

**Accountability, Results and Misconduct:  
Should “controlling fraud” become an explicit focus for Internal Audit?**

Discussion Draft for Departmental Audit Committees  
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**Purpose**

The April 1, 2006 Treasury Board *Directive on Departmental Audit Committees* states that the role of the audit committee is:

“to ensure that the deputy head has independent, objective advice, guidance, and assurance on the adequacy of the department’s control and accountability processes...[by exercising] active oversight of core areas of departmental control and accountability in an integrated and systematic way.”

This paper draws on the author’s experience as co-chair of the Blue Ribbon Panel on Grants and Contributions, which examined ways to move from “red tape to clear results” while improving accountability in program administration.<sup>1</sup> Almost all program administrators and grant recipients consulted by the Panel believe that the administration of grant and contribution programs is highly inefficient due to the “web of rules” and the accompanying risk-averse behaviour that developed in response to highly publicized failures of accountability.<sup>2</sup>

Although the *Directive on Departmental Audit Committees* makes no explicit mention of fraud or misconduct, most Canadians would expect the new audit committees to oversee a strengthening of controls to detect and deter such activity. In this context, three of the most important tasks of the two dozen listed in the *Directive* are:

“to review ... the arrangements ... to ensure compliance with laws, regulations, policies, and standards of ethical conduct,”

“to review ... departmental internal control arrangements,” and

“to recommend, and regularly review, a departmental internal audit charter or internal audit policy for approval by the deputy head.”

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<sup>1</sup> *From Red Tape to Clear Results: The Report of the Independent Blue Ribbon Panel on Grant and Contributions Programs*, Ian Clark and Frances Lankin, February 2007, Treasury Board of Canada Secretariat, Ottawa, 140 pages. Cat. No: BT22-109/207 ISBN: 978-0-662-49799-8.

<sup>2</sup> The Auditor General provides a good definition of accountability in Chapter 7 of her March 2004 Report:

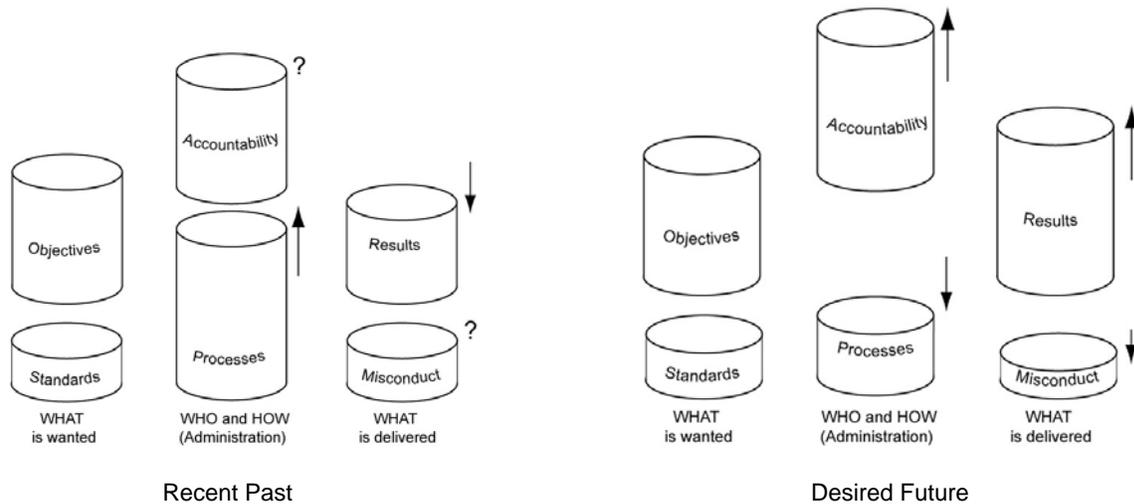
“*The obligation to render an account of, and accept responsibility for, one’s actions, both...the results obtained and the means used.*”

The phrase “accept responsibility for” is important because a common complaint about government is that “no one seems to be accountable for what goes on.” There is a widespread belief that there should be greater personal consequences for inappropriate uses of public funds.

## Questions

The relationships between standards, processes, accountability, results and misconduct are illustrated in the diagram below. The questions posed in this paper are:

- Could a clearer definition of misconduct and an explicit focus on controlling misconduct help with the task of reducing the web of rules?
- Could a credible anti-fraud initiative provide sufficient assurance of adherence to public service standards of conduct to give managers enough confidence to take more dramatic steps to streamline performance-reducing processes and to encourage more results-oriented behaviour?
- Would a sharper focus on the things that are crucial to accountability – specifying results in ways that can be used to hold people to account and identifying the kinds of misconduct that are the most important for audit to address – make it possible to simultaneously reduce the process burden, increase accountability, increase results and reduce misconduct?



## Accountability-focused results specification

A crucial element in reducing the web of rules is specifying the result that the public expenditure is intended to achieve, followed by an assurance that it has been achieved. But it is important to be realistic in the specification. Funding authorities and performance auditors are often tempted to request that a program or project specify results at a high level (e.g., the impact of a job-training grant on regional employment; or the impact of a public health contribution agreement on indicators of community wellbeing). It is usually impossible for managers to meet such requests in a meaningful way because the generation of credible measures requires sophisticated longitudinal studies that take account of all the contributing factors. For many programs the most appropriate specification of results is that of “project deliverables.” Examples of project deliverables are the training of a specific number of people or the provision of a specific number of vaccinations. These are results for which the recipient and the program can be held to account. It is incumbent on reviewers at a higher level, representing the government as a whole, to judge if these results are effective in advancing the government’s broader socioeconomic goals.

## Accountability-focused audit

In Canada, public service discourse is usually couched in positive terms of management improvement. This is reflected in the Treasury Board's traditional "two Ps and three Es": probity, prudence, economy, efficiency and effectiveness. There is relatively little guidance from the Treasury Board of Canada on controlling misconduct.<sup>3</sup> The contrast with other countries, particularly the U.K., is striking.

The HM Treasury web site provides glossy presentations with guidance for managers on "tackling fraud" as well as copies of the *Fraud Report: An analysis of reported fraud in Government Departments* published each year since 2002-03. The U.K. has taken the lead in the European Union on these matters and produces an annual *Statement on the 2007 EC Budget and measures to counter fraud and financial mismanagement*.<sup>4</sup> The Government of Australia has a "fraud control" web site operated by the Attorney General's department,<sup>5</sup> and agency heads are required:

"to certify in their annual reports that their agency has prepared fraud risk assessments and fraud control plans and has in place appropriate fraud prevention, detection, investigation, reporting and data collection procedures and processes that meet the specific needs of the agency and comply with the Commonwealth Fraud Control Guidelines."<sup>6</sup>

The General Accountability Office in Washington produces dozens of reports each year highlighting "fraud, waste, abuse and mismanagement" in American government spending.

The U.K. and Australian central agencies provide useful definitions of fraud as it relates to public administration and examples of the most common occurrences. Annex 1 reproduces the seven categories of employee fraud used in the U.K.'s just-released *Fraud Report* for 2006-07.

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<sup>3</sup> Although there are up to date guidelines for how to deal with an employee after misconduct has been alleged (see *Guidelines for Discipline, effective April 1, 2005*), a search for "fraud" on the Treasury Board of Canada web site in December 2007 yields as its most recent policy statement the 21-year old policy information notice, *Internal Audit Responsibility with Respect to Fraud and Abuse in Government (PIN) - September, 1986*.

<sup>4</sup> [http://www.hm-treasury.gov.uk/documents/international\\_issues/eu\\_information/int\\_eu\\_statefraud.cfm](http://www.hm-treasury.gov.uk/documents/international_issues/eu_information/int_eu_statefraud.cfm).

This publication has an extensive glossary which, inter alia, distinguishes between a fraud and an irregularity. "Fraud and Irregularity:

- Fraud (as defined by the Penal Convention) covers intentional acts or omissions, in respect of both expenditure and revenue, which involve the use or presentation of false, incorrect or incomplete statements or documents, or specific non-disclosure of information, or misapplication of funds or benefits.
- Irregularity (as defined by Council Regulation 2988/95) covers both simple omissions due to errors, or negligence, which undermine the EC and intentional and deliberate acts.

For example, a genuine payment made after the closing date for claims represents an irregularity; but import of goods under false papers is fraud. Member States are required by regulations to report irregularities in the three main Budget sectors (own resources, agriculture and structural funds) on a quarterly basis."

<sup>5</sup> <http://www.ag.gov.au/fraud>

<sup>6</sup> See page 8 of REQUIREMENTS FOR ANNUAL REPORTS FOR DEPARTMENTS, EXECUTIVE AGENCIES AND FMA ACT BODIES, Department of the Prime Minister and Cabinet, 13 June 2007, [http://www.dpmc.gov.au/guidelines/docs/annual\\_report\\_requirements.pdf](http://www.dpmc.gov.au/guidelines/docs/annual_report_requirements.pdf).

## Targets for audit based on seriousness of deficiency

If internal audit is to be used in a more focused way, it is necessary to identify the targets. This paper proposes that the areas of focus should be the most serious offence or deficiency. Deficiencies can be categorized according to classes:<sup>7</sup>

- **Fraud:** an intentional act or omission, in respect of either expenditure or revenue, which involves the use or presentation of false, incorrect or incomplete statements or documents, or specific non-disclosure of information, or misapplication of funds or benefits. Fraud is a criminal offence.
- **Irregularity:** an omission due to error or negligence, or a deliberate, act short of fraud, which undermines the integrity of government.
- **Imprudence:** an act or omission that falls short of the professional standards or ethical norms that could reasonably be expected of a person in that situation.
- **Wastefulness:** the payment of more than is necessary for goods or services required to deliver a government program.
- **Inefficiency:** the production of less output per dollar than would be possible with better processes and better management.
- **Ineffectiveness:** the production of less social benefit per dollar than would be possible with a better program design delivering better outputs.

Of these, only committing a fraud or an irregularity would be classified as misconduct, and the deficiencies falling into these classes would be the primary targets for audit. Preliminary lists of offences or deficiencies are provided in Annex 2 (for public servants) and Annex 3 (for program recipients). The types of common employee fraud that top the list are derived from the HM Treasury Report.

There are two principal reasons why “controlling fraud” has not been adopted as a focus for internal audit in Canada. The first is that only a very small fraction of public servants engage in fraud<sup>8</sup> and focusing on it would send the wrong signal to public servants. The second is that only very small sums, relative to departmental budgets, are involved and greater savings can be found by focusing on other areas.<sup>9</sup> But these objections were likely equally valid in the U.K. and Australia and their governments came to different conclusions. Perhaps it is time for Canadian governments to revisit the question.

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<sup>7</sup> The first two definitions are derived from HM Treasury, op cit., and can be thought of as the antithesis of the first item (probity) on Treasury Board of Canada’s two Ps and three Es. The others are proposed by the author as the antithesis of prudence, economy, efficiency and effectiveness.

<sup>8</sup> The author’s experience with an operational department with good internal audit and management systems in the late 1980s would suggest that about one in a thousand employees will be under suspicion of fraud in any given year. It was also the author’s experience that police are reluctant to prosecute such cases, since they constitute relatively insignificant instances (in terms of dollars involved) of white collar crime and carry no direct threat to citizens.

<sup>9</sup> Indeed, one could make the case that the volume of taxpayers’ resources at issue is inversely proportional to the audit priority suggested in this paper, with the greatest gains possible from designing more effective policies and programs and the least savings possible from eliminating fraud.

## **Annex 1: Categories of Fraud used in HM Treasury Fraud Report 2006-07<sup>10</sup>**

The report identifies seven types of fraud committed during the review period by employees of government departments.

1. Payment fraud: These are frauds that involve falsely creating or diverting payments. Examples of cases reported included:
  - Creating bogus customer records and bank accounts in order to generate false payments;
  - Intercepting cheques and Payable Orders and attempts to cash them. In some cases alterations are made to payee details and amounts;
  - Creating false records to support fraudulent claims for benefits;
  - Processing false claims by accomplices for benefits, grants or repayments;
  - A member of staff authorising payments to himself.
2. Theft of assets: This category relates to the theft of physical assets, including cash. Many cases arose because of weak security but some were opportunistic thefts (e.g. items such as laptops or mobile phones stolen from peoples' desks), demonstrating the importance of storing such items securely at all times when not in use.
3. Receipt fraud: Fraud in this area can include the theft of incoming cash or cheques (which can be opportunistic or coupled with the manipulation of financial records to disguise thefts) or adjusting records of amounts owed by customers to departments in return for cash rewards or other incentives.
4. Travel and subsistence fraud: Fraud in this area involves such activities as the completion of fraudulent claims for payment or the creation of false payroll records. Examples of fraud include claims for journeys that were not made, overstated claims, claims for allowances for which there was no entitlement, forged signatures authorising payment, forged documentation supporting claims or applications for employment, falsification and/or unauthorised amendments of timesheets, false claims for working unsociable hours, deliberate failure to repay salary overpayments and the creation of non-existent personnel on payrolls.
5. Procurement fraud and credit card fraud: Procurement is the whole process of acquisition from third parties and covers goods, services and construction projects. Procurement fraud can involve contractors, sub-contractors, Crown Servants or any combination of these often colluding to perpetrate a fraud or act of corruption. These categories cover tendering irregularities, unauthorised or irregular use of the Government Procurement Card (GPC) and payment claims for goods or services that were not delivered.

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<sup>10</sup> HM Treasury Fraud Report 2006-07: an analysis of reported fraud in Government departments, October 2007, <http://www.hm-treasury.gov.uk/media/E/3/fraudreport0607311007.pdf>

6. Personnel management related fraud: Examples of fraudulent activities reported under this category included:
- Staff on sick leave but working elsewhere;
  - Abuses of flexible working time systems;
  - Misuse of official time (e.g. abusing the department’s computer misuse policy);
  - Deceit or misrepresentation for advantage (e.g. false references or false qualifications used to secure employment).
7. Exploiting assets and information fraud: This type of fraud involves using the assets of the organisation for other than official purposes and/or supplying information to outsiders for personal gain. Many of these cases had no reported value, as assessing losses is not always possible.

The number of cases and their value is illustrated in the following table.

Fraud Category	Cases		Value	
	Number	%	£	%
Travel, Subsistence & Other Allowances	69	6.47	245,000	6.35
Pay or Allowances Paid Via the Payroll	53	4.97	162,300	4.21
Theft of Assets	403	37.77	512,100	13.27
Exploiting Assets and Information	49	4.59	9,800	0.25
Procurement Fraud	10	0.94	56,800	1.47
GPC/Credit Card Fraud	36	3.37	27,800	0.72
Personnel Management Related Fraud	253	23.71	21,800	0.56
Payment Fraud	84	7.87	2,504,900	64.92
Receipt Fraud	74	6.94	281,000	7.28
Other	36	3.37	37,100	0.96
Total	1067		3,858,600	

**Annex 2: Areas of Focus for Audit and Review:  
Departmental Operations**

<b>Fraud</b>	<b>Irregularity</b>	<b>Imprudence</b>	<b>Wastefulness</b>	<b>Inefficiency</b>	<b>Ineffectiveness</b>	<b>Offence or Deficiency</b>	<b>Review Mechanism</b>	<b>Persons Accountable</b>	<b>Accountability Consequences and Remedial Action</b>
x						1. Theft of assets	Audit followed by forensic audit	Perpetrator	Criminal charges and dismissal
x						2. Payment fraud or receipt fraud	Audit followed by forensic audit	Perpetrator	Criminal charges and dismissal
x						3. Credit card fraud	Audit followed by forensic audit	Perpetrator	Criminal charges and dismissal
x						4. Procurement fraud	Audit followed by forensic audit	Signatories	Criminal charges and dismissal
x						5. Exploiting assets and information fraud	Audit followed by forensic audit	Perpetrator	Criminal charges and dismissal
x						6. Circumvention of contract or procurement procedures for personal benefit	Audit followed by forensic audit	Signatories	Criminal charges and dismissal
x						7. Travel and allowances fraud	Audit	Signatories	Criminal charges and dismissal
x						8. Personnel management related fraud	Audit	Perpetrator	Reprimand or dismissal
	x					9. Misreporting of deliverables	Audit	Signatories	Reprimand or dismissal
	x					10. Unintentional misreporting of finances due to ignorance or incompetence	Audit	Signatories	Reprimand
	x					11. Deficient procedure for contracting or purchasing due to inattention or incompetence	Audit	Signatories	Reprimand
		x				12. Unreasonable expenditures on travel and hospitality	Audit	Signatories	Reprimand
		x				13. Inadequate financial recordkeeping	Audit	Signatories	Training and review of delegation
		x				14. Inadequate financial controls	Audit	Signatories	Training and review of delegation
		x				15. Inadequate risk management framework	Audit	Signatories	Training and review of delegation

Fraud	Irregularity	Imprudence	Wastefulness	Inefficiency	Ineffectiveness	Offence or Deficiency	Review Mechanism	Persons Accountable	Accountability Consequences and Remedial Action
			x			16. Purchase of more goods and services than needed	Audit	Signatories	Reprimand and review of delegation
			x			17. Payment of higher prices than needed	Audit	Signatories	Reprimand and review of delegation
			x			18. Year-end spending on low priority items	Audit	Signatories	Reprimand and review of delegation
				x		19. Excessive rules that distract from accountability targets	Management review	Senior management	Process redesign and change management
				x		20. Inefficient processes	Management review	Senior management	Process redesign and change management
				x		21. Excessive reporting in formats of limited value for accountability	Management review	Senior management	Process redesign and change management
				x		22. Inconsistent demands to recipients	Management review	Senior management	Process redesign and change management
				x		23. Unrealistic demands to recipients that produce unmeaningful responses	Management review	Senior management	Process redesign and change management
				x		24. Failure to deliver agreed deliverables	Evaluation	Program manager	Review of performance and feasibility of agreed deliverables
				x		25. Lack of results measures where available and generally accepted as meaningful	Evaluation	Program manager	Respecification of objectives and expectations
					x	26. Unclear program objectives and unclear expectations for recipients	Evaluation	Program manager	Respecification of objectives and expectations
					x	27. Lack of overall program effectiveness, relative to plausible alternatives	Evaluation	Senior management	Policy review, program redesign and change management

**Annex 3: Areas of Focus for Audit and Review:  
Grants and Contributions Recipients**

<b>Fraud</b>	<b>Irregularity</b>	<b>Wastefulness</b>	<b>Imprudence</b>	<b>Inefficiency</b>	<b>Ineffectiveness</b>	<b>Offence or Deficiency</b>	<b>Review Mechanism</b>	<b>Persons Accountable</b>	<b>Accountability Consequences and Remedial Action</b>
<b>x</b>						1. Commission of a fraud for a personal benefit	External audit followed by forensic audit	Perpetrator	Criminal charges and funding for project frozen until repayment plan approved or project frozen until plan to repay approved. Person not allowed to work on projects in future
<b>x</b>						2. Commission of a fraud for organizational benefit	External audit followed by forensic audit	Perpetrator	Criminal charges and termination of funding to organization
	<b>x</b>					3. Misrepresentation of finances or deliverables to the benefit the organization	External audit	CFO	Organization in compliance audit sampling group for set number of years, notation to file shared with others in department
	<b>x</b>					4. Circumvention of contract or procurement procedures for personal benefit	External audit	Signatories	Criminal charges and funding for project frozen until repayment plan approved or project frozen until plan to repay approved. Person not allowed to work on projects in future
	<b>x</b>					5. Misrepresentation of finances or deliverables due to inadvertence or incompetence	Audit	CFO	Monitoring and assessment of organization financial stability, approval of improvements to the organization internal control processes. Funding continues, given approval of improvement plan (potentially including capacity-building initiatives) with more frequent financial and deliverable reporting, more visits from program manager. Other potential federal funders notified
	<b>x</b>					6. Incorrect reconciliation of bank reports, repeatedly	Site visit	CFO	Monitoring and assessment of recipient financial statements more regularly. Letter on file for reference in future funding
	<b>x</b>					7. Incorrect coding of items to the project, repeatedly	Audit	CFO	Approval of improvements to internal coding control mechanisms of the organization. Letter on file for reference in future funding
	<b>x</b>					8. Non compliance with TB allowable expenditures, repeatedly	Audit	CFO	Approval of improvements to internal allowable expenditure mechanisms of the organization. Letter on file for reference in future funding

Fraud	Irregularity	Wastefulness	Imprudence	Inefficiency	Ineffectiveness	Offence or Deficiency	Review Mechanism	Persons Accountable	Accountability Consequences and Remedial Action
	x					9. Non compliance with financial approval processes repeatedly	Random site visits	CFO	
	x					10. Non compliance with the budget category expenditures and allowable movement between categories	Audit	CFO	Requirement for recipient to submit general purpose audited financial statements by category on a quarterly basis
	x					11. Deficient procedure for contracting or purchasing due to inadvertence or incompetence	Audit	Contract signatories/CEO	All contracts required approval of Program Manager for duration of project and note to file
	x					12. Non compliance with TBS contracting or purchasing requirements	Site visit	Contract signatories/CEO	Comprehensive audit of contracts and purchasing, recommendations for improved processes by organization and sign off by organization that they will comply.
	x					13. Giving preferential treatment in the letting of contracts	Audit	Contract signatories/CEO	Comprehensive audit of contracts and purchasing, recommendations for improved processes by organization and sign off by organization that they will comply.
	x					14. Unreasonable expenditure on travel and hospitality	Audit	Signatories and up	Requirement for recipient to submit general purpose audited financial statements for travel on a quarterly basis
		x				15. Year-end spending on low priority items	Audit	CFO/CEO	Review of requirements
		x				16. Purchase of more goods and services than needed	Audit	Purchasers and senior management	Comprehensive audit of contracts and purchasing, recommendations for improved processes by organization and sign off by organization that they will comply.
		x				17. Allocating goods and services purchased through grants and contributions to other purposes in the organization	Site visit	Contract signatories/CEO	Comprehensive audit of contracts and purchasing, recommendations for improved processes by organization and sign off by organization that they will comply.
		x				18. Purchase of the wrong goods and services	Site visit	Contract signatories/CEO	Comprehensive audit of contracts and purchasing, recommendations for improved processes by organization and sign off by organization that they will comply. Regular site visits.
		x				19. Payment of higher prices than needed	Audit	Purchasers and senior management	Comprehensive audit of contracts and purchasing, recommendations for improved processes by organization and sign off by organization that they will comply. Regular site visits.

Fraud	Irregularity	Wastefulness	Imprudence	Inefficiency	Ineffectiveness	Offence or Deficiency	Review Mechanism	Persons Accountable	Accountability Consequences and Remedial Action
			x			20. Inadequate financial recordkeeping	Periodic site visits	Contract signatories/CEO	Monitoring and assessment of recipient financial statements more regularly. Letter on file for reference in future funding. Capacity building with organization
			x			21. Inadequate financial controls	Random site visits	Contract signatories/CEO	Monitoring and assessment of recipient financial statements more regularly. Letter on file for reference in future funding. Capacity building with organization
					x	22. Indicated deliverables not delivered on time, without pre-approval	Site visit	Contract signatories/CEO	More regular site visits, review of terms and conditions with signatories, letter on file
					x	23. Indicated deliverables not met according to agreed targets	Site visit	Project manager and up	More regular site visits, review of terms and conditions with signatories, letter on file