

1.1 Understanding Fraud and Corruption

Session Overview

Fraud and corruption has been the major concern of most countries all over the world. It has caught attention not only because of the widespread occurrence both in the private and public sector as reported by auditors but more so because of the wide publicity in the media and numerous complaints from the public. With the increasing concern on fraud and corruption SAIs are expected to demonstrate that the audit addresses these concerns. The SAIs should actively consider adopting a formal policy or strategy for deterring fraud and corruption.

As Auditors we should perform our work with professional skepticism and with sufficient knowledge and skills in dealing with fraud and corruption during the course of our audit. Whether conducting financial audit, performance audit or special examinations, auditors should be aware of the possible existence of fraud and corruption and be able to address this.

As discussed earlier in the Introduction to the Course, we are not going to learn in this course the conduct of forensic auditing which comprises investigations, auditing and forensic accounting. Forensic audits are undertaken with the assumption that the matter may end in civil or criminal proceedings.

This session deals with conceptual issues related to fraud and corruption, the elements of fraud and corruption, the types of fraud and corruption and the factors that enhance the probability of fraud and corruption.

Learning Objectives

By the end of this session, participants will be able to explain the concepts of fraud and corruption and their elements, types of fraud and corruption, the factors associated with fraud and corruption, to the extent that it is in conformity with the ASOSAI Guidelines and other best practices, as evaluated by the instructor.

Definitions of Fraud and Corruption

1.1 The ASOSAI Guidelines for Dealing with Fraud and Corruption defines fraud and corruption as follows:

Fraud involves deliberate misrepresentation of facts and/or significant information to obtain undue or illegal financial advantage.

Corruption involves effort to influence and/or the abuse of public authority through the giving or the acceptance of inducement or illegal reward for undue personal or private advantage.

Chapter II of the ASOSAI Guidelines lists some of the many general and specific definitions of fraud and corruption among which are as follows:

1.2 Definitions of Fraud

1.2.1 XVI INCOSAI URUGUAY 1998 viewed fraud as a legal concept, which involves acts of deceit, trickery, concealment, or breach of confidence that are used to gain some unfair or dishonest advantage; an unlawful interaction between two entities, where one party intentionally deceives the other through the means of false representation in order to gain illicit and unjust advantage.

1.2.2 According to SPASAI Fraud Guide, “fraud is a generic term which embraces all the means that human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. There is no finite rule to define fraud as it includes surprise, trick, cunning and unfair ways by which another is cheated.

1.2.3. Fraud as it is commonly understood today , means dishonesty in the form of an intentional deception or a wilful misrepresentation of a material fact. Lying, the wilful telling of an untruth, and cheating, the gaining of an unfair or unjust advantage over another, could also be used to further define the word fraud because both that and dishonesty denote intention or willingness to deceive.

1.2.4. The Canadian Audit Guide 21 on Fraud Awareness refers to fraud as an action where there is a loss of a valuable resource resulting from a false representation made knowingly, without belief in its truth. Such actions could result in charges being laid under various applicable Canadian laws.

1.2.5 According to the National Audit Office of UK, fraud involves the use of deception to obtain an unjust or illegal financial advantage as well as intentional misstatements in, or omissions of amounts or disclosures from, an entity's accounting records or financial statements. It also includes theft, whether or not accompanied by misstatements of accounting records or financial statements.

1.2.6 The Fraud Examiners Manual views fraud as any intentional or deliberate act to deprive another of property or money by guile, deception or other unfair means. Similarly International Standard of Auditing (240) also treats fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

1.2.7. Essentially, fraud refers to intentional misrepresentation of financial information by one or many individuals among the management employees or third parties. It involves the use of deception to obtain an illegal financial advantage.

1.2.8 Fraud may involve:

- manipulation, falsification or alteration of records or documents
- misappropriation/misapplication of assets
- suppression or omission of the effects of transactions from records or documents
- recording of transactions without substances
- misapplication of accounting policies

1.3 Definitions of Corruption

1.3.1 ADB's Anti-Corruption Policy (2 July 1998)

ADB defines corruption as “the abuse of public or private office for personal gain.” A more comprehensive definition is as follows:

“Corruption involves behavior on the part of officials in the public and private sectors, in which they improperly and unlawfully enrich themselves and/or those close to them, or induce others to do so, by misusing the position in which they are placed.”

1.3.2 The Anti-Corruption Act of the Republic of Korea

The term “act of corruption” is the act of any public official’s abusing his position or authority or violating laws and regulations in connection with his duties to seek gains for himself or any third party.

1.3.3 The World Bank defines corruption as the abuse of public power for personal gain or for the benefit of a group to which one owes allegiance.

1.3.4 The Chartered Institute of Public Finance and Accountancy of UK defines corruption as the offering, giving, soliciting or accepting of an inducement or reward, which may influence the action of any person. That is, an individual receives a bribe as a reward or incentive for action or inaction contrary to the proper conduct of his or her duties, for the direct benefit of a third party.

1.3.5 Klitgaard¹ (1996) developed a model to explain the dynamics of corruption.

$$\text{Corruption} = \text{Monopoly power} + \text{Discretion} - \text{Accountability}$$

1.4 Distinctions Made by Experts

1.4.1. Prof. G.J. Rossouw, Rand Afrikaans University, South Africa

Fraud is an act of dishonesty with the intention to deceive another party which results in gain for the deceiver or his/her beneficiaries and or loss for the deceived. “Fraud is to deprive by deceit”.

Corruption is a breach of loyalty owed by an agent to a principal caused by third party involvement consisting of the offering or the soliciting of an advantage that results in an unauthorized transaction.

Corruption is associated with the misuse of public positions and consequently mostly associated with the public sector and public officials. As a result of these connotation corruption can be painted as something that only affects the public sector, public officials and politicians. By collapsing the distinction between fraud and corruption, fraud is equally associated with the public sector, public officials and politicians. This inevitably shifts the focus away from the private sector and from the fact that any employee in any company whether private or public can indulge in fraud. The collapse of the distinction thus conceals the fact that fraud occurs in both the public and private sectors.

A second reason for maintaining the distinction revolves around third party involvement. Corruption per definition implies third party involvement, while fraud does not necessarily imply third party involvement. In the case of corruption agents violate their duty to their principals by colluding with a third party. Instead of fulfilling their obligations to their principals they abuse their positions by either offering or soliciting an advantage from a third party. Of the two parties mentioned above, two have immediate knowledge of the act of corruption, viz., the agent and the third party. Thus in terms of uncovering acts of corruption there are potentially two different sources with immediate knowledge of the incident and not only one as in the case of fraud. Exactly because fraud lacks this third party involvement, it is more difficult to detect it and consequently a different approach is required to identify and combat it. By collapsing the distinction between fraud and corruption this important difference between the two phenomena vanishes.

¹ World Bank Publication, Pillars of Integrity, The Importance of SAIs in Curbing Corruption

Thirdly, fraud and corruption further differs with regards to the accessibility of the available information about them. In the case of fraud the deceiving party, whether it consists of a single individual or of syndicate, has no interest whatsoever in disclosing the existing information about the fraudulent act. To the contrary, the objective is to keep it concealed as long as possible. Thus the deceiving party could be regarded as an almost inaccessible source of information. This implies that information about the incident of fraud should be obtained from other sources other than the deceiving party.

In the case of corruption there also might be an agreement of secrecy between the two parties involved, but this is not necessarily the case. Other than in the case of fraud, where the interests of the members of the deceiving party are identical, it might not be identical in the case of corruption. One of these two parties might feel aggrieved by the fact that the other party tried to corrupt him/her or alternately might feel aggrieved that he/she had no other option than complying to the act of corruption. A typical example thereof is the aggrieved passenger who was forced on arrival at the airport to gain entry to the country. Such an aggrieved party to the act of corruption might be willing to part with information about the incident.

In such cases of corruption the information about the act of corruption is more accessible compared to fraud. This difference has important implications and applications for the detection strategies that can be utilized to identify cases of corruption. In the case of corruption third parties outside the organization where the corruption occurs, with other words, the public who have had first hand experience of corruption, can be a valuable source of information.

1.4.2 ASOSAI Guidelines states

Fraud is most likely to involve deliberate misrepresentation of information that is recorded and summarized by an entity; its impact can be compared to an accounting error and would involve issues such as measurement, occurrence, and disclosure. Fraud poses a serious problem from an audit perspective because it is normally accompanied by efforts to cover / falsify / misdirect entity records and reporting. The efforts to misrepresent may involve the management itself—an aspect that has received considerable attention in the wake of major corporate failures. **When management gets involved in the perpetration of fraud, the activity assumes the proportion or the additional bearing of corruption. Fraud and corruption are therefore interlinked, although certain types of fraud do not necessarily qualify for being viewed as corruption and can be perpetrated by an individual or a small group.** The problem which corruption poses for audit is that it links up as a concept with the acts of bribery. It is possible to conceive of situations where bribery may have a direct impact on financial statements, for example where a corporation pays an influential decision-maker a bribe to secure a contract. In such situations the issue of proper disclosure is involved because the corrupt practice of the illegal payment/expense is normally covered up through an accounting or reporting fraud. However, in many instances

corruption does not necessarily result into transactions that are recorded and reported by the entity. This especially applies to situations where a position of authority or discretion available under rules is encashed by an official in the public sector. Such corruption, which because of its widespread prevalence, may be most responsible for undermining the social fabric and the credibility and functioning of state institutions, does not normally get reflected in information that comes in the purview of audit.

The Guidelines therefore propose that while fraud and corruption should be perceived independently for their numerous implications, the auditors should be well aware of the complex correlation between the two. In the Guidelines the two will be treated in combination, but attention would be drawn to possibilities of separate treatment, wherever the situation so warrants.

1.5. Elements of Fraud and Corruption

Fraud	Corruption
1. Two parties to fraud : perpetrator and the victim	1. At least two parties to corruption: person who offers reward and the party accepting it.
2. A material omission or false representation made knowingly by perpetrator	2. There must be misuse of office or position of authority for private gain .
3. There must be intent by the perpetrator that the false representation be acted upon by the victim	3. There must be intent to solicit an offer of inducement or reward as benefit for performance of an official act.
4. There generally is an attempt to camouflage	4. There may be an attempt to camouflage .
5. Involves betrayal of trust between the perpetrator and the victim	5. Involves breach of loyalty to a principal
6. May not have third party involvement (Prof. G.J. Rossouw)	6. Necessarily includes third party involvement
7. There is always loss to one party and gain to another	7. The effort to misuse position or illicitly influence another may not necessarily result in loss to a party .

1.5.1 Correlation between Fraud and Corruption.

It appears that the elements of fraud and corruption have similarities. In fraud, there are two parties: the perpetrator and the victim. In corruption, there are at least two parties: the person who offers reward and the party accepting it. It will be noted that the first element under corruption appear to be contradicted by the sixth element which states “necessarily include third party involvement”. But this contradiction can be explained by the fact that the ASOSAI guidelines which is the source of the first element mentioned only persons as parties to corruption, the person giving the offer and the person receiving the offer. In the public sector, the offeror may be a person from the private sector and the person receiving the offer or reward is a public officer who has a principal who is not a person, the government, thus, there are actually three parties: the offeror, the public officer receiving the offer and the government who ultimately suffers the damage spawned by corruption.

In both fraud and corruption, there is intent, for fraud intent to falsely represent while for corruption intent to solicit an offer of reward as benefit for performance of an official act. Both likewise attempt to camouflage.

There are also certain distinctions. In fraud, there is a material omission or false representation made knowingly by perpetrator for a personal gain; in corruption, there must be misuse of office or position of authority for personal gain. However, if the perpetrator of the fraud is a public officer, his material omission or false representation assumes the form of misuse of office or position for personal gain, hence, there is no difference in this case.

Another distinction is the betrayal of trust: in fraud there is betrayal of trust between the perpetrator and the victim, whereas in corruption there is a breach of loyalty to a principal. However, in fraud, if the perpetrator of the fraud is a public officer, the victim which is the government is also the principal of the public officer, there is therefore a breach of loyalty to the government, in which case, there is no distinction between these two elements.

Another distinct element is the involvement of a third party. According to Professor Rossouw, fraud may not have third party involvement; while corruption necessarily includes third party. Likewise, in fraud there is always loss to one party and gain by another; in corruption, the effort to misuse position or illicitly influence another may not necessarily result in loss to a party.

Types of Fraud and Corruption

2.1. The ASOSAI Guideline identified some of the most typical fraud and corruption, as follows:

- **Bribery** is the giving, receiving, offering or soliciting of any “thing of value” in order to influence a person in the performance of, or failure to perform, his / her duties.
- **False Statements and False Claims** occur whenever a person knowingly and willfully falsifies a material fact or makes a false or fictitious representation or files a false or fictitious claim that results in economic or financial loss to the

person to whom the false representation has been made.

- **Embezzlement** is the fraudulent conversion of personal property by a person in possession of that property where the possession was obtained pursuant to a trust relationship. Examples of means to conceal embezzlement are the use of kiting or lapping scheme.
 - **Kiting** occurs when a person withdraws cash from a bank on checks deposited by a person for which the cash has not yet been collected by the bank. To conceal the fraud, the person continuously writes checks against non-existent account balances (“kites” checks from bank to bank).
 - **Lapping** occurs when a person steals cash from payment of accounts receivable, and continuously uses cash from other payments of accounts receivables to conceal the initial theft (“laps” two consecutive accounts).
- **Conflict of Interest** occurs when a person has an undisclosed economic or personal interest in a transaction that adversely affects that person’s employer.
- **Phantom Contractor** is a non-existent company whose invoice is submitted for payment by a person involved in the purchase process.
- **Purchases for Personal Use.** A person may purchase items intended for personal use or may make excess purchases of items needed, some of which are then diverted to personal use.
- **Split Purchases.** Contracts are split into two or more segments to circumvent the procurement authority limitations, and thus to avoid competitive bidding. This may involve bribery from the contractor to a person of the other party.
- **Collusive Bidding, Price Fixing or Bid Rigging.** Groups of prospective contractors for a contract form an agreement or arrangement, to eliminate or limit competition. This agreement may also involve bribery.
- **Progress Payment Fraud.** The contractor requests progress payments based on falsified information submitted to the other party.
- **Over or under invoicing.** Occurs when there is deliberate misstatement of the invoice value as compared with goods or services received or supplied.
- **Extortion** is the use of authority to secure unlawful pecuniary gain or advantage.
- **Nepotism and Favoritism** unlawful use of public office to favor relatives and friends.
- **Loss of Revenue on account of tax or duty evasion** can include different situations where revenue due to the government is not received or paid.
- **Unfair Recruitment** favoritism exercised in the process of recruitment for unlawful gain.
- **Computer Fraud** is any fraudulent behavior connected with computerization by which a person intends to gain a dishonest advantage. For instance, salami-slicing is a computer fraud where fractions of interest calculations are transferred to a personal account.

2.2 The ADB has also identified an illustrative list of corrupt behaviors, as follows:

- The design or selection of uneconomical projects because of opportunities for financial kickbacks and political patronage.
- Procurement fraud, including collusion, overcharging, or the selection of contractors, suppliers, and consultants on criteria other than the

- lowest evaluated substantially responsive bidder.
- Illicit payments of “speed money” to government officials to facilitate the timely delivery of goods and services to which the public is rightfully entitled, such as permits and licenses.
 - Illicit payments to government officials to facilitate access to goods, services, and/or information to which the public is not entitled, or to deny the public access to goods and services to which it is legally entitled.
 - Illicit payments to prevent the application of rules and regulations in a fair and consistent manner, particularly in areas concerning public safety, law enforcement, or revenue collection.
 - Payments to government officials to foster or sustain monopolistic or oligopolistic access to markets in the absence of a compelling economic rationale for such restrictions.
 - The misappropriation of confidential information for personal gain, such as using knowledge about public transportation routings to invest in real estate that is likely to appreciate.
 - The deliberate disclosure of false or misleading information on the financial status of corporations that would prevent potential investors from accurately valuing their worth, such as the failure to disclose large contingent liabilities or the undervaluing of assets in enterprises slated for privatization.
 - The theft or embezzlement of public property and monies.
 - The sale of official posts, positions, or promotions; nepotism; or other actions that undermine the creation of a professional, meritocratic civil service.
 - Extortion and the abuse of public office, such as using the threat of a tax audit or legal sanctions to extract personal favors.
 - Obstruction of justice and interference in the duties of agencies tasked with detecting, investigating and prosecuting illicit behavior.

Factors that Influence Fraud and Corruption

It is useful for auditors to understand the motivational and organizational/environmental factors of fraud and corruption. The presence of these factors does not necessarily mean that fraud and corruption have occurred. Rather, awareness of their presence should increase the auditor's sensitivity to that possibility. The key factors generally associated with fraud and corruption are as follows:

3.1 Motivational Factors

Motivation and opportunity are the elements that generally underlie the commission of fraud and corruption. These could take the form of:

- Economic motivation - financial need or gain is the most common motivation for fraud and corruption. Often, persons convicted of fraud and corruption complain that they had unbearable financial problems for which there was no legitimate recourse.

- Greed – persons with power and authority often commit fraud and corruption because they are motivated by greed.
- Prestige or recognition – persons may feel they deserve more prestige or more recognition. These persons are often motivated by jealousy, revenge, anger, or pride. They often believe that they are superior to others, that they are shrewd enough to confound and confuse others and can commit fraud and corruption without being discovered or detected.
- Moral Superiority – persons may also be motivated by a cause or values that they feel are morally superior to those of the victim, or the government in this case.

3.2 Organizational/Environmental Factors

Auditors should be aware of organizational factors that provide opportunities for fraud. Managers in particular senior managers, are in a position to override internal controls. The risk of fraud is increased when management override of internal controls. Auditors should not also confuse a well-controlled organization with an authoritarian system. The latter may cause both managers and employees to break the rules to get things done. A general breakdown in respect for control provides an opportunity for fraud.

The organisational atmosphere and its perception play a major causative role in perpetration of fraud and corruption.

Where management is perceived as insensitive, insecure, impulsive or too strict, ill-treats employees and judges performance either on short term results or without considering operational constraints, the disgruntlement in the employee is likely to result in instances of fraud and corruption.

Systems and procedures adopted in organisations and organisational policies are particularly important. An organisation in which the corporate policies are unclear, there is inadequate internal control, excessive regulations, red-tape inadequate accountability or history of programme abuse is likely to have more instances of fraud and corruption.

An understanding of the organisational atmosphere will enable an auditor to assess whether there is a higher risk of fraud and corruption in the entity and planning of the audit could be suitably modified. Poor management structure and policies are indicated by a high turn over of employees, absenteeism, poor documentation, low awareness of regulatory requirements and lack of transparency in reward systems

It is important for the auditor to also understand that very often the perpetrator of fraud and corruption rationalises his actions with some kind of justification. For instance an employee accused of fraud and corruption is likely to rationalise his action by saying or believing that his low pay justifies the action or since everybody is doing that he is also well within his right to do it; while a contractor could justify his acts of

fraud and corruption as a cost of doing business or problems of securing contract from a government entity.

Summary

In this session we discussed the conceptual definitions of fraud and corruption, their elements, the most common types of fraud and corruption and the factors that enhanced the probability of fraud and corruption. As Auditors, we should be aware of the possible existence of fraud and corruption and be able to recognize it. Although fraud and corruption has each distinct elements there are many instances where there is a complex correlation between the two. It is also important to understand the factors that increase the probability of the occurrence of fraud and corruption to increase the auditor's sensitivity to their possible occurrence.

References

1. ASOSAI Guidelines in Dealing with Fraud and Corruption, October 1993
2. ADB Anti-Corruption Policy , 2 July 1998
3. Canada Fraud Guidelines, Office of the Auditor General of Canada, March 1993