difference is one of ownership.

The owner, or major shareholder with a controlling interest, is acting on his own behalf and in his own interests. The public servant is acting on behalf of the taxpayers or their elected representatives. The large public corporation is analogous to the public sector in this respect; its share capital is often diffused among thousands of individuals and other organizations and sometimes ultimate ownership is difficult to disentangle among complex intercompany holdings, though the analogy begins to break down when possible liability is considered, as shareholders are not likely to be liable for more than the share value, whereas taxpayers often have to foot virtually the whole bill for fraudulent or corrupt public officials. But in any situation, public or private sector, an employee is generally held to act corruptly when putting personal gain before public or corporate interests in his professional decision-making capacity.

This commonly-held professional ethic can, it would seem, be remarkably difficult to remember in the heady atmosphere surrounding major financial decisions. Some of the cases illustrated later in this book revolve around this problem.

Funders of commercial enterprises have the option of avoiding or withdrawing their funding from an enterprise they consider to be run corruptly; funders of public bodies, i.e., taxpayers, do not have such an option. In these circumstances it is hardly surprising that the law recognizes the particular responsibilities of public servants to be seen to be above suspicion of corruption, as we shall discuss below.

The law

Many people are surprised to find that no effective definition of fraud can be gleaned from English law. Fraud is more of a generic term. It is used to describe any significant and deliberate misrepresentation of financial affairs for the benefit of the perpetrator, or others for whom the perpetrator is acting, possibly without their knowledge. For practical purposes almost any definition of fraud and corruption is likely to be inadequate, or far too long for convenient recall. The act of intentional deception by the perpetrator distinguishes fraud from common error but obtaining proof of intention is usually one of the most difficult aspects of a fraud investigation.