



SECTION H.3 - INTERNAL AUDIT SUPPORT TO FINANCIAL FRAUD PREVENTION AND DETECTION

Introduction

Fraud encompasses a range of irregularities and illegal acts characterized by intentional deception or misrepresentation, which an individual knows to be false or does not believe to be true. Fraud is perpetrated by a person knowing that it could result in some unauthorized benefit to him or her, to the organization, or to another person, and can be perpetrated by persons outside and inside the organization.

Fraud includes, but is not limited to¹:

- a. “Corrupt practices”: the offering, giving, receiving, or soliciting, directly or indirectly, anything of value to influence improperly the actions of another party;
- b. “Fraudulent practices”: any act or omission, including a misrepresentation, that knowingly or recklessly misleads, or attempts to mislead, a party to obtain a financial or other benefit or to avoid an obligation;
- c. “Collusive practices”: an arrangement between two or more parties designed to achieve an improper purpose, including influencing improperly the actions of another party;
- d. “Coercive practices”: impairing or harming, or threatening to impair or harm, directly or indirectly, any party or the property of the party to influence improperly the actions of a party.

A conflict of interest is a situation in which a party has interests that could improperly influence that party’s performance of official duties or responsibilities, contractual obligations or compliance with applicable laws and regulations, and that such conflict of interest, if undeclared, may contribute to or constitute fraud.

The distinguishing factor between fraud and error is whether the underlying action is intentional or unintentional.

¹ The definitions included herein are adapted from the standardized definitions adopted by the International Financial Institutions Anti-Corruption Task Force in the “Uniform Framework for Combating Fraud and Corruption” (September 2006).



There are two types of fraud which Centers are potentially susceptible to:

- (a) financial fraud
- (b) scientific fraud

This Manual section deals with financial fraud only.

Examples of financial fraud to benefit an individual, relevant to a CGIAR Center include:

- Acceptance of bribes or kickbacks for allocating or renewing contracts.
- Embezzlement of money and falsification of financial records to cover up an act, thus making detection difficult.
- Claims submitted for services or goods not actually provided to the Center.
- False travel expense claims
- Unauthorized or illegal manipulation of information technology networks, operating or application systems for unauthorized diversion of funds or benefits to individuals (e.g. through human resources, payroll processing, accounts payable and receivable and disbursements systems).
- Theft of consumable stores and fuel supplies
- Theft or misuse of Center assets such as vehicles, workshops and laboratories
- Theft of experimental station produce which would otherwise be sold by the Center for income
- Abuse for personal gain of duty free privileges provided to Centers
- Intentional and improper related-party activities in which one party receives some benefit not obtainable in an arm's-length transaction e.g. relating to sale to staff of Center assets no longer required.

While the incentives in Centers to commit fraud designed to benefit the organization through fraudulent financial reporting are probably much lower than in a profit making organization there are pressures on Centers in relation to the charging of expenditures to projects, to manipulate chargings to achieve budget targets and meet CGIAR financial performance indicators.

Fraud has not only a financial impact for the Center but also a staff morale impact and a donor reputation impact. Fraud risks and their mitigations should therefore be adequately assessed as part of Center enterprise risk management frameworks. The primary responsibility for the prevention and detection of



fraud is with Center management. However, Internal Auditors have a role in advising on, and providing assurance with regard to management’s efforts.

Ref.	Policy and Practice Requirements	IIA Standards and Other references
H.3-1	<p>Policy: Internal Auditors shall support Center Boards and management in relation to the prevention and detection of financial fraud by:</p> <ul style="list-style-type: none"> ▪ Providing good practice guidance on the management of financial fraud risks ▪ Providing good practice guidance on whistleblowing systems, providing support to these systems, and reviewing their operation ▪ Assessing whether Center enterprise risk assessments adequately address the risks of financial fraud across the organization ▪ Providing advice and facilitation assistance to improve Center financial fraud risk assessments ▪ Proposing audits in medium term and annual internal audit work plans that will provide assurance over a certain period of time regarding financial fraud risk management ▪ Incorporating, in assurance engagements, appropriate examination and testing of controls against financial fraud relevant to the scope of the engagement ▪ Incorporating, in consulting engagements, consideration of controls against financial fraud relevant to the scope of the engagement ▪ Maintaining an attitude of professional skepticism – recognizing the possibility of financial fraud in the area being audited despite the auditor’s knowledge of, and past experience with, the audit client staff 	



	<p>honesty and integrity</p> <p>Discussion:</p> <ul style="list-style-type: none"> ▪ The CGIAR IAU’s Good Practice Note on Business Integrity Strategy provides guidance on the elements, relevant to the Centers, that should be considered in assessing the adequacy of a Center’s financial fraud prevention measures ▪ The CGIAR IAU’s Good Practice Note on Communication of Employee Concerns about Center Compliance provides guidance to Centers on the design and implementation of whistleblowing systems. IAU has also prepared a whistleblower policy template for Centers’ consideration. The CGIAR IAU promotes the implementation of such systems by the Centers. ▪ Allegations or concerns received by Internal Audit through whistleblowing systems, informal means or audits shall be registered by Internal Audit and communicated and followed up in accordance with the Centers’ whistleblowing policy. ▪ The Head of Internal Audit, CGIAR IAU Director or Associate Director, or other designated Internal Auditor may be identified as one of the alternative confidential reporting points for employees under Center whistleblowing systems. 	
<p>H.3-1:1</p>	<p>Practice Requirement:</p> <p>The Head of Internal Audit shall review, as part of the periodic review of Center enterprise risk management, whether Center risk assessments adequately address the risks of financial fraud across the organization. If not considered adequate, Internal Auditors shall provide advice and facilitation assistance to improve Center financial fraud risk assessments.</p>	



	<ul style="list-style-type: none"> ▪ Financial fraud risk should be one element in the Center’s enterprise risk framework that is subject to periodic assessment. This should incorporate the results of unit level assessments such as Finance, Materials Management, Human Resources, Information System Services, Regional Offices and Experimental Stations; or assessments by processes such as Disbursements, Purchasing, Selection of Consultants, Partnership Management, Research Project Management. ▪ Center risk assessments and internal audit planning should take account of the coverage of the external auditor with regard to fraudulent financial reporting (the relevant international standard for external auditors is ISA 240 “The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements) 	
<p>H.3-1:2</p>	<p>Practice Requirement:</p> <p>The Head of Internal Audit shall consider the adequacy of assurance coverage of financial fraud risk management in the medium term and annual internal audit plans, and propose a cycle of audits which include this coverage over a period of time agreed with the Center management and Audit Committee.</p> <ul style="list-style-type: none"> ▪ Assurance coverage may be achieved through audits of units, locations or processes where there are inherent risks of financial fraud ▪ The cycle of coverage will depend on the level of resources available for the medium term and annual internal audit work plans ▪ Surprise audits – initiating audits with no notice to the audit client staff – are a technique to detect financial fraud, or to send a message within the organization that auditors are “watching” for financial fraud 	



	<p>and thus discouraging such activities. On the other hand surprise audits can have negative effects on the morale of otherwise honest and diligent staff. The geographic dispersion and many of the locations in which Center operations take place can also make the logistical organization of a surprise audit visit challenging. The value of a surprise audit must be weighed against these and other factors identified by the Internal Auditor. If a surprise audit is being contemplated this should normally be discussed with the Director General or senior management of the area being overseen. In exceptional circumstances the Head of Internal Audit may approve a surprise audit without such prior consultation.</p>	
<p>H.3-1:3</p>	<p>Practice Requirement:</p> <p>Internal auditors shall consider, as part of their planning and execution of assurance audits, the risk of financial fraud, and whether internal controls for the prevention and detection of financial risks have been adequately designed and effectively implemented. Appropriate tests for the existence and effectiveness of these controls should be included in the audit work programs.</p> <p>Discussion:</p> <ul style="list-style-type: none"> ▪ The CGIAR IAU has prepared a detailed standard audit work plan for regional offices and remote experimental stations which identifies those elements of the plan related to the review of controls against, and testing for, typical financial frauds that are most likely for such locations. ▪ In the case of procurement, open and transparent competitive bidding is the best control against financial fraud or corruption. Where possible, procurement 	



	<p>audits should try to compare prices paid by Centers against the market to identify any significant discrepancies which may be an indicator of financial fraud via procurement, including kickbacks to Center staff.</p> <ul style="list-style-type: none">▪ The same advice as above also applies to travel and consulting services provided to the Center.▪ Audits of regional offices, remote experimental stations and Headquarter’s management of liquid assets should include reviews of the management of petty cash and bank accounts including the controls to prevent or detect fraudulent activity involving these. Although the value of total funds at risk in outreach locations is much less than at Headquarters, if fraud is occurring on a regular basis undetected for long periods the loss amounts can quickly become significant. The CGIAR IAU’s Good Practice Note on Management of Liquid Assets provides guidance on controls in this area.▪ Audits of information systems should consider the adequacy and effective implementation of control to prevent unauthorized entries aimed at perpetrating or disguising fraudulent activity. Particular attention should be given to this when auditing financial systems, internet banking applications, procurement systems and human resources systems.▪ Audits of consumable stores, fuel stores and workshops should consider the adequacy and effectiveness of controls over inventory and the use of workshop equipment to prevent misappropriation or misuse of facilities	
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	<ul style="list-style-type: none"> ▪ Internal Auditors should consider, during their audits, factors which may lead to heightened likelihood of financial risks, such as the “tone at the top” for the management of the area, low morale, staff redundancies, high staff turnover, uncertainty about the future of the location, poor segregation of incompatible financial or administrative authorities. ▪ Internal Auditors should allow for opportunities during their audits to meet informally and privately with staff so that the staff may feel comfortable about conveying any concerns (if they have these) about financial fraud or poor controls. 	
<p>H.3-1:4</p>	<p>Practice Requirement:</p> <p>Internal auditors shall be alert, during their planning and execution of audits, for indicators of financial fraud.</p> <p>Discussion:</p> <ul style="list-style-type: none"> ▪ To the degree that fraud may be present in activities covered in the normal course of audit work, internal auditors have a responsibility to exercise due professional care as specifically defined in Standard 1220 of the <i>International Standards for the Professional Practice of Internal Auditing</i> with respect to fraud detection. ▪ However, most internal auditors are not expected to have knowledge equivalent to that of a person whose primary responsibility is detecting and investigating fraud. Also, audit procedures alone, even when carried out with due professional care, do not guarantee that fraud will be detected. ▪ A well-designed internal control system should not be conducive to fraud. Tests 	<p>Standard 1210.A2 –I</p> <p>Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.</p>



	<p>conducted by auditors improve the likelihood that any existing fraud indicators will be detected and considered for further investigation.</p> <ul style="list-style-type: none">▪ In conducting engagements, the internal auditor's responsibilities for detecting fraud are to:<ul style="list-style-type: none">○ Consider fraud risks in the assessment of control design and determination of audit steps to perform. While internal auditors are not expected to detect fraud and irregularities, internal auditors are expected to obtain reasonable assurance that business objectives for the process under review are being achieved and material control deficiencies arising whether through simple error or intentional effort, are detected.○ Have sufficient knowledge of fraud to identify red flags indicating fraud may have been committed. This knowledge includes the characteristics of fraud, the techniques used to commit fraud, and the various fraud schemes and scenarios associated with the activities reviewed.○ Be alert to opportunities that could allow fraud, such as control weaknesses. If significant control weaknesses are detected, additional tests conducted by internal auditors should be directed at identifying other fraud indicators. Some examples of indicators are unauthorized transactions, sudden fluctuations in the volume or value of transactions, control overrides, unexplained exceptions, and unusually large write offs. The Internal Auditor should recognize that the presence of more than one indicator at any one time increases the probability that fraud has occurred.	
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	<ul style="list-style-type: none"> ▪ When evaluating and recommending controls to prevent or reduce fraud risks to an organization, cost and benefit considerations should be made. The evaluation should consider whether fraud could be committed by an individual or requires collusion. In practice, 100 percent fraud prevention is neither possible nor cost effective. On the other hand, controls have value besides their preventive nature – they protect staff in key positions susceptible to fraud from suspicion or accusations of fraud, and they protect the Center’s reputation for stewardship of donor (public) funds. This value should also be taken into account in the cost-benefit analysis. 	
<p>H.3-1:5</p>	<p>Practice Requirement:</p> <p>When the Internal Auditor detects indicators of fraud, they shall inform the Head of Internal Audit, and after joint evaluation, decide whether an investigation should be recommended.</p> <p>Discussion:</p> <ul style="list-style-type: none"> ▪ Where an investigation is recommended, this should normally be discussed with the Director General. Provided there are no indications of their involvement in the suspected fraudulent activity, this may also be discussed prior to that with Center managers responsible for oversight of the area in which the fraud may have occurred. ▪ According to the protocol established for each Center, the Board Chair and Chair of the Audit Committee should be notified of suspected frauds and of proposed next steps. In normal circumstances this would 	



	<p>be done by the Director General.</p> <ul style="list-style-type: none"> ▪ In very unusual situations, where the Head of Internal Audit has determined that a higher level of confidentiality is required, the Head of Internal Audit may report concerns directly to the Board Chair and Chair of the Audit Committee, and agree on an appropriate course of action, without first discussing these concerns with Center management. ▪ Depending on the protocol established for the Center, the Director General, Audit Committee Chair or Board Chair may be the determining authority with regard to the launch of an investigation. ▪ In some cases Internal Audit may be requested to conduct the investigation, in which case the policy and practice requirements set out in Section I.7 of the Manual apply. In other cases Center security personal, legal counsel, other internal experts or an external investigator may be designated by the Center to conduct the investigation. The CGIAR Secretariat may be requested to commission the investigation where there are potentially significant donor reputation issues and the investigation must be seen to be fully independent of the Center. In such cases, Internal Audit will provide support as necessary to the external investigator. 	
<p>H.3-2</p>	<p><u>Policy:</u> When requested to conduct audits of project financial statements, interim Center financial statements, or draft Center annual financial statements in preparation for the external audit, Internal Auditors shall consider the risks of material misstatements in the financial statements due to fraud according to the International Standards on Auditing</p>	<p>ISA 240 The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements</p>



	<p>Discussion:</p> <ul style="list-style-type: none">▪ The relevant standard is ISA240, which is applicable to external financial statement audits, and to which CGIAR Internal Auditors will adhere for internal audits of financial statements.▪ Requests for such audits are not frequent, and they are not part of the regular assurance services provided by Internal Audit, as they are normally undertaken by external auditors. However requests for internal audits of financial statements are occasionally made by Center management to assist with donor accountability, or to provide assurance at the time of handover of Center chief financial officers or Directors General.▪ Numerous or difficult to follow journal entries may be an indicator of the need for more staff training but could also be an indicator of fraudulent financial reporting▪ Significant write back of accruals after balance date, large transactions sitting in suspense accounts or strange/unexplained reconciling items in bank reconciliations may be an indicator of fraudulent financial reporting▪ For both Center and project financial statements, special attention should be given to cut-off, in particular the treatment of accruals to ensure the matching principles in FG2 and IFRS are observed, and that restricted project expenditures are being properly reported according to the correct financial year.▪ For Center financial statements, special attention should be given to reviewing the basis of management judgments and estimates (e.g. provisions, valuations) to ensure these are soundly bases and not	
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	being used to manipulate the financial reporting	
H.3-2:1	<p>Practice Requirement:</p> <p>The Internal Auditor shall plan and execute the financial statement audit so that there is adequate attention given to the risks of misstatements due to fraudulent financial reporting.</p> <p>Discussion:</p> <ul style="list-style-type: none"> ▪ Fraudulent financial reporting may be accomplished by the following: <ul style="list-style-type: none"> ○ Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared ○ Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information ○ Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure ▪ Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. Fraud can be committed using such override techniques as: <ul style="list-style-type: none"> ○ Recording fictitious journal entries, particularly close to the end of the accounting period, to manipulate results ○ Inappropriately adjusting assumptions and changing judgments used to estimate account balances e.g. projected donor income 	



	<ul style="list-style-type: none">○ Omitting, advancing or delaying recognition in the financial statements of events and transactions that may have occurred during the reporting period○ Concealing, or not disclosing facts that could affect the amounts recorded in the financial statements○ Engaging in complex transactions that are structured to misrepresent the financial position or performance○ Altering records and terms related to significant and unusual transactions	
H.3-3	<u>Policy:</u> The CGIAR IAU shall promote awareness and understanding among the CGIAR Internal Auditors of the types of financial frauds to which the Centers are susceptible, how they are executed, indications of their presence, and techniques to review these indicators.	