

Preventing fraud and corruption: Call the internal auditor¹

How assured are you?

As organisational governors or executive leaders, how are you assured that fraud and corruption are prevented?

*How confident are you that your fraud and corruption² policies, systems and processes are robust?
How do you know that your integrity systems are working well 'all of the time'?*

Fraud and Corruption Impacts

The effects of fraud and corruption on organisations and their communities are well documented. They can be devastating. Their consequences include:

- Undermining of trust with investors, the public, trading partners and staff;
- Critical damage to the mana of organisations and reputations of individuals;
- Broad victim impact, harm caused to employers and employees who have unwittingly been part of the deception;
- Diversion of resources and attention from business objectives for investigations and recovery; and
- Imposition of significant regulatory penalties, particularly if management negligence is a contributory factor.

Significant fraud can also have broader societal impacts such as economic loss and community deprivation caused by unjustified distribution of wealth and power, exploitation of resources.

**Clearly fraud and corruption should be prevented.
This must be a key priority for governors and executive leaders.**

¹ This paper was prepared jointly by IIANZ and TINZ in November 2023

² The Office of the Auditor General defines **Fraud** as an intentional act by one or more individuals involving the use of deception to obtain an unjust or illegal advantage. **Corruption** is the abuse of entrusted power for private gain. Corruption is a type of fraud, and it includes bribery.

Proactive ethical leadership

Proactive ethical leadership at governance and executive leadership sets the standard for behaviours of integrity, transparency and accountability in an organisation. These behaviours can be applied and measured by leadership in several ways with the use of ethical principles, integrity frameworks and model standards.³ But how are you assured that you have the right conditions to enable a fraud and corruption aware culture? Internal Audit can help to assure and improve the effectiveness of your organisational settings and culture.

The Institute of Internal Auditors asserts that “tone at the top is the ethical environment fostered by organisational leadership, and the single most important factor in determining the organisation’s resistance to bribery and corruption.” (IIA 2014).

Why is assurance needed?

The Serious Fraud Office outlines fraud survey resources:

<https://sfo.govt.nz/counterfraud/cfc/additional-resources/fraud-surveys/>

Specific to New Zealand, the KPMG Fraud Barometer for 2022 confirmed the trend in recent years of management and employees continuing to be the most common categories of perpetrators. Those who hold management or operational power over information, finances and relationships are more likely to abuse that power to benefit themselves. These types of fraud are most often linked to weaknesses in internal controls.⁴

This is supported by the Association of Certified Fraud Examiners who publish an annual Global Fraud Survey. Their report counted more than 2,100 fraud cases in 133 countries in 2022. In nearly 50% of the reported cases, fraud occurred because internal controls were lacking or overridden.

New Zealand is not immune

Despite its top ranking in the TI Corruption Perception Index, New Zealand is not immune to fraud, nor should anyone with fiduciary responsibilities take them lightly. Three prominent cases reported in 2023 show the detrimental impact of fraud and corruption:

- **Mortgage Fraud** - Four people were sentenced to jail in 2022 and 2023 for their role in an \$8.7 million mortgage fraud case. Together they attempted to circumvent lending restrictions, resorting to fraud, as they lacked the income to obtain finance. This included setting up fake employment agreements to enable loan agreements during 2015-2016. This breached the trust between bankers, mortgage brokers and customers which can ultimately impact the ability of future borrowers to secure loans.
- **Westland District Council** – a corrupt assets manager was jailed for accepting bribes in exchange for providing his associates with lucrative contracts with the Council. The perpetrators misused confidential procurement information to their advantage and benefit. However, the damage to trust and confidence in the Council was far more significant and enduring, which affected its social contract with the community.
- **Christchurch Earthquake Recovery Authority (CERA)** – two CERA employees were found guilty of using official information corruptly for their personal benefit. They knew about plans for the city and how much landowners and investors were prepared to sell for or pay

³ The Office of the Auditor General (Integrity and how to support it), the Public Service Commission (Standards of Integrity and Conduct), the Institute of Directors (the Four Pillars of Corporate Governance) and the NZX (Corporate Governance Code) provide examples of ethical, integrity and model standards guidance.

⁴ <https://kpmg.com/nz/en/home/insights/2022/09/fraud-barometer-2022.html>

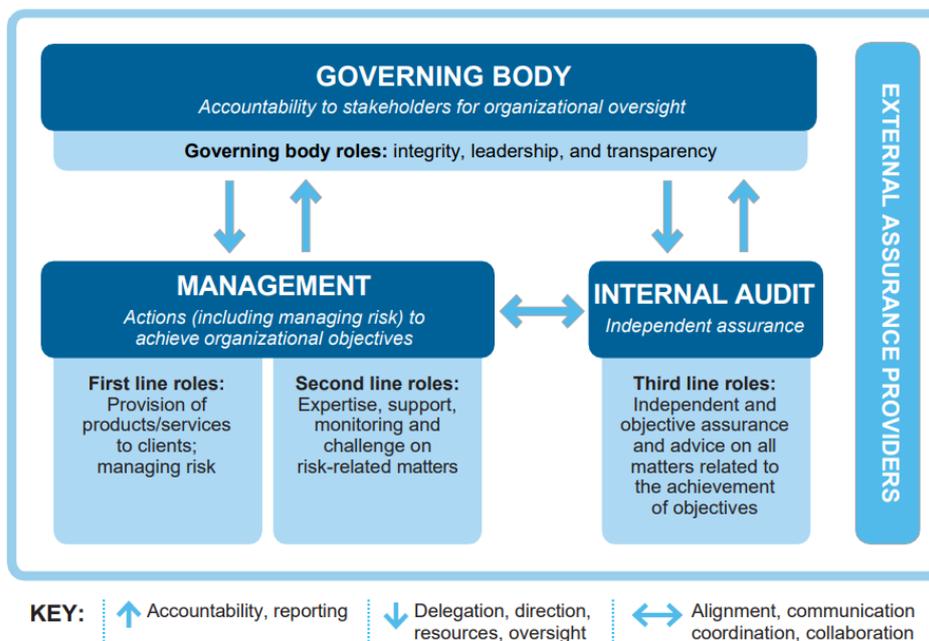
and used that information to broker deals through a private company they set up. Their offending contributed to missed opportunities in the city's regeneration, eroded public trust, and caused reputational harm to their organisation and colleagues.

What tools do governors and executive leaders have?

The Institute of Internal Auditors recommends a 'Three Lines' model to setting fraud controls within the organisational business structure.

- *First Line* – managers are responsible for implementing controls for their business activity and ensure that they operate effectively.
- *Second Line* – these roles provide complementary expertise to support, monitor and challenge First Line managers.
- *Third Line* – this role provides independent and objective assurance on the adequacy of governance and risk management and is usually fulfilled by Internal Audit.

The IIA's Three Lines Model



How do these three lines ensure and assure leaders?

First and Second Lines (ensure)

Senior management – drive conduct and culture and expectations and set organisational targets and objectives. They own and manage risk and ensure that the right controls (e.g. complaints, whistleblowing/speak up systems) are established and supplemented with managing compliance so that they know controls are effective.

Third line (assure)

Internal Audit – an independent⁵ function or capability led by a Chief Audit Executive who (should) reports directly to the highest organisational authority such as the Board, Chair of the Audit Committee, or the Chief Executive. An effective Internal Audit function is uniquely positioned to connect with and transcend the entire organisation. They have a strong understanding of organisational context, objectives, end-to-end processes and systems, and they are attuned to its culture and fraud vulnerabilities. Internal auditors are bound by professional standards that require them to be alert to fraud risk in every audit they carry out. They are governors’ and executive management’s “person on the ground” to provide objective assessments of the control environment to safeguard against significant risks, including risks of fraud and corruption.

What is the value-add of Internal Auditors, as a source of assurance on fraud and corruption?

The Association of Certified Fraud Examiners (ACFE) 2022 report findings reflect the significant role that Internal Audit plays, and the value it adds, in detecting and deterring fraud. The AFCE 2022 report noted:

- Internal Audit consistently ranks second only to ‘tips’, as the most effective way to uncover wrongdoing.
- When Internal Audit is established, median losses to fraud and duration of frauds were cut by one-third.

While Internal Audit clearly has a critical role in assuring their organisations have effective processes and systems to detect and prevent corrupt practices, it is not their primary responsibility to detect or prevent corrupt practices. That is the responsibility of everyone in the organisation from the boardroom to the shopfloor. However, Internal Audit is well placed to educate, promote and role-model counter-fraud and anti-corruption practices to improve organisational resilience; and audit, test and monitor control systems to assure their operating effectiveness. The existence of Internal Audit, particularly one with a strong organisational presence, can also be an effective deterrent measure against fraud and corruption.

An assurance checklist for governance and executive leaders

How do Governors know, and get assurance that, ethics and integrity are strong, and fraud and corruption prevention and detection arrangements are operating effectively?

Here is checklist for your self-assessment. Ask if your organisation has:

- A designated senior person responsible for ethics, integrity and fraud control.
- A code of conduct aligned to the required public focused values, a statement of business ethics for all parties to the extended enterprise (suppliers, customers, constituents, staff etc.)
- A fraud and corruption policy communicated to all employees, contractors, consultants, and suppliers which includes a meaningful whistle-blower policy and program.
- The whistle-blower policy includes a “just culture” or “speak up” policy that encourages staff to share information that might be relevant to fraud or corruption in the confidence that there will be no retribution for them doing so and with a focus on shared awareness of risk.

⁵ Internal Audit independence is enabled by freedom from management responsibility for entity activities and services other than the provision of assurance and consulting advice.

- Pre-employment screening, credit and police checks for new hires and background checks on major suppliers.
- An effective and open process for staff to disclose their interests transparently, and there are clear expectations on the recording and management of conflicts of interest, whether perceived, potential or actual.
- Mechanisms (e.g., use of technology in detecting fraud, periodic fraud self-assessments), to enable the organisation to remain alert to the indicators of fraud and corruption.
- A meaningful assessment of customer complaints and employee raised concerns.
- An investigation and discipline process for alleged unethical and corrupt behaviours.
- Audit committee oversight of fraud and corruption control arrangements, investigations activity and ensuring management considers fraud and corruption risks in decision-making.
- An Internal Audit function that periodically assesses the organisation's ethics and fraud control arrangements, soft controls and integrity culture.

A last challenge for governance and executive leaders

How confident are you that you have limited your organisation's vulnerability to fraud and corruption?

- Have you discussed fraud and corruption risk at the board or executive level in the last 12 months?
- Do you have sufficient preventative and detective measures against fraud and corruption? How do you know they work?
- Are you leading and directing culture and conduct initiatives and setting ethical expectations?
- Are you relying on management assertions that integrity systems are working, or do you also require independent assurance?
- Does your Internal Audit function plan explicitly to cover fraud and corruption risk?

Where can you get help?



Standards, guidance, information



Counter Fraud Centre, guidance, case studies



Business Integrity Programme



Good practice resources, reports



Standards, model standards, guidance



Resources, insights, networks



Corporate Governance Institute, Rules and guidance