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The Institute of Internal Auditors Australia

Whitepaper

Fraud and Corruption Risk Assessments

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Level 7, 133 Castlereagh Street, Sydney NSW 2000 | PO Box A2311, Sydney South NSW 1235
T +61 2 9267 9155 **F** +61 2 9264 9240 **E** enquiry@iia.org.au **www.iia.org.au**

Fraud and Corruption Risk Assessments

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Background

Purpose

This white paper presents a methodology for using prompts to help ensure the most important fraud and corruption risks are identified, thus increasing the effectiveness of fraud and corruption risk assessment and mitigation strategies; thereby reducing the incidence of fraud and corruption. The methodology is useful for conducting fraud and corruption risk assessments, and also for internal and external auditing; thus helping to ensure compliance with relevant standards and guidelines.

Background

The importance of conducting fraud and corruption risk assessments is generally well accepted. For example: "Fraud risk assessment is key to a successful prevention system and is an important management tool for preventing and detecting fraud ." Nonetheless, many risk management practitioners, operational personnel and auditors rely substantially on their personal experiences and knowledge to help ensure significant fraud risks have been identified. Where a person's experience and knowledge of the complex area of fraud and corruption is limited, the concern increases that important fraud and corruption risks may escape identification, and thus mitigation.

Discussion

Issue

Fraud and corruption risk assessments often fail to identify the most significant risks. Using categories of fraud and corruption as prompts in the risk assessment process is a useful way to ensure significant fraud and corruption risks are considered.

History

The management of business risk has become accepted as an important component of corporate governance. For most organisations, fraud and corruption are significant business risks. This has been highlighted in numerous guidelines on governance, fraud and corruption control, for example the Australian Standard on Fraud and Corruption Control and guidelines issued by Auditors-General and Independent Commissions against Corruption.

Internal auditors should consider the risks of fraud in order to comply with the International Professional Practices Framework, especially Standards 1210.A2, 1220.A1, 2060, 2120.A2 and 2210.A2.

Discussion

In order to identify significant fraud and corruption risks it is helpful to use prompts, particularly the elements of fraud and corruption risks and categories of fraud and corruption risk that are relevant to your organisation.

It is recommended the major categories of fraud and corruption risk that apply to your organisation should be considered in the planning phase, and used in the detailed fraud and corruption identification and assessment phase. The categories used should be 'best fit' for your organisation.

A number of generic categories are explored in this white paper as examples. They are decisions; information; funds-in; funds-out; things we own or use; and perceptions.

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Decisions

Decisions are fertile ground for fraud and corruption, particularly when there are significant discretions, poor controls, and significant values involved. Decision categories for consideration in the risk assessment might include:

- Decisions that might give significant benefits, or cause significant costs or inconvenience to clients, suppliers or others.
- Decisions that might give rise to substantial benefits for the individual decision-maker, unit or manager.
- Decisions we make that are important to our organisation.
- Decisions that are otherwise higher risk.

Decisions that are generally higher risk typically include ones where:

- The decision or the reasons for the decision are not well documented
- The considerations taken into account have not been disclosed to the entity affected by the decision.
- The decision does not follow a well-established process.
- The decision is largely subjective.
- The decision is made by only one person.
- The decision is not reviewed properly.
- Decisions of this kind are infrequent.
- The decision-maker selects the item about which to make the decision.
- The decision-maker is inexperienced, has limited knowledge of the matter, has limited time in which to consider the relevant factors, etc.
- The entity affected by the decision is more likely to act corruptly; eg the industry has a reputation for corrupt or criminal activity, or the company has acted corruptly before in Australia or overseas.

Information

Information is often an important item for inclusion in a fraud and corruption risk assessment, due to its value and the reputational damage its misuse or disclosure might cause. Information categories might include:

- Information subject to privacy rules.
- Information that is important to us or could be valuable to a third party.
- Information that could cause significant damage to individuals, other parties, or us.
- Information that is otherwise high risk.

The fraud and corruption related risks of information are generally higher if:

- Other entities and their employees, contractors, etc have access to it.
- Entities that have access to the information may not have the processes, resources or incentive to properly protect it.
- The information is subject to legislative restrictions over its collection, use, protection or disclosure, and this makes improper use or access more serious.
- The information is subject to privacy rules.
- Status of the information is unclear to staff or third parties in relation to confidentiality, level of security required, etc.
- Internal controls for the protection of the information are poor, eg poor password practices, people have access who do not need it, poor IT access controls, inadequate audit trails, etc.
- The information could be valuable to a third party, eg for marketing, commercial decisions, insider trading, illegal use, etc.
- The information could cause significant damage to individuals it is about.
- Costs for the organisation associated with improper use by others could be significant.
- The information is a likely target, eg to embarrass the organisation or key stakeholders.
- It is confidential information that is important to the organisation or others, or is prone to theft, misuse or corruption.

Funds-in

Sources of revenue should generally be considered for associated fraud and corruption risks. Categories might include:

- Regular sources of revenue.
- Occasional and miscellaneous sources of revenue.
- Revenue collected by contractors or third parties.
- Other funds that are substantial, or prone to fraud and corruption.

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Funds-in are generally higher risk if:

- There is not a well-established and constantly used system for handling the revenue.
- The revenue is discretionary, or the calculation of the revenue is complex or involves higher levels of discretion.
- The individual or cumulative amount of the revenue is substantial.
- People paying the revenue resent paying it, for example because it is seen as predatory, unfair or unreasonable.
- Theft of the funds would not be easily detected by the people paying the revenue.
- Collection is undertaken by contractors or third parties.
- Internal controls are poor, for example poor segregation of duties, lack of supervision, limited reconciliations, poor IT or accounting system, etc.

Funds-out

Statistically, the most significant fraud and corruption is associated with outflows of funds. Categories that might be considered are:

- Regular spending.
- Funds to third parties such as contractors doing things for us or on our behalf
- Irregular outgoings.
- Other spending that is substantial or prone to fraud and corruption.

Funds-out are generally higher risk where:

- There are poor internal controls, for example inadequate separation of duties, limited supervision or checking, etc.
- Payments are not part of a continuous process, or are irregular.
- Only one person makes, initiates or authorises that type of payment.
- Individual or cumulative payments are large.
- There are high levels of subjectivity in the payments.
- Contractual arrangements are loose or subject to change.
- There is no, or limited, post-transaction monitoring of payments to check they appear to be reasonable.
- There is a history of allowing suspicious payments.

Things we own or use

Assets and resources owned or controlled by our organisation are often susceptible to fraud and corruption. Categories that might be considered are:

- Things that are valuable.
- Things that are easily taken, might not be missed, etc.
- Things that staff, contractors or others are likely to misuse.
- Other things we own or use that are significant, or prone to fraud and corruption.

There are generally higher risk of items being stolen where:

- The items have a high value.
- The items are physically easy to take.
- The items are desirable or easy to sell.
- The items may not be missed if taken.
- The items are not accounted for in a register.
- If the items are taken it can be difficult to identify who took them.
- Physical security is poor, for example poor access and security controls.
- There is a history of items like these disappearing.
- The accounting or other controls covering these items are poor, so it is easy to hide the misappropriation in the books or records.
- There is a history of allowing staff to take the items.

These are generally higher risk of these items being misused where:

- Internal controls over their use are poor.
- There is a lack of policy guidance as to what use is, or is not, allowed.
- Staff, contractors or other people are likely to misuse the items.
- Misuse is unlikely to be detected or followed-up.
- It would be difficult to detect or prove who misused the items.

Perceptions

There may be situations when perceptions of fraud and corruption may damage morale, reputation, brand, and relations with regulators, even when there is no evidence of fraud or corruption. It may therefore be worth considering perceptions of fraud and corruption in decision-making. This may include decisions we make, or things we do, or others do on our behalf, that people are likely to think are being done corruptly. It is important we are seen to be honest and acting

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with integrity.

Elements of fraud and corruption using the fraud triangle

In considering the elements of fraud and corruption risks, it is helpful to use the fraud triangle. This indicates that fraud requires three things – perceived pressure, perceived opportunity and rationalisation/attitude. Pressure refers to the pressures on a person to perpetrate a fraud, opportunity is the means by which the fraud is committed and rationalisation is the cognitive state that allows the perpetrator to justify the fraud. The elements derived from the fraud triangle are the pressures on people, perpetrating attitudes, poor internal controls, the nature of the item and other, high risk issues.

Some fraud and corruption risks are associated with pressures on employees and others to commit fraud and corruption. Examples include real and perceived financial pressures, addictions, peer pressure, threats from organised crime gangs, and psychological pressures.

Perpetrating attitudes may encourage employees and others to perpetrate fraud and corruption. Examples that might give rise to associated risks include industry practices, organisational culture and subcultures, attitudes of supplier or client groups, management or regulatory tolerance of wrongdoing, lack of clarification about required ethical standards, and perceived inadequate consequences for wrongdoing.

Poor internal controls provide opportunities for fraud and corruption. Fraud and corruption risks may be associated with people and structures operating internal controls, a poor understanding of the risks of fraud and corruption, poor controls to mitigate those threats, inadequate communication to those responsible for internal controls, and poor monitoring.

The nature of items such as assets, revenue and information may affect fraud and corruption risks. Examples include desirability, portability, ease of access, and ease of removing or copying of the item.

Other high risk issues include other risks that could give rise to substantial negative consequences, or where the likelihood of fraud and corruption is particularly high.

Conclusion

Summary

Using categories as prompts in fraud and corruption risk assessments can help ensure significant risks are identified. A number of generic categories are explored in this white paper as examples:

- Decisions.
- Information.
- Funds-in.
- Funds-out.
- Things we own or use.
- Perceptions.

Conclusion

The categories used should be those most appropriate to your organisation. The categories used in this white paper are generic and, if used, should be subject to tailoring.

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Purpose of White Papers

A White Paper is an authoritative report or guide that informs readers concisely about a complex issue and presents the issuing body's philosophy on the matter. It is meant to help readers understand an issue, solve a problem, or make a decision.

Author's Biography

Written by: Matthew Lyon
B.Comm, CPA, AMIAA

Matthew has been involved in internal audit for 10 years in the NSW Government. Prior to this he was Financial Accountant for Catholic Education Office Parramatta. He spent 15 years with the Audit Office of NSW, the last four as engagement manager. He has also served in a number of charities and the Wollongong Council Audit and Finance Committee.

He co-authored the IIA Australia white papers on Fraud Risk Indicators, Corruption Indicators in Internal Audit, Corruption Related Risks in Decision-Making and Conflicts of Interest.

Edited by: Andrew Cox
MBA, MEC, GradDipSc, GradCertPA, DipBusAdmin, DipPubAdmin, AssDipAcctg, CertSQM, PFIIA, CIA, CISA, CFE, CGAP, CSQA, AIPA, AFA, MACS Snr, MRMIA

About the Institute of Internal Auditors–Australia

The Institute of Internal Auditors (IIA) is the global professional association for Internal Auditors, with global headquarters in the USA and affiliated Institutes and Chapters throughout the world including Australia.

As the chief advocate of the Internal Audit profession, the IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for Internal Audit integrity and professionalism around the world with its 'International Professional Practices Framework' (IPPF), a collection of guidance that includes the 'International Standards for the Professional Practice of Internal Auditing' and the 'Code of Ethics'.

The IPPF provides a globally accepted rigorous basis for the operation of an Internal Audit function. Procedures for the mandatory provisions require public exposure and formal consideration of comments received from IIA members and non-members alike. The standards development process is supervised by an independent body, the IPPF Oversight Council of the IIA, which is appointed by the IIA–Global Board of Directors and comprises persons representing stakeholders such as boards, management, public and private sector auditors, regulators and government authorities, investors, international entities, and members specifically selected by the IIA–Global Board of Directors.

IIA–Australia ensures its members and the profession as a whole are well-represented with decision-makers and influencers, and is extensively represented on a number of global committees and prominent working groups in Australia and internationally.

The IIA was established in 1941 and now has more than 180,000 members from 190 countries with hundreds of local area Chapters. Generally, members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

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