

# **The Auditor's Duty to Detect Instances of Fraud and Corruption**

*Fraud and corruption have an impact at three levels of the social life. They render a fundamental human right, that of equality, inapplicable, distort the democratic procedure by perverting proper decision-making and, lastly, render the rule of law ineffective, thus undermining the citizen's security and faith in the supremacy of the law over arbitrariness.*

Corruption in the area of public service primarily attacks the principle of equality. As regards people holding the purse strings, public works, supplies and services seem to comprise the domain in which corruption is by far most pre-eminent. The honest participants in tendering competitions are pushed aside by those who aim to increase their marks by bribing those responsible. Tailored invitations to tender, over-laxity or undue strictness in examining supporting documents, leniency in evaluating technical specifications, all of these constitute means of circumventing the legislation that aims to secure equal treatment for all candidates, while ensuring that the public interest is optimally served. There is a similar problem with the selection of staff for posts in public administration. It also applies to the grant of official authorisations to operate industrial enterprises, to the growth in the number of public-sector posts, the operation of coastal shipping lines and, in the area of health, obtaining better medical care from doctors and nurses. Corruption removes equality and gives the impression that people are more capable, qualified or competent than they actually are. Where corruption is involved, proportionality between the selection of the right objective and the appropriate means of attaining it suffers. Environmental protection constitutes the first victim, for example, in cases where there is laxity in complying with restrictions and permits are granted for activities that are damaging to the environment which do not comply with legal requirements. Development aid is not granted on the basis of objective criteria, which means that development efforts are undermined or defeated.

*According to international audit standards the primary responsibility for the prevention and detection of fraud rests with governance and management entities. Putting in place effective internal control systems means that the systems are able to*

***control the main risks and one of the most important is the one of fraud or the risk of corruption. Auditors' main input is to ask the managers to strengthen their internal control systems.***

Bribery, fraud, misappropriation, theft and neglect of duty are the most common criminal offences that the European Court of Auditors may detect during the course of its audits<sup>1</sup>. *Bribery*, in its passive form, takes place primarily in the areas of procedures

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<sup>1</sup> In *Re Kingston Cotton Mill Company (No. 2)* Court of Appeal LINDLEY L.J.1896 1 CH331 The company's articles of association contain special regulations relating to auditors (...) Auditors are, however, in my opinion bound to see what exceptional duties, if any, are cast upon them by the articles of the company whose accounts they are called upon to audit. Ignorance of the articles and of exceptional duties imposed by them would not afford any legal justification for not observing them. Some reliance was placed in this case on arts. 123 and 124. Those, however, relate to \*285 the duties of the directors, and not of the auditors. Art. 124 empowers the auditors to direct what accounts shall be kept and how they shall be kept; but there is nothing in this article which makes an auditor responsible for not ordering an account to be kept which he did not think necessary. His duty in this respect is governed by the general principles which have been already stated. If on those principles it can be truly said that an auditor ought to have required a particular account to be kept, then art. 124 prevents him from effectually urging as a defence that he had no authority to require it. But beyond that, art. 124 cannot be invoked against the auditor. I pass now to consider the complaint made against the auditors in this particular case. The complaint is that they failed to detect certain frauds. There is no charge of dishonesty on the part of the auditors. They did not certify or pass anything which they did not honestly believe to be true. It is said, however, that they were culpably careless. The circumstances are as follows: For several years frauds were committed by the manager, who, in order to bolster up the company and to make it appear flourishing when it was the reverse, deliberately exaggerated both the quantities and values of the cotton and yarn in the company's mills. He did this at the ends of the years 1890, 1891, 1892, and 1893. There was no book or account (except the stock journal to which I will refer presently) shewing the quantity or value of the cotton or yarn in the mill at any one time. It would not be easy to keep such a book. Nor is it wanted for ordinary purposes. There is considerable waste (20 or 25 per cent. on the average) in the manufacture of yarn from cotton, and the market prices of both cotton and yarn are subject to great fluctuations. The balance-sheets of each year contained on the asset side entries of the values of the stock-in-trade at the end of the year, and those entries were stated to be "As per manager's certificate." There were also in the balance-sheets entries on the opposite side of the values of the stock-in-trade at the beginning of the year. The quantities did not appear in either case. The auditors took the entry of the stock-in-trade at the beginning of the year from the last preceding balance-sheet, and they took the \*286 values of the stock-in-trade at the end of the year from the stock journal. This book contained a series of accounts under various heads purporting to shew the quantities and values of the company's stock-in-trade at the end of each year, and a summary of all the accounts shewing the total value of such stock-in-trade. The summary was signed by the manager, and the value as shewn by it was adopted by the auditors and was inserted as an asset in the balance-sheet, but "As per manager's certificate." The summary always corresponded with the accounts summarized, and the auditors ascertained that this was the case. But they did not examine further into the accuracy of the accounts summarized. The auditors did not profess to guarantee the correctness of this item. They assumed no responsibility for it. They took the item from the manager, and the entry in the balance-sheet shewed that they did so. I confess I cannot see that their omission to check his returns was a breach of their duty to the company. It is no part of an auditor's duty to take stock. No one contends that it is. He must rely on other people for details of the stock-in-trade on hand. In the case of a cotton mill he must rely on some skilled person for the materials

for appointing contractors and the acceptance of deliverables under a contract. In the first instance, an official who has been bribed either sets out the tendering terms in such a way that they correspond entirely to the person who bribed him, or he interprets and applies them in such a way that whoever bribed him is eventually selected. In the case of acceptance of deliverables, an official who has been bribed is willing to confirm that what the briber supplies to a department complies with the terms of the contract, despite evidence of significant shortcomings. *Fraud* relates to payments. It may be committed by a third person against a department or by an official within a department. In the first case, a third person fraudulently passes himself off as being entitled to a sum of money or some other economic benefit from the European Union. For example, a farmer falsely certifies that his crop was destroyed by fire in order to receive compensation, whereas he has actually already harvested it. In the second case, one example would be that of an official who is handling the case producing false supporting documents relating to non-existent contracts or creditors and managing to disburse public funds to that same farmer or obtain financial benefits to which that farmer is not entitled. *Misappropriation* takes place when bodies in a public department appropriate for themselves either money entrusted to them by that same department or state property for official use that is in their possession; *theft* takes place

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necessary to enable him to enter the stock-in-trade at its proper value in the balance-sheet. In this case the auditors relied on the manager. He was a man of high character and of unquestioned competence. He was trusted by every one who knew him. The learned judge has held that the directors are not to be blamed for trusting him. The auditors had no suspicion that he was not to be trusted to give accurate information as to the stock-in-trade in hand, and they trusted him accordingly in that matter. But it is said they ought not to have done so, and for this reason. The stock journal shewed the quantities--that is, the weight in pounds--of the cotton and yarn at the end of each year. Other books shewed the quantities of cotton bought during the year and the quantities of yarn sold during the year. If these books had been compared by the auditors they would have found that the quantity of cotton and yarn in hand at the end of the year ought to be much less than the quantity shewn in the stock journal, and so much less that the value of the \*287 cotton and yam entered in the stock journal could not be right, or at all events was so abnormally large as to excite suspicion and demand further inquiry. This is the view taken by the learned judge. But, although it is no doubt true that such a process might have been gone through, and that, if gone through, the fraud would have been discovered, can it be truly said that the auditors were wanting in reasonable care in not thinking it necessary to test the managing director's return? I cannot bring myself to think they were, nor do I think that any jury of business men would take a different view. It is not sufficient to say that the frauds must have been detected if the entries in the books had been put together in a way which never occurred to any one before suspicion was aroused. The question is whether, no suspicion of anything wrong being entertained, there was a want of reasonable care on the part of the auditors in relying on the returns made by a competent and trusted expert relating to matters on which information from such a person was essential. I cannot think there was. The manager had no apparent conflict between his interest and his duty. His position was not similar to that of a cashier who has to account for the cash which he receives, and whose own account of his receipts and payments could not reasonably be taken by an auditor without further inquiry. The auditor's duty is not so onerous as the learned judge has held it to be. The order appealed from must be discharged with costs.

when such appropriation is committed by a third person. Lastly, *breach of duty* applies to cases where an official who has not even been bribed breaches an official duty incumbent upon him or her, not as a result of negligence, but rather with the intention of favouring a third person, whether that person be a tenderer for a contract or someone falsely presenting themselves as a person to whom the European Union has an obligation.

As a result of the massive scandals uncovered in private companies, current audit practice has adopted a position in favour of auditors detecting acts of a criminal nature. Generally speaking, the views taken in contemporary auditing, as set out in the related audit guidelines, may be summarised as follows: *Firstly*, auditors ought to carry out their tasks with *reasonable scepticism* as to both the auditee's honesty and the absence of criminal acts related to the accounts and transactions being audited. They must not begin the audit by taking it for granted that acts of a criminal nature have not been committed, but nor must they allow themselves to view the auditee as a suspect who is obliged to prove his or her innocence. *Secondly*, when auditors detect errors, either in the actual accounts or the underlying transactions, their task is to assess whether the error detected may be due to fraudulent activity and, by extension, the perpetration of a criminal act. Where they assess that such might be the case, they must clarify the matter by intensifying their audit work. *Thirdly*, irrespective of whether such cases arise, auditors also have to apply techniques of a different nature to investigate whether criminal acts have been committed in the course of the management under scrutiny. The techniques applied will not result in the issue of a certificate stating that no criminal acts have been committed – which would be extremely difficult, if not impossible – but will enhance the level of certainty that such acts were not perpetrated in the managerial activity concerned.

Bribery, fraud, misappropriation, theft and breach of duty are committed with malicious intent and aimed at benefiting the person who perpetrates such an act or a third person. The culprits may be found amongst the directors or managers of the body under examination, the ordinary members of its staff or people external to the body, who may be either counterparties or complete outsiders. There may be more than one culprit and those culprits might be any one or more of the types of people just mentioned who have agreed to cooperate in committing a criminal offence. An effective internal control system has to be in place, but always within reason, in order to preclude the perpetration of such criminal acts<sup>2</sup>. The system of internal management must not allow financial powers to be attributed to just one person without simultaneously providing for *ex ante* or *ex post* verifications of the actions of the person concerned or providing for a second person working jointly with the assignee of those financial powers in carrying out operations or activities with which the assignee has been entrusted.

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<sup>2</sup> THE CHARTERED INSTITUTE OF PUBLIC FINANCE AND ACCOUNTANCY, Combating financial crime. Further Guidance on Anti-money Laundering for Public Service Organisations, Institute of Public Finance and Accountancy/CIPFA publications, London, UK, 2009.

***Hence, corruption is not a matter of criminal law alone. It is not a matter that concerns the prosecuting authorities, police and the Public Prosecutor's Office alone. And it is not associated exclusively with the mentality of suppression and penalisation. Audit Institutions are in a position to pinpoint the systemic reasons for fraud and corruption. They don't track down specific guilty persons; they detect situations that give rise to fraud and corruption.***

The role of the Audit Institutions in fighting corruption is crucial<sup>3</sup>. Not only because the passive vehicle of corruption is answerable to the public, but also because corruption which deflects the proper course of public expenditure results in bad financial management. The Audit Institution's interest in corruption is threefold: firstly because when an administrative decision to make public funds available is taken following corruption on the part of the official responsible, the decision is illegal. It is a decision taken in the context of abuse of power, as it is termed in administrative law. Therefore, a classic case of illegality exists. Secondly, the Court of Auditors is interested in sound financial management, namely, whether the correct means are employed to achieve the political objective that has been set. Means that are selected as a result of corruption of the persons responsible constitute grounds for presumption of the fact that a bad choice has been made and thus constitute proof of poor financial management. Lastly, the official who has been bribed is *de facto accountant*, by virtue of his or her acceptance of a bribe. The money that the official receives, i.e. the well-known "small envelope", is public money, because it is given so that a public service can be carried out, irrespective of the intentions of the payer of the bribe and his or her undue offering.

There are many ways in which fraud and corruption can be suppressed. One method is what we would term classic *ex post*, where the State awaits complaints lodged by victims and acts in the customary manner. Another way is by organising a special prosecution department with specialist police officers whose mission will be to expose those guilty of corruption by examining, for example, anonymous complaints and the financial position of the public bodies or by setting well-devised traps, and so on. Fraud and corruption phenomena are suppressed using these methods and an effective warning is given to anyone hoping to make money from corruption. However, the phenomena are not checked at their roots.

Court of Auditors by holding discussions with auditee bodies and asking to see documents, verifies that control or cooperation is not confined to internal inspectors or associates merely signing with their eyes closed on the basis of a blind trust they have in the member of staff mostly involved in exercising the responsibility concerned

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<sup>3</sup> RUIZ GARCIA Eduardo. 'El auditor ante el fraude', in Revista de los órganos autonomicos de control externo, 1997, n. 10, pp. 10-12. KOK Christianus. 'The fight against Euro-Fraud', European Brief, December 1994. FRIEDMANN Bernhard, WEBER Hubert. 'La lucha contra las irregularidades y el fraude: La contribucion del Tribunal de Cuentas Europeo', Revista de los órganos autonomicos de control externo, 1997, n. 10, pp. 6-9. LAFFAN Brigid. 'Financial control: The Court of Auditors and OLAF', in The Institutions of the European Union. Oxford University Press 2006, pp. 210-228.

because, according to the dictates of contemporary auditing practice, they must be treated with *scepticism*<sup>4</sup>. An auditor has to assess the atmosphere of integrity generated in the department being audited on the basis of the example its head sets in this regard and the interest he or she shows in suppressing illegal activities. Any head of department who believes that *presumption of innocence* prevents him or her from introducing any fraud-prevention policy or mechanisms for detecting criminal offences develops a climate that is favourable to anyone who readily yields to the temptation of easy financial gain. This is why auditors also believe that a managerial environment in which the head holds such views is particularly risky. Equally, a lax and tolerant environment in which the errors made by heads are easily excused is also risky.

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<sup>4</sup> INTERNATIONAL STANDARD ON AUDITING 240 THE AUDITOR'S RESPONSIBILITIES RELATING TO FRAUD IN AN AUDIT OF FINANCIAL STATEMENTS The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behaviour which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability. 5. An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skilfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates are caused by fraud or error. When obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud. The requirements in this ISA are designed to assist the auditor in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement. (...) the auditor shall maintain professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

Property over which the auditee body has control may be misappropriated or stolen. An auditor looks into whether there is an inventory of such property, whether it is updated regularly and is genuine, accurate and complete, thus giving a true picture of the identity and value of each item. These courses of action are subject to regular checking in the accounts of a legal person under public law, but ought to be taken in any case with a view to preventing or repressing criminal acts that target such property. An auditor pays particular attention to a body's general policy regarding the safekeeping of property in its possession, the clear division of responsibilities between those in charge of safekeeping and the procedure followed – which may differ from what is foreseen in the related guidelines – so that safekeeping does not become a dead letter.

Court of Auditors' primary concern is sums of money, which may be in the form of cash in the auditee's cash desk or deposits in its bank account. The detection of a deficiency constitutes the most significant evidence that a criminal act, misappropriation or theft has taken place. Misappropriations are usually covered by creative accounting or other tricks, which is why it would be rare to find an entirely visible deficiency, other than in the case of a cashier disappearing with whatever he can remove from the cash desk! A deficiency may prove to be attributable to payments to people who do not exist or to people who do, but to whom there is no reason to make such a payment, in which case the amount disbursed is either appropriated entirely by the body that committed the criminal offence within the auditee body or shared with the person who obtained the amount concerned by fraudulent means. Hence, an auditor does not confine himself to merely examining supporting documents. After he has carried out a risk analysis and/or sampling checks, he verifies the existence of people who are listed as having received monies or substantiates the entitlement on whose basis a payment was made. Practised accounting officers' skills enable them to incorporate public money they are handling into their assets, whether for a short or long period, in order to derive financial gain. Accounts that cannot be reconciled or that have entries in which there are sequential inconsistencies over time, as well as interim or suspense accounts that show excessive movements or amounts, arouse an auditor's suspicion and his or her interest in investigating further<sup>5</sup>.

What has been stated up to now concerns cases where a management body that is being audited suffers a direct loss of resources following the removal of property or assets belonging to it. When a breach of duty or bribery occurs, either a body is illegally encumbered with obligations in respect of a third person or a third person's obligations to a body are extinguished, but in the absence of any legal ground. When a

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<sup>5</sup> [2003] EWHC 1319 (Ch) HIGH COURT OF JUSTICE, 11th June 2003, Mr. JUSTICE EVANS – LOMBE, BARINGS Plc 515 In principle, it seems to me that lack of segregation allows a trader, if fraudulent, to misreport his trades. The possibility of misreporting means that checks by the customer or by risk control for unauthorised trades might be ineffective. And by, for example, reporting trades he has not done, a trader could obtain margin for unauthorised trades. Therefore lack of segregation must increase the risk of unauthorised trading. However I have to take account of BFS' own expert's view that the increase in risk was "fairly minimal".

public project, procurement or service is awarded to a contractor who has bribed the members of a tender-evaluation committee to this end, the public body is encumbered with an obligation that it would not have assumed under normal circumstances. Such bribery is also to the detriment of any tenderer whose more advantageous bid is rejected as a result. Similarly, when a body accepts a project, procurement or service as being in conformity with the terms of the contract when this is not actually the case, but the members of the acceptance committee have been bribed and illegally attested that it is, the outcome is the illegal extinction of the contractor's obligation to the body.

It is difficult for auditors to investigate such incidents because, as a rule, they do not possess the related technical expertise. However, the philosophy of contemporary auditing is that an auditor must give the auditee the impression that none of their actions is left unexamined in the end. It is then that the auditor, after carrying out risk analysis or sampling, may turn to specific audit procedures with a view to drawing up an opinion that is based on his or her own expertise.