
AUDITING OF SENSITIVE AREAS/FRAUD RISKS

1. Purpose of Report

The purpose of this report is to set out Risk Assurance's proposed approach to auditing sensitive areas of activity potentially open to fraud. This report also discusses the need for support of all Council business units with a responsibility for preventing fraud.

2. Executive Summary

Risk Assurance has a responsibility for reviewing whether the Council has suitable management controls and processes to mitigate and prevent any risks of fraudulent activity. Risk Assurance has provided assurance by carrying out a programme of audit work and reviews focused on areas which are considered to be most risky.

Risk Assurance have been reviewing the approach to their responsibilities in this area in the light of a new auditing standard which sets out more clearly the external auditor's responsibility for considering the risk of fraud. Risk Assurance are proposing some minor changes to the way internal assurance is provided, relying on a partnership between business units and Risk Assurance

3. Recommendations

It is recommended that the Subcommittee:

1. *Receive the information.*
2. *Note that Risk Assurance will work with business units to determine the nature and extent of reviews of risky activities, transactions and locations carried out by the business units and Risk Assurance and to ensure these reviews satisfactorily meet the requirements of the Council's external auditors.*
3. *Note that Risk Assurance will still carry out its own work to provide independent assurance that sensitive areas are being adequately managed and controlled.*
4. *Note that Risk Assurance will report quarterly to the Management Board and Audit and Risk Management Subcommittee on the results of its fraud programme testing.*

4. Background

One of Risk Assurance's roles is to help ensure probity, efficiency and effectiveness throughout the Council. This role includes assessing whether there are suitable management controls in place to prevent and detect fraud. In 2002, Risk Assurance developed a three year work programme which was designed to address some of these risks through a series of individual subject and area reviews. Over the last three years, all subjects and areas identified in the work programme have been reviewed.

In the last year, the New Zealand Institute of Chartered Accountants (ICANZ) has issued a new auditing standard; *The Auditor's Responsibility to Consider Fraud in an Audit of a Financial Report (AS-206)*. Amongst its requirements, this standard places greater emphasis on the external auditor making enquiries of management, governance and others on matters such as their assessment of the risk of fraud, as well controls to prevent and detect fraud. The standard has effect from 1 January 2005.

The standard sets out guidance on what can constitute fraud. The two main areas of fraud are intentional misstatement from fraudulent financial reporting and misappropriation of assets. Fraudulent financial reporting can include:

- manipulation, falsification, or alteration of accounting records or supporting documentation from which financial reports are prepared;
- misrepresentation in, or intentional omission from, the financial reports of events, transactions or other significant information and/or
- intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent reporting can be committed by management override of controls using technique such as:

- recording fictitious journal entries, close to the end of an accounting period
- inappropriately adjusting assumptions and changing judgements to estimate account balances;
- omitting, advancing or delaying recognition in the financial reports of events and transactions that have occurred during the reporting period;
- concealing or not disclosing facts that could affect the amounts recorded in the financial reports;
- engaging in complex transactions structured to misrepresent the financial position or financial performance of the entity; and
- altering records and terms relating to significant and unusual transactions.

Misappropriation of assets can occur through embezzling receipts, stealing physical assets or intellectual property, causing an entity to pay for goods and services not received, and using an entity's assets for personal use.

Following the issue of this standard the Office of the Auditor General expects public entities to have in place a fraud policy which includes “a system for undertaking regular reviews of transactions, activities or locations that may be susceptible to fraud”.

5. Discussion

5.1 Auditor-General expectations

The Auditor-General expects that every public entity should formally address the matter of fraud, and formulate an appropriate policy on how to minimise it and (if it occurs) how it will be dealt with.

A fraud policy should include, as a minimum, these key elements:

- A system for undertaking regular reviews of transactions, activities or locations that may be susceptible to fraud.
- Specifications for fully documenting what happened in a fraud and how it is to be managed.
- The means for ensuring that every individual suspected of committing fraud (whether they are an employee or someone external to the entity) is dealt with in the same manner.
- The principle that every effort is to be made to gather sufficient reliable evidence to support a prosecution, and that every case of fraud will be referred to the appropriate law enforcement agency with a view to prosecution.
- The principle that recovery of the lost money or other property will be pursued wherever possible and practicable.

5.2 Council policies and standards

Council has a standard in place called the *Investigating Possible Misconduct* Standard. The purpose of this standard is to explain who to report an allegation or suspicion of misconduct with potentially serious implications to. It also describes how a preliminary investigation is carried out and how that is escalated to a full investigation. In addition, the Code of Conduct sets out behaviour that is unacceptable to the Council and which states that swift and appropriate action will be taken in respect of any breach.

Notwithstanding the above, Risk Assurance will, in conjunction with Human Resources, review both the standard and the Code of Conduct to ensure these documents meet the Council’s requirements and expectations of the Auditor-General.

5.3 Identification of sensitive areas

Given the adoption of the new auditing standard and the completion of Risk Assurance’s current three year cycle of work, it is timely to consider what work the team should do over the next three year cycle. Given that the Office of the Auditor General clearly has certain expectations about the systems that should be in place, Risk

Assurance considers that it has a continued role in reviewing and assessing these systems, with the assistance of business units and corporate management. Risk Assurance has identified a number of areas where there are risks of fraudulent and inappropriate activities. These include:

- Cash and petty cash handling
- Payroll transactions including regular payments, special payments and bonuses and leave management
- Accounts payable processes including vendor creation, compliance with financial delegations and changes to vendor bank accounts
- Credit notes and debt write offs
- Travel related expenditure and expense claims
- Entertainment, staff welfare and catering expenditure
- Consultants and contractors expenditure
- Gifts received and given
- Purchase card transactions
- Fuel cards/taxi chits
- Car pool usage
- Cell phone and telephone usage
- Expense payments to elected members
- Receipting and sales processes
- Journal entries
- Accruals adjustments
- Grant payments
- Use of suspense accounts
- Fixed assets
- Stocks and consumables
- Conflict of interest situations
- Manipulating tender processes
- Information theft

5.4 Outline of proposed work

Risk Assurance has developed a forward work programme for testing and reviewing these areas to provide assurance for the committee and senior management. This testing will be spread over a three year cycle from 2006-2009. The main elements of this programme are that Risk Assurance will:

- identify lead business units who will be responsible for regular reviews of the above systems;
- ensure that these units undertake regular reviews of transactions, activities and locations to provide assurance that fraud risk is being satisfactorily managed;
- examine the results of these reviews to ensure that adequate review has been undertaken and to assess the significance of any findings;
- collate the results of these reviews into an overall view and opinion for the committee;

- carry out any audit review of transactions, activities and locations determined necessary to provide any independent assurance of the results of business unit reviews;
- carry out trend analysis to identify any variances, issues in selected areas of work;
- provide the Management Board and Audit and Risk Management Sub Committee with a regular quarterly update on all activity.
- Provide a training and education function for all interested business units to raise fraud awareness throughout the Council.

The ramifications and impact of this work will be discussed with Management Board before being formally promulgated.

5.5 Business unit review of systems

Risk Assurance will discuss with business unit managers what systems are in place to prevent fraud in each of the sensitive areas. Where no system is currently in place to prevent fraud, Risk Assurance will work with managers to ensure that satisfactory systems are put in place to review transactions, activities and locations which are subject to fraud. The complexity of systems will vary dependent on the significance of risk in each area.

5.6 Links with other Risk Assurance work

Risk Assurance will continue to carry out specific focussed reviews of transactions, activities and locations. Risk Assurance will also carry out trend analysis of transactions, activities and locations based on a pre determined programme. The results of audit testing will be incorporated into the internal controls contained within the Risk Management Framework.

5.7 Training and education process

Risk Assurance will develop processes for raising awareness and educating business units about the risks of fraud in sensitive areas and the responsibilities of business unit managers and their employees. The scope this will take will need to be considered but this could include running seminars and courses, providing advisory messages and guidance on the Intranet, by email or memo and providing regular trend analysis and variance information for business units. Risk Assurance will ensure that any training and education is consistent with the guidance contained within Council standards.

6. Conclusion

Risk Assurance will look to provide assurance to the Management Board and the Audit and Risk Management Subcommittee that management controls over sensitive areas and fraud risk areas are satisfactory. This assurance will be provided by a combination of risk based audit reviews, training and education of Council employees and business units and review of business unit initiatives to address any risks for particular transactions, activities and locations.

Supporting Information
<p>1) Strategic Fit / Strategic Outcome</p> <p><i>This project supports Key Achievement Area 9 Governance and Citizen Information: As per the Annual Plan, Governance and Citizen Information includes all those activities that make the Council accountable to the people of Wellington and ensure the smooth running of the city.</i></p>
<p>2) LTCCP/Annual Plan reference and long term financial impact</p> <p><i>Relates to C534: Committee and Council process</i></p>
<p>3) Treaty of Waitangi considerations</p> <p><i>There are no Treaty of Waitangi implications</i></p>
<p>4) Decision-Making</p> <p><i>This is not a significant decision.</i></p>
<p>5) Consultation</p> <p>a) General Consultation</p> <p><i>Not required.</i></p> <p>b) Consultation with Maori</p> <p><i>Not required</i></p>
<p>6) Legal Implications</p> <p><i>None</i></p>
<p>7) Consistency with existing policy</p> <p><i>There are no Treaty of Waitangi implications</i></p>

Contact Officer: *John Scott, Director Risk Assurance*