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Parliamentary paper

Fraud awareness, prevention, and detection in the public sector

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Auditor-General's overview

Until recently, most surveys on fraud in New Zealand focused on the private sector. In 2011, I commissioned PricewaterhouseCoopers (PwC) to carry out a survey on fraud awareness, prevention, and detection to gain better insight into fraud in the public sector.

PwC surveyed almost 2000 people working in the public sector, achieving a response rate of 74%. This response rate places the survey results among the most reliable information sources about perceptions and practices in detecting and preventing fraud in the public sector.

This report sets out for Parliament and public entities the main results of our survey along with other insights from local and international sources about fraud awareness, prevention, and detection. Overall, the results show a strong commitment within the New Zealand public sector to protecting public resources.

However, we cannot be complacent if we are to maintain our good record of keeping fraud at bay. It is particularly important to be vigilant in the current global economic climate, because there is an increased risk of fraud when people struggle to make ends meet. It is also important to remember that trusting staff is not a fraud control. Systems do not commit fraud, people do. Public entities need to ensure that they have the right systems in place.

We have already extensively analysed and reported the results of the survey to public entities and our auditors, with our recommendations for preventing and minimising fraud. In doing so, we have encouraged public entities to share information about fraud incidents. Public entities have been asked to take the simple step of informing their auditor quickly when they suspect that fraud has been committed. (The detailed fraud survey results are available on our website, www.oag.govt.nz/2012.)

Using the information that auditors receive from public entities, we will continue to regularly update and share information about the fraud incidents advised to us. Sharing information we can quickly minimise risks and limit losses, while working to strengthen and protect our sense of community and values.

Lyn Provost
Controller and Auditor-General

11 June 2012

Part 1
Introduction

1.1   This report:

- sets out why the Auditor-General commissioned a fraud survey of the public sector in 2011 and provides information about other recent Australasian surveys on fraud;
- provides high-level survey findings and international comparisons; and
- describes our knowledge of the incidence of fraud in the New Zealand public sector.

1.2   In this Part, we discuss:

- the purpose of the Auditor-General's fraud survey; and
- other recent Australasian surveys on fraud.

1.3   In Part 2, we discuss the main survey findings and international comparisons. In Part 3, we present detailed results of our survey. In Part 4, we discuss frauds that have been reported to us by our Appointed Auditors.

The purpose of our survey

1.4   New Zealand generally has a "clean" image when it comes to fraud. We consistently rank highly in international and domestic surveys that measure public trust in government and the effectiveness of systems and processes that deal with fraud and corruption. We attribute the general absence of systemic large-scale corruption in the private and public sectors to the integrity of our standards and controls, underpinned by strong and shared common values within a small and cohesive society.

1.5   However, we cannot be complacent if we are to maintain our good record of keeping fraud at bay. It is particularly important to be vigilant in the current global economic climate, because there is an increased risk of fraud when people struggle to make ends meet.

1.6   Fraud always attracts a great deal of interest — irrespective of its scale. Invariably, questions are asked about how the fraud took place and whether the controls designed to stop fraud were operating effectively.

1.7   Until recently, most surveys of fraud in New Zealand focused on the private sector, and there had never been a fraud survey of the whole public sector. In 2011, the Auditor-General commissioned PricewaterhouseCoopers (PwC) to carry out a survey on fraud awareness, prevention, detection, and response to gain better insight into fraud in the public sector.[1] This included finding out about:

- fraud risk factors;

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1   See the Appendix for a description of the survey methodology.

- prevention, detection, and response mechanisms and awareness of these; and

- specific incidents of fraud.

1.8   The aim of this report is to provide you with the results of that survey. The results confirm a strong commitment within the public sector to protecting public resources.

1.9   Minimising the opportunity and removing the temptation to commit fraud are the best ways that public entities can protect the public's resources. Building a culture where governance, management, and staff are receptive to talking about fraud is important. Our findings suggest that the incidence of fraud is lowest where a public entity's culture is receptive to these discussions, communication is regular, and where incidents are reported to the relevant authorities.

Other recent Australasian surveys on fraud

1.10   Our survey into fraud in the New Zealand public sector is not the only recent survey about fraud in Australia or New Zealand. In the last three years, at least nine surveys on fraud in Australasia have been published. Figure 1 gives an overview of the most recent reports that included public sector participants.

1.11   Results from these surveys are not directly comparable because of differences in the scope and time period respondents were asked about, the sampling approach, the response rate, and the analysis, including the extent to which responses from the public sector and from New Zealand were included. However, the results of these surveys confirm many of the main findings of our survey.

Figure 1
Reports of fraud-related surveys in Australasia that included public sector results, 2008-2012

Author, date, and title	Location	Definition/scope	Response rate	Number of respondents	Type of respondent	Incidence*
Office of the Auditor-General (2011), *Cleanest public sector in the world: Keeping fraud at bay*	New Zealand	Fraud/corruption	74%	1472	Public sector	23%
J Lindley, P Jorna, and R G Smith (2012), *Fraud against the Commonwealth 2009-10 annual report to government*	Australia	Fraud	80%	152	Public sector	31%
J Lindley, P Jorna, and R G Smith (2011), *Fraud against the Commonwealth 2008-09 annual report to government*	Australia	Fraud	84%	149	Public sector	39%
Australian National Audit Office (2011), *Fraud control in Australian Government agencies*	Australia	Fraud	92%	160	Public sector	31%
PricewaterhouseCoopers (2011), *The 2011 Global Economic Crime Survey Results for New Zealand*	78 countries	Economic crime	Unclear	3877 (93 from New Zealand)	Total	50%
					Public sector	60%
PricewaterhouseCoopers (2011), *Fighting fraud in the public sector*	35 countries	Economic crime	Unclear	177 (14 from Australia)	Public sector	37%
PricewaterhouseCoopers (2009), *Fighting fraud in the public sector*	35 countries	Economic crime	Unclear	170	Public sector	37%
KPMG (2010), *Fraud and misconduct survey*	Australia and New Zealand	Fraud	10%	214	Total	53%
					Public sector (15)	61%
KPMG (2008), *Fraud and misconduct survey*	Australia and New Zealand	Fraud	21%	420	General	45%

* The percentage of respondents who replied that they knew of at least one incident of fraud, corruption, or economic crime having been committed in their entity in the survey period.

Part 2
Main survey findings and international comparisons

2.1   In this Part, we set out the high-level results of our survey and compare them with the results from other recent Australasian fraud surveys.

2.2   Despite New Zealand's generally "clean" image, fraud is a fact of business life here. Anyone who has been part of an entity that has been defrauded knows that financial loss is only part of the effect of fraud. Additional costs include loss of trust in workmates and colleagues, the loss in productivity when assessing and repairing internal systems, and the sense of betrayal and consequent loss of trust.

2.3   Australasian surveys also identify that entities that experience fraud suffer a damaging loss of trust as well as the loss of money. Fraud damages an entity's public reputation[2] and internal working relationships. Because fraud involves dishonesty, managers and staff may feel shocked, betrayed, disillusioned, and demoralised.[3] They may find it difficult to re-establish trust in the people they work with. When entities fail to prevent fraud, the disruption distracts them from delivering effective and efficient services.[4] As these effects can never be entirely reversed, it is better for entities to protect themselves against fraud.

Public sector is committed to preventing fraud

2.4   Our survey confirms a strong commitment within the public sector to protecting public resources. Respondents throughout the public sector told us that their entities generally have the essentials in place. These include:

- mature and connected policies and approaches for mitigating fraud risks;
- a clear commitment from their governing bodies and management team to preventing fraud; and
- receptive environments for talking about fraud.

2.5   Minimising the opportunity and removing the temptation to commit fraud are the best ways that entities can protect the public's resources. This can be done by building a culture where governing bodies, managers, and staff are receptive to talking about fraud.

More awareness of emerging fraud risks is needed

2.6   Ongoing vigilance is particularly important in the current global economic climate, because the risk of fraud increases when many people struggle to make ends meet. Experience internationally generally confirms a greater incidence of

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2   KPMG (2010), *Fraud and misconduct survey*; PricewaterhouseCoopers (2009), *Fighting fraud in the public sector*.

3   PricewaterhouseCoopers (2009), *Fighting fraud in the public sector*; Damian Bennett (2010), *Fraud in recessionary times*, Hayes Knight.

4   Lindley, J., Jorna, P., and Smith, R. G., (2012), *Fraud against the Commonwealth 2009-10 annual report to government*, Australian Institute of Criminology; KPMG (2010), *Fraud and misconduct survey*.

fraud in recessionary economic climates, with fraud increasing because of "need" rather than "greed". There have been well-publicised large frauds during the global financial crisis[5] and an increase internationally in frauds in small entities.[6] Staff may feel less secure in their employment and, with the entity's suppliers also under pressure, public entities are at real risk from fraud and other economic crimes.[7]

2.7   Despite this, 69% of respondents to our survey did not feel that their public entity had a change in risk because of the current economic climate. Australasian surveys also found that, although people identify fraud as a risk for other entities, they are much less concerned about risk in their own entities.[8]

2.8   Our survey found that most known frauds were committed by one internal person acting alone. Australasian surveys also found that public sector frauds are more likely to be committed by internal perpetrators (except for benefit-paying entities, which are vulnerable to external perpetrators).[9] The Australian Institute of Criminology found that, although the incidence and financial losses of public sector internal fraud are generally lower than those of external fraud, reported losses from internal fraud had increased by 10%.[10] KPMG found that internal staff (usually acting alone) committed 65% of major frauds, which accounted for 98% of frauds by value.[11] In a breakdown of public sector perpetrators from a small sample size, KPMG found that:

• non-managers committed 62% of the fraud incidents, which accounted for 7% of the fraud by value; and

• managers committed 26% of the fraud incidents, which accounted for 85% of the fraud by value. The value of frauds committed by managers was on average 29 times higher than those committed by non-managers and five times higher than those committed by external perpetrators.[12]

2.9   Respondents to our survey told us that the main perpetrator in fraud incidents that they were aware of was an operational (46%) or administrative/support

5   KPMG (2010), *Fraud and misconduct survey*.

6   PricewaterhouseCoopers (2011), *The 2011 Global Economic Crime Survey Results for New Zealand*.

7   PricewaterhouseCoopers (2011), *The 2011 Global Economic Crime Survey Results for New Zealand*.

8   In the not-for-profit sector, 86% believed that fraud was a problem for others, but only 8% for their entity. See BDO New Zealand (2012), *Not-for-profit Fraud Survey*. Only 20% of respondents thought that fraud was a serious problem for their own entity. See KPMG (2010), *Fraud and misconduct survey*.

9   Lindley, J. and Smith, R. G., (2011), *Fraud against the Commonwealth 2008-09 annual report to government*, Australian Institute of Criminology.

10   Lindley, J., Jorna, P., and Smith, R. G., (2012), *Fraud against the Commonwealth 2009-10 annual report to government*, Australian Institute of Criminology.

11   KPMG (2010), *Fraud and misconduct survey*.

12   KPMG (2010), *Fraud and misconduct survey*.

service (22%) person. However, in the current challenging economic environment, international data shows that fraud is increasingly committed by those at a managerial level or above. People in these positions can often override controls and may be able to conceal their offending better.

2.10   According to our survey, the most frequent types of fraud within the New Zealand public sector were:

- theft of cash (21%);
- theft of plant, equipment, or inventory (17% combined);
- fraudulent expense claims (14%);
- payroll fraud, such as falsifying timesheets (9%); and
- false invoicing (8%).

2.11   In comparison, the main types of fraud for the Australian public sector included:

- misuse of entitlements (for example, a credit card);
- financial reporting (intentional misstatements to deceive the users of financial reports); and
- intellectual property theft.[13]

Trusting staff is not a fraud control

2.12   Respondents to our survey often commented that they trusted their staff and colleagues to "do the right thing". This was one of the most common reasons people gave for not responding to our survey when we rang to follow up. They did not feel the survey would be relevant to their circumstances.

2.13   Although many of these people did then respond to our survey, their initial decision not to underlines how we can inadvertently fail to protect our entities from loss and our staff from suspicion. Our values, integrity, culture, and systems protect us only to a certain extent. If we become complacent, they can also become a weakness that provides the opportunity for fraud. Our survey found that nearly 80% of known frauds were committed by an internal person acting alone. These individuals were trusted employees until their betrayal of that trust was discovered. Most of these individuals thought they would not get caught.

2.14   New Zealand is a country of small businesses, and the public sector is similarly small. In our survey, 579 respondents were in entities with fewer than 50 full-time equivalent staff. Understandably, when people work closely together, they want to be able to trust each other. However, KPMG found that warning signs were overlooked or ignored in 38% of major frauds.[14] This indicates that the risks from

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13   Lindley, J., Jorna, P., and Smith, R. G., (2012), *Fraud against the Commonwealth 2009-10 annual report to government*, Australian Institute of Criminology.

14   KPMG (2010), *Fraud and misconduct survey*.

fraud could be reduced by being vigilant and responding when concerns are first identified.

2.15   Preventing fraud is not only about protecting resources. Fraud distracts people from their jobs, is organisationally corrosive, and undermines public trust and confidence in the public sector. Fraud prevention is important not just to limit loss but also to protect the culture of an entity and the public's trust that taxes and rates are used for proper purposes.

2.16   The combination of a lack of perceived risk from the wider economic climate and a reliance on trust in each other suggests that the public sector could do more to ensure that we are aware of emerging fraud risks. This includes sharing information about incidences of fraud.

Maintaining a culture of integrity keeps fraud at bay

2.17   Overall, the incidence of fraud in our public sector appears to be relatively low compared to the results suggested by other surveys. Less than a quarter of our survey respondents (22.5%) were aware of any fraud having been committed in their public entity in the last two years.

2.18   In the Australasian surveys, the proportion of survey respondents whose entities had detected fraud ranged from:

- 37% to 53% for all respondents; and
- 23% to 61% for public sector respondents.

2.19   Our survey showed the smallest amount of public sector fraud in any of the comparable surveys.

2.20   PwC's international findings agree with our survey findings that there is a correlation between the size of the entity and the number of incidents reported. Larger entities experience more fraud than smaller ones.[15]

2.21   It is important to have strong controls and to follow the systems that are laid out. KPMG found that weak controls created the opportunity for 32% of frauds and overridden controls created the opportunity for 22% of frauds.[16] In small entities that have fewer controls, organisational culture and compliance with controls play a significant part in maintaining an effective anti-fraud culture.[17]

2.22   The results of our survey reinforce that informing employees about the risks of fraud, how to protect the public entity from fraud, and what to do if a fraud has

15   PricewaterhouseCoopers (2011), *The 2011 Global Economic Crime Survey Results for New Zealand*; KPMG (2010), *Fraud and misconduct survey*.

16   KPMG (2010), *Fraud and misconduct survey*.

17   Association of Certified Fraud Examiners (2010), *Report to the nations on occupational fraud and abuse*.

been detected is important in minimising incidents of fraud. These are steps that all public entities can take, and our survey shows that many are doing so already.

2.23 Our survey showed a strong correlation between the culture of a public entity and the incidence of fraud, and the results suggest that communicating regularly about fraud helps to keep fraud at bay. A culture of integrity is built and maintained by public entities being receptive to, and communicating about, fraud prevention, risks, and incidence. This means:

- setting the tone at the top;
- putting in place appropriate controls, including policies and procedures;
- talking openly about fraud and the risk of fraud;
- making sure that staff feel safe to report fraud;
- making sure that staff know about fraud policies and procedures – regularly telling them that fraud is not tolerated, how they can help prevent it, and how to raise their concerns; and
- telling staff about incidents of fraud and how they have been dealt with.

2.24 Having appropriate policies and procedures is a good first step. However, for these to be effective, managers need to ensure that employees know about them and how to use them. Openly discussing fraud prevention practices and the checks that are in place to identify offenders can increase the perception of risk of being caught, which may deter potential perpetrators.[18]

2.25 Communicating previous incidents of fraud has also been shown to be an effective way to reduce fraud. Currently, communication of fraud incidents to staff is poor. Slightly less than 30% of respondents to our survey said that management communicates incidents of fraud. However, our survey indicates that those entities that had communicated previous incidents of fraud to staff generally had fewer incidents of fraud. This again highlights the importance of sharing information and communicating with staff to minimise the risk of more fraud being committed.

A culture of integrity is most effective when supported by strong internal controls

2.26 Systems do not commit fraud, people do. Controls must be in place. Public entities need to ensure that they have the right systems in place and that their staff are always vigilant. The best way a public entity can protect itself from fraud is for managers to be willing to talk with staff about fraud risks, hear from staff about suspected fraud risks, and take action in response to incidents of fraud.

18 Schaefer, P. (2006), *Employee theft: Identify and prevent fraud, embezzlement, pilfering, and abuse*, www. businessknowhow.com/manage/employee-theft.htm.

2.27   Public entities with effective management controls do well in minimising fraud risk. According to our survey, 36% of all fraud incidents that respondents were aware of had been detected by internal controls. Internal controls are the frontline of fraud protection and detection. They were the single largest means by which frauds were detected in our survey. This finding is consistent with Australasian survey results, which confirm that fraud is most likely to be detected using internal controls.[19] In one survey, internal controls detected 42% of identified frauds.

2.28   Tip-offs are another successful way of detecting fraud.[20] In our survey, internal whistle-blowers detected less fraud than in some other surveys. For instance, in the Australian public sector, 29% of internal frauds were identified by whistle-blowers, suggesting that having good protected-disclosure systems can be helpful.[21]

2.29   Some people expect that external audit will detect fraud. The purpose of an external audit is to give assurance about the representative fairness of an entity's financial statements, not to detect fraud. Entities that rely on external audits to detect fraud are at risk.[22] In our survey, less than 1% of frauds were detected by external auditors.

Reporting deters fraud

2.30   Our survey showed that there is a high level of trust within public entities that managers would take action on any suspected or detected frauds. In our survey, 95% of respondents said that they would be willing to raise concerns about fraud and believed that their concerns would be taken seriously, and 78% were confident that fraud would be reported if it were discovered. Consistent with these views, 87% considered that, when risks are raised, their entity takes proactive steps to reduce those risks.

2.31   Despite this confidence, only 39% of fraud incidents that respondents were aware of had been reported to enforcement agencies. The Auditor-General expects public entities to consider reporting matters of fraud to an appropriate authority. This authority is usually the New Zealand Police and, if the incident is believed to be serious, the Serious Fraud Office. Entities that report fraud to the Police protect themselves and send a clear "zero tolerance" message. Entities are also expected to advise their auditor as soon as possible of any alleged, suspected, or actual fraud that requires management action.

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19 PricewaterhouseCoopers (2011), *Fighting fraud in the public sector; KPMG (2010), Fraud and misconduct survey*.

20 BDO New Zealand (2012), *Not-for-profit Fraud Survey*.

21 Lindley, J., Jorna, P., and Smith, R. G., (2012), *Fraud against the Commonwealth 2009-10 annual report to government*, Australian Institute of Criminology; KPMG (2010), *Fraud and misconduct survey*.

22 Association of Certified Fraud Examiners (2010), *Report to the nations on occupational fraud and abuse*.

2.32   The Australasian surveys also showed a marked difference between how people thought their entity would respond and how the entity did respond when fraud arose.[23] For instance, only 51% of public entities dismissed fraud perpetrators.[24] Many entities did not have, or did not intend to implement, reporting mechanisms for responding to fraud incidents.[25]

2.33   We recognise that a range of factors have to be balanced when deciding whether to refer suspected offending to enforcement agencies. These factors may include the scale and nature of wrongdoing, the likelihood of securing a conviction, how long ago the event(s) took place, the attitude and situation of the alleged offender, and any reparation that has been made.

2.34   However, our survey shows that reporting fraud to the Police appears to be effective in preventing more fraud from being committed. Public entities that had reported fraud matters to the Police had fewer known incidents of fraud. Of those who said that fraud had been reported to the Police, 21% told us that fraud had been committed in the last two years. Of those who said that fraud matters had not been reported to the Police, 49% told us that fraud had been committed in the last two years. Increased transparency and awareness of fraud reduces the chances of repeat offending.[26] Without formal records, offenders are free to reoffend – sometimes within the same entity.[27]

2.35   If fraud has been committed and managers are not seen to take action, staff confidence in managers can be seriously eroded. This may have an adverse effect on staff who would otherwise report their suspicions of fraud. Public entities should be aware that reporting fraud to enforcement agencies maintains the willingness of staff to speak up about fraud concerns. Managers should take reactive steps, such as disciplinary action, as well as proactive steps to strengthen controls and ensure that staff are aware of how the public entity handles fraud and how staff can help prevent it.

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23   BDO New Zealand (2012), *Not-for-profit Fraud Survey*.

24   PricewaterhouseCoopers (2011), *Fighting fraud in the public sector*.

25   KPMG (2010), *Fraud and misconduct survey*.

26   Association of Certified Fraud Examiners (2010), *Report to the nations on occupational fraud and abuse*.

27   Lindley, J., Jorna, P., and Smith, R. G., (2012), *Fraud against the Commonwealth 2009-10 annual report to government*, Australian Institute of Criminology; PricewaterhouseCoopers (2011), *Fighting fraud in the public sector*.
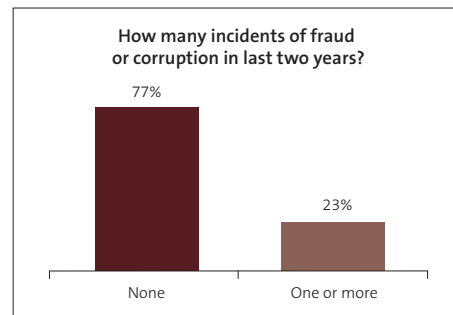
Part 3
Detailed results of our survey

3.1   In this Part, we present the results of our survey on overall incidents of fraud in the public sector. It breaks down those results in terms of small (579 respondents), medium (585 respondents), and large (300 respondents) public entities.[28] It also highlights the results from different types of public entity.[29]

Incidents of fraud in the public sector

3.2   Nearly a quarter of respondents to our survey were aware of at least one incident of fraud or corruption in their public entity within the last two years.

How many incidents of fraud or corruption in last two years?

77%

23%

None   One or more

3.3   Respondents from small public entities were less aware of an incident of fraud in the last two years (9%) compared with those from medium (21%) and large public entities (53%).

3.4   The types of public entity with the highest response rates for awareness of one or more incidents of fraud were State-owned enterprises, government departments, district health boards, airport companies, electricity lines businesses, licensing trusts or community trusts, and local authorities. Respondents from independent Crown entities, local government (other), and port companies were not aware of any incidents of fraud in the last two years.[30] Figure 2 shows the percentage of respondents who were aware of one or more incidents of fraud in their public entity by entity type.

Figure 2
Percentage of respondents who were aware of one or more incidents of fraud in their public entity in the last two years

	One or more incidents of fraud
Central government	28.4%
Local government	32.5%
Schools	7.7%
Public sector overall	**22.5%**

28   We have defined a small public entity as having fewer than 50 full-time equivalent employees (FTEs), a medium public entity as having between 51 and 500 FTEs, and a large public entity as having more than 500 FTEs.
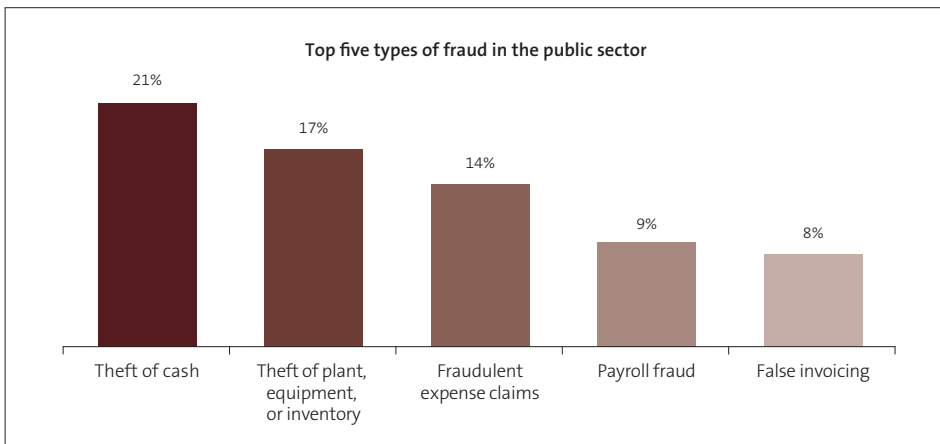
29   Figures in the text and graphs have been rounded. See the Appendix for an explanation of how we grouped public entities into types. The detailed results by type of entity are on our website, www.oag.govt.nz/2012.

30   Local government (other) includes council-controlled organisations that are exempted under section 7 of the Local Government Act 2002 and "miscellaneous" public entities (which are mainly trusts that are public entities under the Public Audit Act 2001).

3.5   The total dollar value of fraud in the last two years was mostly low, with 15% of respondents saying there was no monetary loss and 61% saying the dollar value was less than $10,000. Twenty-nine percent of respondents from large public entities said that they had incurred fraud losses of more than $10,000.

3.6   However, it is not always possible to accurately establish how much money has been lost in a fraud because sometimes the records and the investigation are incomplete.

3.7   Those who knew of an incident in the last two years were asked for details of the most recent incident.

3.8   Most of the most recent fraud incidents that respondents were aware of (80%) were committed by one internal person acting alone, typically at an operational staff level (46%) or administrative support level (22%). This finding was similar for small, medium, and large public entities and all entity types.

Types of fraud

3.9   The most common type of fraud that respondents were aware of was theft of cash. This finding was similar for small, medium, and large public entities.

3.10   The most common types of fraud within small public entities were:

- theft of cash (21%);
- theft of plant, equipment, or inventory (20% combined); and
- fraudulent expense claims (19%).

Top five types of fraud in the public sector

Theft of cash	Theft of plant, equipment, or inventory	Fraudulent expense claims	Payroll fraud	False invoicing
21%	17%	14%	9%	8%

3.11   The most frequent types of fraud within medium public entities were:

- theft of cash (21%);
- theft of plant, equipment, or inventory (21% combined);
- fraudulent expense claims (13%); and
- payroll fraud (13%).

3.12   The most frequent types of fraud within large public entities were:

- theft of cash (21%);
- theft of plant, equipment, or inventory (14% combined);
- fraudulent expense claims (13%);
- payroll fraud (11%); and
- conflicts of interest (such as making or receiving payments, or receiving undeclared gifts or services, to influence a decision or give preferential treatment) (11%).

3.13   Medium and large public entities were, by far, the most likely to experience payroll fraud. This could mean that it is an area of particular risk or that these public entities have more effective systems for detecting payroll fraud than smaller public entities.

3.14   The most common reason why fraud was committed was that the perpetrator did not think they would get caught (40%). A quarter of respondents said that it was committed because internal control policies and procedures were not followed (27%). These two reasons were the same for small, medium, and large public entitles. These findings were similar across all the different types of public entity.

Main reasons fraud was committed

Person didn't think they would get caught	Internal control policies and procedures not followed	Lack of internal control policies and procedures
40%	27%	8%

How was fraud detected?

3.15   Internal control systems were the most successful mechanism for detecting fraud, with 36% of respondents aware that frauds were detected in this way. Internal tip-offs (other than through a formal whistle-blowing system) led to 20% of the frauds detected. This finding was also the same for small, medium, and large public entities.

3.16   Prevention is the first line of defence against frauds for many public entities. Respondents from all the different entity types reported that internal control systems were a successful way of detecting fraud. Internal tip-offs (other than through a formal whistle-blowing system) were the most successful way of detecting fraud for airport companies, local authorities, Māori trust boards, and rural education activities programmes.

3.17   Respondents said that less than 1% of fraud incidents were detected by the external auditor. This low percentage is not surprising, because detecting fraud is neither the purpose nor the focus of an external audit.
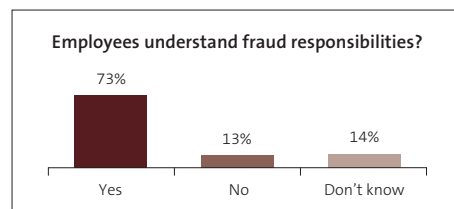
Fraud controls

3.18   The pace of change in many work environments means that the process of ensuring that fraud controls align with the work environment should be an ongoing exercise.
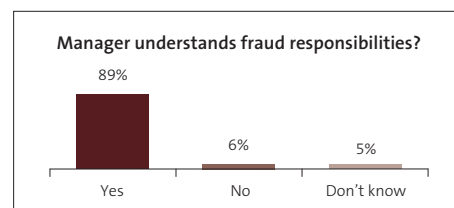
3.19   Seventy-one percent of respondents said that their public entity reviews its fraud controls after a fraud had been committed. This could mean that some of the fraud controls are no longer effective, because systems and processes change over time. To work effectively, we recommend that fraud controls be reviewed annually or every two years.

Clear roles and responsibilities

3.20   Although the culture modelled by the leaders of a public entity is critical, preventing fraud is not the responsibility of any one person. Overall, 73% of respondents said that other employees understood their responsibilities for preventing and detecting fraud. Respondents from small public entities were more confident (81%) compared with those from medium (68%) and large public entities (59%). Chief executives and administration staff had the highest confidence.

Employees understand fraud responsibilities?

Yes	73%
No	13%
Don't know	14%

3.21   Respondents from all levels in the public sector (from the chief executive through to operational and administration staff) felt confident that managers understood their roles and responsibilities for preventing and detecting fraud (89%). Again,

Manager understands fraud responsibilities?

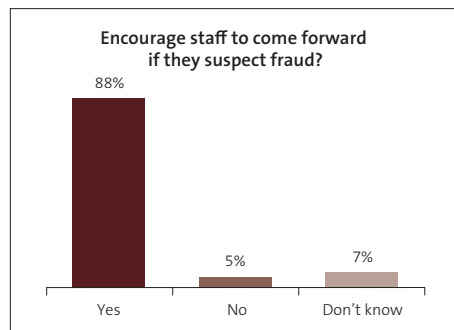|	
Yes	89%
No	6%
Don't know	5%

respondents from small public entities were more confident (93%) than those from medium (86%) and large (79%) public entities.

3.22   Senior managers understand well the importance of building an anti-fraud culture and regularly communicating with staff about incidents of fraud. However, only 29% of respondents said that managers told staff about incidents of fraud.

3.23   In our view, all employees need to understand their roles and responsibilities so that a culture receptive to discussing fraud can be supported and maintained.

Environment receptive to conversations about fraud

3.24   Most respondents (88%) worked in an environment where staff were encouraged to come forward if they suspected fraud had been committed. This finding was similar for all staff levels and for small, medium, and large public entities.

Encourage staff to come forward if they suspect fraud?
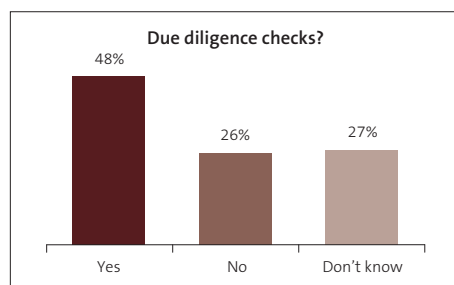
88%

5%   7%

Yes   No   Don't know

3.25   Most respondents (95%) also said that they could come forward knowing that their concerns would be taken seriously and without fear of retaliation. This finding was similar for all staff levels and for small, medium, and large public entities. Respondents from all the different types of public entity had a positive response rate between 84% and 100%.

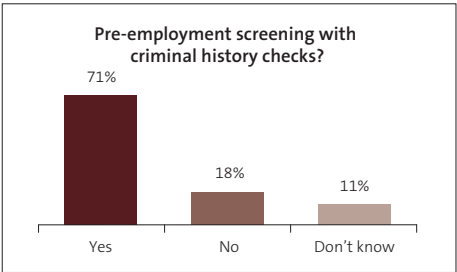## Due diligence checks and pre-employment screening

3.26   Many frauds are committed through the use of fake suppliers or suppliers with a close personal relationship with an employee. Carrying out due diligence checks can help to mitigate the risk that suppliers can pose. Due diligence checks involve requesting references or credit checks. Other kinds of checks that can be done include:

• removing unused suppliers from the system; and

• regularly monitoring the changes to supplier details.

3.27   Only 48% of respondents said that due diligence checks were carried out. This finding was similar for small, medium, and large public entities. In our view, all public entities should be carrying out due diligence checks on new suppliers.

Due diligence checks?

48%

26%   27%

Yes   No   Don't know

3.28   Most often, it is trusted employees who commit fraud. Trusting employees is important, but to trust without first ensuring that it is appropriate to do so exposes public entities to unnecessary risk. Overall, 71% of respondents said that new employees undergo pre-employment screening that includes a

Pre-employment screening with criminal history checks?

71%   18%   11%

Yes   No   Don't know

criminal history check. This finding was similar for small, medium, and large public entities.
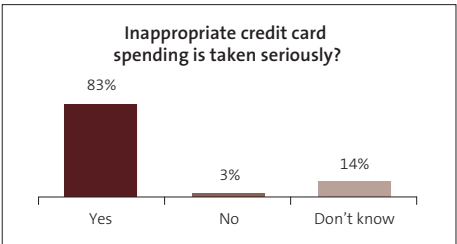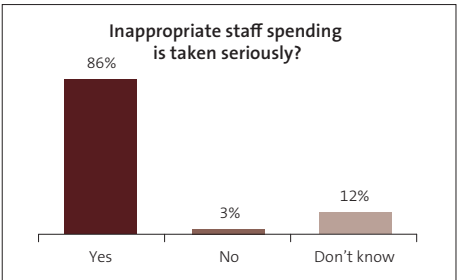
Responding to risks

3.29   Most respondents (87%) were confident that their public entity would take proactive steps to reduce the risk of fraud if a fraud were discovered in their entity. This finding was similar for small, medium, and large public entities. The only types of public entity to have less than 85% of respondents agreeing with this statement were district health boards, airport companies, council-controlled organisations, and local government (other).
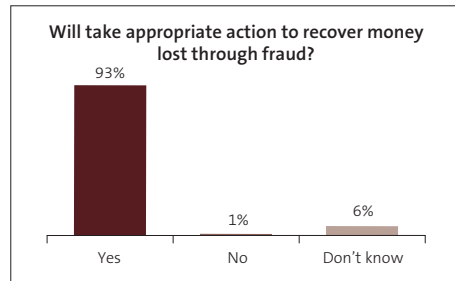
Credit card and expense claim fraud

3.30   Most respondents (83%) were confident that their public entity would take inappropriate credit card spending seriously and discipline the person involved. This response rate was similar for small, medium, and large public entities. District health boards had the lowest response rate for the central government sector with 76%, and electricity lines businesses had the lowest for the local government sector with 68%.

Inappropriate credit card spending is taken seriously?

83%   3%   14%

Yes   No   Don't know

Inappropriate staff spending is taken seriously?

86%   3%   12%

Yes   No   Don't know

3.31   Respondents were more confident (86%) that inappropriate expense claims were taken seriously and resulted in disciplinary action. Small public entities (87%) were more confident than medium (81%) and large entities (78%).
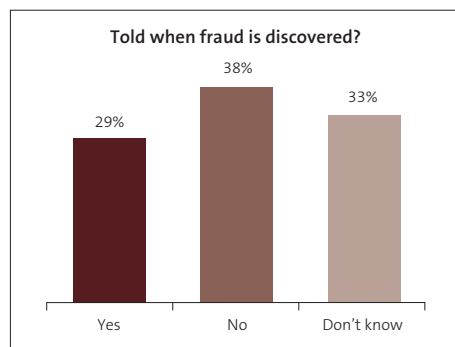
3.32   Most respondents (93%) were confident that their public entity would take action to recover any misappropriated funds. This response rate was similar in small, medium, and larger entities and throughout the public sector. Government departments had the lowest response rate for the central government sector with 84%. Port companies had the lowest for the local government sector with 50%.

Will take appropriate action to recover money lost through fraud?

93%

1%

6%

Yes   No   Don't know

3.33   A clear process to recover funds shows the seriousness with which fraud is taken. In our view, chief executives and senior managers need to send clear messages to staff that they will seek to recover any misappropriated funds.

Telling staff about incidents of fraud

3.34   Less than a third of respondents said that their senior managers told all staff about incidents of fraud. More senior managers from small public entities (39%) tell staff than in medium (24%) and large public entities (18%).

Told when fraud is discovered?

38%

29%

33%

Yes   No   Don't know

3.35   Communicating with staff is vital in raising awareness about fraud. Greater awareness makes it easier for staff to be vigilant, can confirm the entity's "zero tolerance" approach to fraud, and helps to maintain an environment where it is easy for staff to speak up about risks and raise any concerns.

Referring suspected fraud to the appropriate authorities

3.36   Most respondents (78%) expected that fraud would be reported to the appropriate authorities. Respondents from small public entities were more likely to think that the fraud would be reported (80%) than those from medium (75%) and large public entities (69%). The lowest positive response rate in the central government sector was government departments, where 70% of respondents said their public entity would report fraud to the relevant law enforcement agency. The highest was autonomous Crown entities and Māori trust boards (both with 91%).

3.37   In the local government sector, 50% of respondents from port companies and 63% of respondents from airport companies thought their public entity would report fraud to the relevant law enforcement agency.
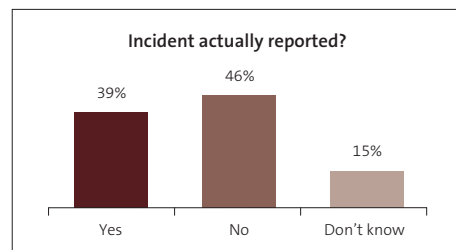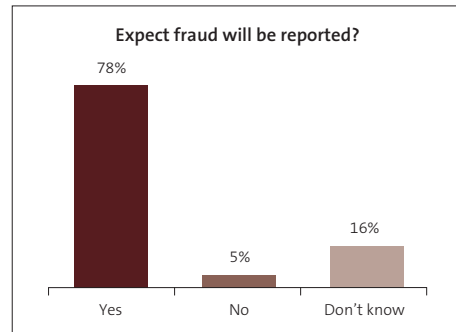
3.38   The highest positive response rate came from respondents in local authorities and schools (both 81%).

3.39   Almost half of the most recent incidents of fraud were not reported to the appropriate authorities. Large public entities were more likely to report fraud to the appropriate authority (43%) than medium (32%) and small (32%) public entities.

Expect fraud will be reported?

Yes	No	Don't know
78%	5%	16%

Incident actually reported?

Yes	No	Don't know
39%	46%	15%

3.40   Many public entities are reluctant to bring criminal charges against their employees because of the time and costs of preparing a case and resolving matters in the courts, and a perception that fraud is a low priority for the New Zealand Police.

3.41   However, all public entities are expected to consider reporting fraud to the appropriate authorities. We encourage all public entities to do this.

3.42   Any decision made not to respond to fraud can erode staff confidence in the senior management team. It can create a perception that managers are not committed to preventing fraud and discourage staff from reporting their concerns. Taking no action when fraud is committed also increases the risk that an employee suspected of committing fraud could move to another public entity and continue their dishonest behaviour.

Part 4
Fraud reported to the Office of the Auditor-General by Appointed Auditors

4.1   In this Part, we present a summary of the incidents of fraud that our Appointed Auditors have reported to us during 2009 and 2010. As part of their professional obligations, our Appointed Auditors are required to inform us of any incidents of fraud in a public entity that they audit.

4.2   Although it is important to be clear that we cannot know the full extent of fraud in the public sector, our work in collating the reported incidents of fraud gives us an indication of the fraud risks in the public sector.

4.3   The two most frequent types of fraud reported to us are similar to the types of fraud that respondents to our survey were aware of. However, conflicts of interest and misappropriation of funds feature highly in the types of fraud that are reported to us but not in our survey results.

4.4   For schools, the most frequent type of fraud was misappropriation of funds followed by payroll fraud. For Crown entities, the most frequent type of fraud was fraudulent expense claims. For council-controlled organisations, it was theft of cash. The type of fraud most frequently experienced by tertiary education institutions involved a conflict of interest.

4.5   The main reason that frauds reported to us were committed was that internal control policies and procedures were not followed. This finding was similar to our survey findings, although to a lesser extent. A key risk factor in fraud reported to us is the amount of trust that is placed on an individual.

Reported reasons why fraud is committed

4.6   There is a variety of reasons why frauds are committed in schools, with the most common reason being too much trust placed on an individual. This is followed by lack of segregation of duties.

4.7   For Crown entities, tertiary education institutions, and council-controlled organisations, the main reason the fraud was committed was because internal control policies and procedures were not followed.

How fraud was detected

4.8   For all the public entity types, internal control systems were the most successful method in detecting fraud. This is the same finding as our survey results. Changes of duties or personnel helped detect fraud in schools and Crown entities. However, fraud reported to us was also detected by changes of duties or personnel, by external audit, or by chance. These three methods of detection did not feature highly in our survey results.

4.9   Our survey finding that only 39% of incidents of fraud are reported to the relevant law enforcement agency is consistent with what public entities have told Appointed Auditors. Some additional outcomes of the fraud incidents that are reported to us include private agreements between the entity and the perpetrator and some frauds that are still under investigation. These outcomes were not apparent in our survey. In some instances, we do not know whether the incident of fraud reported to us was reported to the appropriate law enforcement agency.

Share knowledge about fraud risks

4.10   All of us who work in the public sector need to recognise that "doing the right thing" does not mean keeping quiet about suspected or detected fraud in an effort to be fair to the person or people suspected of fraud.

4.11   The public sector is entrusted with public money, so entities need to be aware of:
- maintaining the highest possible standards of honesty and integrity;
- the importance of transparency and accountability for the use of public funds; and
- the risk of perception that something has been "swept under the carpet".

4.12   "Doing the right thing" means speaking up. A suspected or detected fraud means that controls are working or that staff know what to look for and the environment supports them speaking up about any suspicions, or both.

4.13   A fraud presents the opportunity to share information so we can all learn from each other's experiences – and tighten our controls where we need to. Through speaking up and sharing information, we consider that the public sector will get better at recognising risks, and preventing and detecting fraud. This should help to reduce the losses suffered by the public sector through fraud.

4.14   Fraud awareness, prevention, and detection are the responsibility of each entity's governing body and its management. However, everyone working in the public sector has a part to play in protecting our public entities and public resources. Preventing fraud means focusing on fraud risks. We can learn just as much, if not more, about these risks from our detected frauds as we can from the smaller number of cases that are reported.

4.15   Public entities have been asked to take the simple step of informing their auditor quickly when they suspect that fraud has been committed. Although auditors are not responsible for detecting fraud, as part of our audit work we discuss fraud risks and fraud prevention activity with public entities to share information on trends and good practice.

4.16   Using the information that auditors receive from public entities, we will continue to regularly update and share information about the fraud incidents advised to us. Agencies and others who are interested will be able to see which sorts of controls or procedures are working to identify potential fraud in workplaces similar to theirs. The cumulative effect of this co-operation and sharing will be stronger controls, and our efforts to keep our public sector clean will be greatly aided.

Appendix
About our fraud survey

PricewaterhouseCoopers (PwC) carried out the survey and data analysis on behalf of the Auditor-General. PwC's full report on the research, including data analysis, and individual reports by type of entity[31], are available on our website (www.oag. govt.nz). The survey was conducted from 14 February to 3 June 2011. There were 1472 respondents, with a response rate of 74%.

Survey terms

In our survey, we used the following definitions:

- **fraud** means an intentional and dishonest act involving deception or misrepresentation by a person, to obtain or potentially obtain an advantage for themselves or any other person;
- **theft** means to dishonestly, and without claim or right, take or deal with any property with intent to deprive any owner permanently of the property or interest in it; and
- **corruption** is the abuse of entrusted power for private gain (such as soliciting or receiving gifts or other gratuities to perform an official duty or omit to perform an official duty).

Survey methodology

For the survey, we used a complex sample structure to get insight from staff at different organisational levels and to be able to provide results by sector.

The three sectors were central government entities (45% of respondents), local government entities (22.3% of respondents), and schools (32.7% of respondents).

The types of public entity in the central government sector included:

- autonomous Crown entities;
- central government (other);[32]
- Crown agents or companies;
- Crown research institutes;

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31 We have issued nine reports about the survey results for the following types of entities: government departments; autonomous Crown entities, central government (other), Crown agents or companies, Crown research institutes, and independent Crown entities; district health boards; tertiary education institutions; State-owned enterprises; local authorities; airport companies, port companies, electricity lines businesses, local government (other), and council-controlled organisations; licensing and community trusts; and schools.

32 Central government (other) includes a variety of entities in central government that do not fit into the other entity types. It includes Air New Zealand, National Provident Fund, Reserve Bank of New Zealand, New Zealand Superannuation Fund, Government Superannuation Fund, and AMI Insurance Limited (and the subsidiaries belonging to these entities). It also includes smaller entities such as producer boards, patriotic and canteen funds, and other miscellaneous entities (mainly trusts). Entities that are listed in Schedule 4 of the Public Finance Act 1989 are also included.

- district health boards;
- government departments;
- independent Crown entities;
- Māori Trust Boards;
- rural education activities programmes;
- State-owned enterprises; and
- tertiary education institutions.

The types of public entity in the local government sector included:

- airport companies;
- council-controlled organisations and council-controlled trading organisations;
- electricity lines businesses;
- fish and game councils;
- licensing trusts and community trusts;
- local authorities;
- local government (other);[33] and
- port companies.

Using a tiered selection method sample, we approached chief executives of certain public entities within each sector, asking that person to provide contact details for staff at different levels of the public entity as follows:

- **Tier 1:** We asked all entities in the following sectors to participate – government departments, Crown entities, local authorities, energy companies, State-owned enterprises, port companies, airport companies, rural education activities programmes, licensing and community trusts, Māori trust boards, and fish and game councils.

- **Tier 2:** We sought statistically representative samples from each of the following sectors – schools, council-controlled organisations and council-controlled trading organisations, local government - other, and central government – other.

We then sought participation from the individual contacts provided using an online survey.

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33 Local government (other) includes council-controlled organisations that are exempted under section 7 of the Local Government Act 2002 and "miscellaneous" entities (which are mainly trusts that are public entities under the Public Audit Act 2001).

Publications by the Auditor-General

Other publications issued by the Auditor-General recently have been:

- Institutional arrangements for training, registering, and appraising teachers
- New Zealand Qualifications Authority: Assuring the consistency and quality of internal assessment for NCEA
- Statement of Intent 2012–2015
- Public entities' progress in implementing the Auditor-General's recommendations 2012
- Draft annual plan 2012/13
- Local government: Results of the 2010/11 audits
- Severance payments: A guide for the public sector
- Health sector: Results of the 2010/11 audits
- Central government: Results of the 2010/11 audits (Volume 2)
- New Zealand Blood Service: Managing the safety and supply of blood products
- Central government: Results of the 2010/11 audits (Volume 1)
- Education sector: Results of the 2010/11 audits
- Managing the implications of public private partnerships
- Cleanest public sector in the world: Keeping fraud at bay
- Annual Report 2010/11
- Transpower New Zealand Limited: Managing risks to transmission assets
- The Treasury: Implementing and managing the Crown Retail Deposit Guarantee Scheme
- Managing freshwater quality: Challenges for regional councils
- Local government: Improving the usefulness of annual reports
- New Zealand Transport Agency: Delivering maintenance and renewal work on the state highway network

Website
All these reports, and many of our earlier reports, are available in HTML and PDF format on our website – www.oag.govt.nz. Most of them can also be obtained in hard copy on request – reports@oag.govt.nz.

Mailing list for notification of new reports
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