

CHAPTER-6

AUDIT OF FRAUD AND CORRUPTION CASES

6.01 Introduction

Examination of system for detection and prevention of fraud and corruption will be an integral part of all regularity audits and performance audits, when it forms one of the audit (sub) objectives.

6.02 Fraud examination

Fraud examination is a part of the normal auditing procedures and includes:

being alert for situations of control weaknesses and inadequacies in record keeping errors and unusual transactions or results which could be indicative of fraud/corruption, improper expenditure or lack of probity; and focusing audit strategy on areas and operations prone to fraud and corruption by developing effective high risk indicators for fraud.

6.03 Characteristics of fraud

6.03.01 Fraud should be distinguished from error. The distinguishing factor between fraud and error is whether the underlying action is intentional or unintentional for example, the following actions amount to error and not fraud :

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts: and
- A mistake in the application of accounting principles relating to measurement, recognition, Classification, presentation or disclosure.

6.03.02 The meaning and nature of Fraud can be understood by referring to the following definitions.

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

6.03.03 Fraud involving one or more members of management or those charged with governance is referred to as “management fraud”. Fraud involving only employees of the entity is referred to as “employee fraud.” In either case, there may be collusion within the audited entity

or with third parties outside the audited entity.

6.03.04 Fraud has legal(criminal) connotation. Auditors do not make legal determinations of whether fraud has actually occurred. They can report suspected or presumptive fraud.

6.03.05 Ample caution needs to be exercised before terming an act as “Fraud”. For an act to come within the ambit of fraud the following elements are required to be present.

- The act is intentional on the part of one or more individuals working in collusion with each other.
- The objective of the act is to obtain or give illegal advantage in violation of the laws, rules and guidelines existing on the subject:
- An act committed in good faith, which by subsequent turn of events, proves to be incorrect or based on wrong information is not fraud.
- The advantage or benefits to an individual or a group of individuals will have to be tangible and not notional or presumptive and
- Such act would cause loss to exchequer or be against public interest.

6.03.06 **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 transaction without substances and
- Misapplication of accounting policies.

6.03.07 The mandate of Government Audit is broader than solely that of financial statement auditor and includes responsibility of verification of regularity and performance. Hence the auditor should be aware of the possibility of fraud not only in the preparation and presentation of financial statements but in other areas covered by regularity (compliance) and performance audits as well.

Considerations of materiality

6.03.08 Assessments of materiality in Government Audit may often not be restricted to risks of material misstatements in the financial statement, but comprise fraud in the context of the broader scope of Government Audit. While determining materiality levels for different audit areas, adjustments to the materiality level that may make audit more responsive to risk arising from fraud and corruption should be considered.

6.03.09 In Government auditing, it might be appropriate to set lower materiality levels than the private sector auditing to ensure higher

levels of accountability of the audited entity and various legal and regulatory requirements. The occurrence of fraud may lead to a qualification of audit opinion even when the fraud is disclosed in the financial statements.

6.03.10 Though traditionally materiality has been one of the prime factors to determine the audit priority, however, in case of fraud detection since the act is illegal, materiality assumes lower significance. Although the temptation of embezzlement of a lower amount is much less, lack of internal controls may lead to a series of misdemeanours all of small amounts.

6.03.11 Audit cannot always establish and determine whether a misrepresentation was an error or fraud. While Audit looks at records, fraud examination goes beyond audit. Hence, Audit can put red flags (an indication that further scrutiny of the items would be required) which need further investigation by appropriate agencies and reporting the result to audit.

6.04 Characteristics of corruption

6.04.01 Corruption is a complex issue. The following definitions indicate the nature of corruption.

- 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.
- Corruption is the abuse of public power for personal gain or for the benefit of a group to which one owes allegiance.

6.04.02 An act of corruption would comprise of one or more of the following elements:

- There must be at least two parties. viz., the person who offers the reward or inducement and the party accepting it;
- There must be misuse of office or position of authority for private gain;
- There is either an offer and/or acceptance of inducements.
- An attempt to solicit an offer of inducement or reward as benefit for performance of an official act;
- Any act through which public or entity property is dishonestly misappropriated;
- There may be an attempt to camouflage; and
- Corruption involves breach of trust.

6.05 Nexus between fraud and corruption

6.05.01 Corruption and fraud are not mutually exclusive. There is in most

cases anexus between the two.

- 6.05.02** 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 the entity records and reporting. Thus, fraud can directly affect the financial statements and records of the audited entity.
- 6.05.03** Quite often the efforts to misrepresent may involve the management itself. 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 to cover lapses.
- 6.05.04** One problem which corruption poses for audit is that it is linked 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 tax officer collects a bribe from an entity to provide a tax relief or where an entity pays an influential decision maker a bribe to secure a contract. In such situations, the issue of proper disclosures is involved because the corrupt practice of the illegal payment expense is normally covered up through an accounting compliance or reporting fraud.
- 6.05.05** In some cases corruption may have only a consequential and not a visible and direct effect on the accounting records. For example when the quality specifications are compromised in a supply order to benefit a supplier.
- 6.05.06** In many instances corruption does not necessarily reflect in the 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 misused by an official. Such corruption does not normally get reflected in information that comes in the purview of audit. For example, when a tax officer collects bribery to give a refund, which is lawfully due to a taxpayer. Thus, whereas the loss to the auditee is usually fairly apparent in cases of fraud in the case of corruption the corrupt employee may benefit from the act but there may not be any loss to the auditee or effect on financial information.
- 6.05.07** Both fraud and corruption are without proper authority and involve breach of trust and therefore are illegal or irregular. They also involve an element of non-transparent conduct or behavior. In fact corruption is

a special type of fraud and treated as such in many jurisdictions. In any case audit teams and officers should be well aware of the complex distinction as well as correlation between the two.

6.06 Types of fraud and corruption

There are several types of fraud and corruption. Some illustrative types (relating to contracting for goods and services) are indicated in Appendix- A

6.07 Respective Responsibilities of Management and Audit

Responsibilities of Management

6.07.01 It is the responsibility of those charged with governance of the entity to ensure oversight of management that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting effectiveness and efficiency of operations and compliance with applicable laws and regulations.

6.07.02 In relation to fraud, it is important to recognise that the responsibility for the prevention and detection of fraud and error rests primarily with the management of the audited entity through a system of internal control. The responsibility for adequate and timely disclosure of any cases of fraud and corruption rests with the management and the responsibility of ensuring reliability and results of operation must include concerns arising from risk of fraud and corruption. The management is expected to document the system established for prevention, detection, follow-up and reporting of fraud and corruption.

Responsibilities of Audit

6.07.03 Detection of fraud is not the primary objective of audit. Audit must, however evaluate and report on the adequacy and competence with which the management has discharged its responsibility in relation to prevention, detection, response and follow-up/remedial measures in relation to fraud and corruption. The auditor should make the management aware of the absence or lack of application of reliable and valid performance measures and indicators should increase the possibility of occurrence of fraud and corruption.

6.07.04 Audit should be alert to shortcomings in systems and controls that are likely to provide an environment conducive for fraud and corruption and should recommend to the management measures to improve the control environment and minimize the risk of fraud and corruption.

6.07.05 Any indication that an irregularity illegal act, fraud or error may have occurred which could have a material effect on the audit opinion should cause the auditor to extend procedures to confirm or dispel such suspicions.

6.07.06 It should be borne in mind that if a material fraud was perpetrated but not discovered in audit the conduct, of audit personnel can be called in question. Particularly if the evidence was such as would arouse suspicion in an auditor of normal prudence. Hence the audit personnel need to be aware of the possibilities of fraud at the planning stage and should be vigilant while carrying out the audit work.

6.08 Considerations of fraud in audit of financial statements.

6.08.01 During audit of financial statements, two types of internal misstatements are relevant to the auditor. *viz.*, misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

6.08.02 Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may be accomplished by the following:

- Manipulation, falsification (including forgery) or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in or intentional omission from the financial statements of events, transactions or other significant information and,
- Intentional misapplication of accounting principles relating to the amounts, classification, manner of presentation or disclosure, etc.

6.08.03 Misappropriation of assets involves the theft of an entity assets and can be perpetrated by employees as well as management.

6.08.04 The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared in all material respects in accordance with an applicable financial reporting framework. An auditor obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by fraud or error. An auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected because of such factors as, the use of judgment, the use of testing. The inherent limitations of internal control and the fact that much of the audit evidence available to the auditor is persuasive rather than conclusive in nature.

6.09 Considerations of fraud in performance audits

6.09.01 Similar considerations apply in case of performance audits. In performance audits while selecting objectives, sub-objectives and issues, the vulnerability risk to fraud and corruption should be given due consideration.

6.09.02 In the course of performance audit the effectiveness of internal controls to prevent and detect fraud and corruption should be considered as one of the audit objectives depending upon the materiality and risk analysis.

6.09.03 Where the performance audit team comes across any possible indicators of fraud, it should probe the matter further and report its findings. Some of the significant areas for scrutiny from fraud angle could be the integrity of performance information and evidence of delivery of goods and services.

6.10 Considerations of fraud in receipt audit

6.10.01 Audit should not in any way substitute itself for the revenue authorities in the performance of their statutory duties. However, auditors should satisfy themselves that the requirements of legality and regularity are observed in individual assessments and in general that the department machinery is sufficiently safeguarded against error, fraud and corruption.

6.10.02 In the audit of receipts, it would be necessary in the case of a department which is a receiver of public moneys to ascertain what arrangements (internal controls) are in place to ensure the prompt detection, investigation and prevention of irregularities, double refunds, fraudulent or forged refund vouchers or other loss of revenue through fraud, error or willful omission or negligence to levy or collect taxes or to make refunds. Auditors may also suggest appropriate improvements in the systems and procedures for prevention, detection and reporting of cases of fraud and corruption.

6.11 Considerations of fraud in audit of World Bank and other externally assisted projects

Audit is responsible for reporting to the funding agency whether the implementing agencies have carried out expenditure on the scheme in accordance with the pattern specified in the project appraisal report relating to the schemes and terms of such assistance and Government of India instructions and to identify matters relating to inadequacies in systems and control, cases of fraud or presumptive fraud, wasteful expenditure and failure of administration to take corrective action on recommendations contained in earlier report.

6.12 Professional skepticism

6.12.01 Professional skepticism is an attitude that includes a questioning mind and

acritical assessment of audit evidence. Professional skepticism requires a questioning of whether the information and audit evidence obtained suggests the existence of fraud having a material effect on audit findings/opinion.

6.12.02 Due to the characteristics of fraud the auditor's attitude of professional skepticism assumes particular importance when considering the risks of fraud having material effect. When obtaining reasonable assurance, an auditor should maintain an attitude of professional skepticism throughout the audit, consider the potential for management override of controls and recognize the fact that audit procedures that are effective for detecting error may not be appropriate in the context of an identified risk of fraud having material effect. This is notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

6.13 Fraud awareness at the audit planning stage

Risk assessment

6.13.01 The field officers should carry out an independent risk assessment and prioritize their audit planning accordingly. This should include consideration of any information received from the public or media on suspected cases of fraud and corruption. The audit plans should focus on high-risk areas.

6.13.02 Though audit cannot insure against frauds, the possibility of their occurrence should be kept in mind while preparing for and conducting audit by maintaining an attitude of professional skepticism.

6.13.03 While planning his audit the auditor should assess the risk that fraud may cause the financial statements to contain material misstatement or record material irregular transactions.

6.13.04 The auditor may keep in view that the risk of fraud and corruption could be higher in certain organisations like those involved in procurement of goods and services.

6.13.05 The auditor should have a complete understanding of the audited entity including the environment in which the entity operates, the level of internal control and the past performance of the audited entity especially previous instances of fraud and corruption.

6.13.06 Based on the risk assessment, the auditor should develop the audit objective and design audit procedures so as to have reasonable expectation of detecting and evaluating material misstatement and irregularities arising from fraud and corruption. In case of high risk audit the audit team should be

selected keeping in view the requirements of such audit.

6.13.07 The field offices should keep in view the need for flexibility in terms of budget time and expertise of the audit team particularly when fraud and corruption are suspected or discovered in the course of audit.

Identification of areas requiring attention

6.13.08 An understanding of the audited entity should enable the auditor to identify potential high-risk areas and suitably modify audit procedures and techniques. Given the complexity of transactions and refinement of audit methodologies across the globe taking expenditure as the sole criterion is simplistic and unsophisticated. The broader definition of fraud risk should cover areas of specific concern to the Government Auditor although potentially not having a material impact on the financial statements. Some of the common high risk areas illustrative are.

- contracts of service procurement (for example the fraud risk includes violation of prescribed laws and regulations concerning the procedures for inviting, receiving and processing of tenders, selection of bidders)
- inventory and asset management.
- sanctions clearances.
- programme management and performance management information:
- revenue receipts (for example incorrect valuation of goods, inadmissible duty draw back claims, misuse of exemptions and notifications regarding refund claims embezzlement through incorrect account of receipts etc.)
- cash management;
- expenditure on AC bills;
- grants (like grants-in-aid to autonomous bodies non-governmental organisations: for example the fraud risk includes violation of prescribed conditions in providing and administering grants by the Government Departments or in spending by the recipients, intentional misstatements in financial reporting in order to receive unlawful grants);
- financial statements;
- operating information(for example, the fraud risk includes overstatement/ understatement of accomplishments, progress in meeting performance goals, number of citizens served, programme improvements compliance with policies, etc irrespective of whether the possible fraud is related to the entity's (financial statements) computerized environment;
- privatization of public sector functions (for example, the fraud risk includes non-adoption of open competitive process, manipulation of bidding terms and evaluation criteria, etc) joint ventures, public-private partnerships, etc;
- any other areas involving public interface (for example the fraud risk includes fraud in exercise of public authority like issuing of regulations, permissions and concessions)

6.13.09 As the first step during the preliminary Systems Evaluation, the adequacy of

various accounting systems and procedures whether set out in the form of a manual or otherwise should be examined and the extent of check of individual transactions should be determined based on the results of such examination. This is all the more necessary since generally a sample of the transactions is checked in audit and audit personnel cannot escape responsibility if significant deficiencies in the accounting systems and procedures lead to misuse or abuse of public moneys. The concept of Systems Audit is that if an in-depth analysis of the mechanics of a system reveals that it is designed with appropriate controls, checks and balances to safeguard against errors, frauds, etc. Audit can reasonably assume without the necessity of undertaking a detailed examination of the individual events or transactions that the results produced by the system would be fairly accurate. Evaluation of the efficiency and effectiveness of any system will however require sample testing of its actual working.

6.14 Vigilance about fraud at audit execution stage

Vigilance during the course of audit

- 6.14.01** During the course of audit, the audit personnel should be vigilant and seek explanations if it comes across possible fraud indicators.
- 6.14.02** Auditors need to be alert to deviations from acceptable accounting standards including disclosure requirements particularly when there is suspicion of fraud and corruption.
- 6.14.03** The auditor may keep in view that when a fraud is conducted there is a deliberate effort to conceal the facts and distract the auditor.
- 6.14.04** Some possible fraud indicators (red flag areas) are given in Appendix-B. They are illustrative only and should not be taken as exhaustive. The audit personnel should exercise professional skepticism and professional judgment in dealing with possible fraud indicators.
- 6.14.05** It should also be recognised that failure to appreciate the significance of what appears to be a trifling irregularity may result in failure to discover an important fraud or defalcation. Therefore, notice may be taken of the cumulative effect of numerous petty errors or irregularities as being indicative of carelessness and inefficiency in the maintenance of accounts or in financial administration generally.
- 6.14.06** If no satisfactory explanations are offered and the auditor suspects that irregularities may have occurred, he should probe the matter or irregularities.

Information to be sought from the audited entity management

6.14.07 At the commencement of each audit, information about the fraud awareness and related environment should be collected from the audited entity management.

6.14.08 The information should include inter alia;

- Policy and system to prevent and detect fraud/corruption and reporting;
- System to establish accountability for fraud /corruption
- Fraud/ corruption indicators;
- Instances of fraud and corruption noticed since last audit
- Action taken on such cases including strengthening of internal control systems.
- Special areas prone to risk of fraud and corruption and
- Guidelines issued by management with regard to control of fraud and corruption.

6.15 Audit evidence

Nature of evidence

6.15.01 The auditors should clearly understand that the audit evidence obtained can be only persuasive and not conclusive. Yet the evidence in case of suspected fraud and corruption ought to be closer to conclusive. While reporting all cases of suspected fraud or corruption, they should refrain from making any judgment regarding the existence of fraud or corruption but should suggest suspected fraud/ corruption or presumptive fraud.

Some illustrative checks

6.15.02 Analytical procedures are helpful in identifying the existence of unusual transactions or events and amounts ratios and trends that might indicate matters having audit implications. When performing analytical procedures at the planning stage or during the course of audit unusual or unexpected relationships may indicate risk of fraud.

6.15.03 Fraud detection measures need to be built in the audit procedures so that during the audit the auditor can highlight a transaction for a possible fraud or identify such consistent system failures which can lead to a fraud. Some of the checks which could be applied to determine the red flag items during the course of audit are illustrated below.

- examine the use of delegation of powers particularly in vulnerable areas;
- examine the effectiveness and adequacy of internal controls in various areas'
- check for collusion between the supplier and employees/ management
- examine cases of misuse of financial powers;

- check for false statements and false claims: whether information presented to justify a transaction is incorrect and at the point of time when such information was presented the person submitting the information had access to correct information.
- examine evidence for certification split purchases collusive bidding over and under invoicing and making payments on the basis of false progress reports::
- check for loss of revenue due to evasion and/or non-accountable or receipt:
- examine for payment made for services/ supplies not received;
- seek confirmation with other related parties;
- checking of cross-linking of documents for evidence or known wrongdoing: and
- cases of misclassification etc.

Fraud specific internal controls

6.15.04 As regards fraud specific internal controls there could be two types of such controls. viz., active internal controls and passive internal controls. Examples of active internal controls can be the following:

- (i) Signatures and document countersigning procedures:
- (ii) Segregation of duties and functions:
- (iii) Physical asset control:
- (iv) Real time inventory control:
- (v) Document matching and cross linking of documents

6.15.05 Wherever the management of the audited entity makes changes and improvements in the internal control system either due to changes in its environment or as a response to previous instances of fraud and corruption such changes and improvements should be particularly studied and evaluated during audit.

6.15.06 Since complete evidence about cases of fraud and corruption may not be available to Audit, due care should be exercised in arriving at an audit conclusion. In many circumstances additional tests may have to be performed and additional evidence acquired than would normally be considered appropriate and necessary for arriving at an audit opinion.

6.15.07 Whenever a material instance of failure to comply with the applicable laws and regulations is observed the auditor should without automatically assuming the management and staffs are dishonest investigate the control failure with an appropriate degree of professional skepticism. He may also examine if the supporting evidence has been tampered in any manner or any individuals(s) could have benefited from the material violation.

6.15.08 When auditors suspect the possibility of fraud and corruption. They should establish whether it has taken place and there has been resultant effect on the financial reporting especially whether the audit certificate requires qualification. Similar considerations apply in case of performance audits where there has been effect on the

programme execution or performance reporting.

6.15.09 When auditors intend to report on fraud and corruption they should ensure the reliability of audit evidence by verifying it with source documents including third party evidence. Auditors should carefully determine how much evidence they should gather in support of audit findings. Auditors should also keep in view that the possibility that the evidence gathered by them and their findings could become the basis for legal or disciplinary proceedings.

6.15.10 In determining overall responses to address the risk of fraud the auditor should.

- a) evaluate the accounting and reporting policies used by the entity particularly those related to subjective measurements and complex transactions and
- b) Incorporate an element of unpredictability in the selection of the nature timing and extent of audit of audit procedures for example
 - performing substantive procedures on selected account balances and assertions not otherwise tested due to their materiality or risk:
 - adjusting the timing of audit procedures from that otherwise expected.
 - using different sampling methods:
 - performing audit procedures at different locations or at locations on an unannounced basis:
 - use computer assisted audit techniques to gather more evidence about data contained in significant accounts or electronic transaction files to select sample transactions from key electronic files to sort transaction with specific characteristics or to test an entire population instead of a sample:
 - design external confirmations:
 - supplement such external confirmations with inquiries of non- financial personnel in the entity:
 - performing more substantive testing at or near the period end; and
 - performing analytical procedures at a more detailed level etc.

6.15.11 The auditor may identify a risk of material misstatement due to fraud affecting a number of accounts and assertions, including asset valuation, estimates relating to specific transactions and other significant accrued liabilities. The risk may also relate

to significant changes in assumptions relating to recurring estimates. Information gathered through obtaining an understanding of the entity and its environment may assist the auditor in evaluating the reasonableness of such management estimates and underlying judgments and assumptions. A retrospective review of similar management judgments and assumptions applied in prior periods may also provide insight about the reasonableness of judgments and assumptions supporting management estimates.

6.15.12 To respond to the risk of management override of controls the auditor should design and perform audit procedures to:

- (a) test the appropriateness of journal entries and other adjustment made in the preparation of financial statements.
- (b) review accounting estimates for biases that could result in material misstatement due to fraud: and
- (c) obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business (operations) for the entity or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

Computer evidence

6.15.13 Since many records are produced by computers in the usual and ordinary course of work auditors should understand how to collect and handle those records as audit evidence. Collecting computer evidence requires careful planning and execution. Auditors should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence. Compliance with the provisions of General Financial Rules (GFRs)

6.15.14 The Audit personnel should also check compliance with the provisions of Rules 33,34,37 and 38 of the GFRs 2005 (Rules 16 to 19 and 21 of earlier GFRs) regarding.

- reporting losses or shortages of public money, departmental revenue or receipts, stamps, opium stores or other property held by or on behalf of Government irrespective of the cause of loss and manner of detection by the subordinate authority concerned to the next higher authority as well as to the Statutory Audit Officer and to the concerned Principal Accounts Officer even when such loss has been made good by the party responsible for it except cases which need not be reported under the provisions of the GFRs;
- bringing cases involving serious irregularities to the notice of Financial Adviser or Chief Accounting Authority of the Ministry or Department concerned and the Controller General of Accounts, Ministry of Finance, redrawing of amounts lost through misappropriation, defalcation, embezzlement, etc. bearing of loss to Government on account of culpability of

Government servants by the Central Government Department or State Government concerned with the transactions;

- making recovery from the erring Government officials;
- reporting of all cases involving loss of Government money arising from erroneous or irregular issue of cheques or irregular accounting of receipts will be reported to the Controller General of Accounts along with the circumstances leading to the loss to enable him to take steps to remedy defects in rules or procedures. if any connected therewith;
- reporting of losses above the prescribed value due to suspected fire theft, fraud, etc to the Police for investigation as early as possible: obtaining a formal investigation report from the Police Authorities in all cases which are referred to them;
- fixing of responsibility for loss on the concerned officers;
- prompt disposal of cases of loss at each stage of detection, reporting, write off, final disposal in cases of losses including action against delinquents and remedial measures.

6.15.15 Extracts of the provisions of these Rules have been given in Appendix-C

6.15.16 As the Rules may be amended from time to time, the auditors should ascertain the latest Rules applicable and check compliance.

6.15.17 Non-reporting of losses or shortages of public moneys departmental revenue etc as required by GFRs can be an indicator suggesting non-transparency and the presence of an element of fraud or corruption (though not conclusive).

6.15.18 Non-compliance with provisions in Rule 29 of the GFRs for endorsement of sanction to the Audit Officer could also be an indicator for fraud or corruption in some cases. The risk of non-compliance with GFRs from fraud and corruption angle should also be investigated.

6.16 IT fraud

6.16.01 IT fraud could involve the manipulation of a computer databy whatever method in order to dishonestly obtain money, property or some other advantage of value or to cause loss.

6.16.02 Computers provide opportunities for their misuse for economic or financial gains. Computer networks can be used to commit crimes from geographically far off places. Frauds committed using computers vary from complex financial frauds to the simpler

frauds where computer is only a tool to commit a crime. With some State Governments, Union Government Departments and public sector organisations going for e-commerce/ e-payment systems in a large way, possibility of electronic fraud requires attention.

- 6.16.03** IT frauds are committed by insiders, outsiders, vendors, competitors etc. Such frauds are committed by manipulation of input, output or throughput of a computer system. Fraud can also be committed by hacking into the system for causing deliberate damage.

Role of Audit in relation to IT fraud

- 6.16.04** Since many records are produced by computers in the usual and ordinary course of work, auditors should understand how to collect and handle those records as audit evidence. Collecting computer evidence requires careful planning and execution. Auditors should examine whether appropriate controls are in place in order to ensure the authenticity of computer evidence.
- 6.16.05** The steps in prevention of frauds in computerized systems involve setting up of proper access controls both physical and logical. Physical access controls ensure against unauthorized access to computerized system and logical access controls prevent unauthorized access to data and software for its use and manipulation.
- 6.16.06** For auditors the most effective tool is data enquiry analysis and reporting software. Powerful interactive software like ACL and IDEA can quickly sift through voluminous electronic data and assist in the detection and prevention of fraud in an organization. They can be used to process normal data as well as exception reports and audit trails but demand flexibility and creativity on the part of the auditor. The auditor should have capability to revise and upgrade queries based on the findings from previous queries. Besides having auditing skills, it is important that auditors have intimate knowledge of computerized system to understand the possible modes of fraud so that they can isolate all types of risk to the organisation.
- 6.16.07** Increasing use IT systems by auditee requires that the auditor should have access to reliable and verifiable system based audit trails to evaluate the internal control.

The Auditor has to be particularly aware of the audit trail of the checks and balances of IT systems of the levels of control and needs to also have a fair idea of how processing controls can be circumvented by perpetrator of fraud and how data can be accessed and manipulated. It is particularly important for auditor of the IT system to assess in his audit the level of security controls built in and if these are in tune with the sensitivity of data.

- 6.16.08** In case of fraud involving use of computer systems the audit personnel should also comply with the instructions on Information Technology Audit(IT Audit) issued by the IT Audit Wing of Headquarters Office and the Comptroller and Auditor General's Manual of Standing Orders(Audit).

6.17 Documentation

6.17.01 The auditors should collect adequate documentation which may provide evidence during subsequent enquiries investigations court cases etc.

6.17.02 The documentation should include inter alia;

- (a) The identified and assessed risks of fraud, the overall response of the auditor to the assessed risk of fraud and the nature timing and extent of audit procedures and the linkage of those procedures with the assessed risk of fraud;
- (b) The results of the audit procedures including those designed to address the risk of management override of controls;
- (c) communications about fraud made to management etc.

6.17.03 The documentation should also be capable of proving that the Audit personnel have discharged their functions with reasonable care and due diligence and should enable a review of working procedures and working papers.

6.18 Supervision and review

Supervision and review of the work of audit personnel shall be exercised in accordance with the Auditing Standards of the Comptroller and Auditor General of India and instructions issued from time to time.

6.19 Reporting

Initial reporting

6.19.01 Reports of individual cases of suspected/ presumptive fraud corruption should be addressed confidentially in the first instance to the controlling authority concerned with the approval of Group Officers. Copies may simultaneously be sent confidentially to higher authority in cases that are regarded to be so grave or serious. In the case of Controlling Officer based audits the report should be sent confidentially to the concerned Controlling Officer (with a copy to the Chief Controlling Officer concerned) whereas in the case of Drawing and Disbursing Officer based audits the report should be sent confidentially to the concerned Drawing and Disbursing Officer (with a copy to the Controlling Officer concerned).

6.19.02 The situations events that may be suggestive of fraud presumptive fraud should be highlighted in the inspection reports with a recommendation to the executive for detailed investigation and response.

6.19.03 The report of the audit party should indicate inter alia the scope of audit, main findings, total amount involved, modus operandi of the suspected fraud or the irregularity, accountability for the same and recommendations for improvement of internal control system, fraud prevention and detection measures (including changes in the systems and procedures) to safeguard against recurrence of fraud or serious financial irregularity.

6.19.04 In addition to reporting to the management of the audited entity, material/significant cases of fraud and corruption may be reported through separate confidential letters to the specified investigating agency like Central Bureau of Investigation (CBI) Central Vigilance Commission (CVC) in case of Union Government and State Vigilance Commission/LokAyukta etc in case of State Government with the approval of the Accountant General or by him/her depending upon the seriousness of the cases. In this connection the provisions of paragraphs 6.19.8 to 6.19.11 (*infra*) may also be seen.

Qualification in Audit Opinion on financial statements

6.19.05 In case of financial audit instances of possible fraud and corruption may require making qualification in the Audit Opinion on financial statements, depending upon the materiality of the audit findings. In other cases they may be reported to entity management in a special letter or in the regular inspection reports depending upon the circumstances.

6.19.06 When in the opinion of the auditor the financial statements include material fraudulent transactions or such transactions have not been adequately disclosed or the audit conducted by the auditor leads him to the inference that instance(s) of fraud and/or corruption have taken place and when the auditor has adequate evidence to support his conclusion he should qualify the audit certificate/opinion and/or ensure that his findings are adequately included in his audit report. However, the term fraud or corruption may not be used in a conclusive sense unless such action is established in a court of law.

Printing cases relating to fraud and corruption

6.19.07 Cases relating to suspected/presumptive fraud and corruption should be highlighted in the Inspection Reports, Audit Notes, etc. and also in the Audit Reports. All such cases should be printed in bold type.

Reporting to investigating agencies

6.19.08 Accountants General, Principal Directors of Audit, etc should carry out a quarterly review of the audit findings contained in the inspection reports, audit notes etc relating to different wings of their offices and bring specific material/ significant cases of suspected fraud or corruption.

6.19.09 While forwarding the Bond Copy of the Audit Reports to Headquarters the Accountant General, Principal Directors of Audit, etc should highlight in the forwarding letter the number of cases of suspected fraud and corruption together with the money value of the concerned paras included in the bond copy. All such cases should be taken up immediately after approval of the bond copy with the appropriate vigilance or investigative authorities by the Accountant General even if these cases were reported to them earlier. Such cases should be forwarded to the vigilance or

investigative authorities such as the Central Bureau of Investigation Central and State Vigilance Commissions, LokAyukta, etc through confidential letters drawing reference to earlier correspondence, if any, with additional information that these cases have been included in the CAG's Audit Report to Parliament/ State Legislature. While forwarding such cases, the Accountant General/Principal Director should also send a brief write-up of such cases with details of the names of individuals firms address etc and any other necessary information available in field offices which are not mentioned in the Audit Report as per our reporting policy. It should be clearly stated in the communication that in view of the intent of Audit to bring the matter to the notice of Parliament/Legislature, strict confidentiality should be maintained about the matter to avoid any likely breach of privilege of Parliament/ Legislature.

- 6.19.10** The communications to vigilance or investigative authorities should clearly indicate that the audit evidence is obtained from the original documents of the audited entity. They should also indicate that the audit findings are based on the test check carried out and the information and records received from the audited entity. The investigative agency should use information given by us as a lead and make their own examination of the primary/ original records which are available with the audited entity/Department.
- 6.19.11** The reporting to the vigilance or investigative authorities may be completed after approval of the bond copy without waiting for the availability of printed audit reports. While for the Audit Reports relating to State Government and Union Territories the concerned Accountant General will be the Nodal Officer. For the Audit Reports relating to Union Government the reports may be sent by the respective report controlling wings under orders of the ADAI/ DAI concerned.
- 6.19.12** In the submission note to CAG of the bond copy the number of cases of fraud and corruption included in the Draft Report should be mentioned together with the money value of concerned paras.

Past Audit Report letter to the Chief Minister

- 6.19.13** The draft of the annual post-Audit Report letter to the Chief Ministers should contain a brief mention of issues relating to fraud and corruption where such cases appear in the Audit Reports. The field Accountants General should put in place a system of monitoring paras relating to fraud corruption and a brief mention of this should be made in the annual post-audit letters to Chief Ministers. Such letters should be submitted immediately after reports are laid in the State Legislatures.

6.20 Follow-up

- 6.20.01** The field offices shall institute mechanism for recording the cases of fraud and corruption (including possible indicators of fraud and corruption) noticed during the course of audit in separate registers maintained for the purpose. Such cases should be followed up vigorously with the concerned audited entity and with higher executive authorities and should not be settled in a routine manner. All significant cases should

be followed up with the Secretary of the Administrative Department concerned.

- 6.20.02** In following up on reported cases of fraud and corruption the auditor should determine whether the necessary action is being taken with due regard to urgency that the situation demands and become aware of the changes in the systems and procedures which could be validated through subsequent audits.
- 6.20.03** The Principal Accountant General may send annual confidential letters to the Secretaries of the concerned Administrative Departments (in cases where the inspection reports, and notes etc throw a pattern of fraud across the Department) indicating the details of the important cases of suspected fraud and corruption.
- 6.20.04** It should be noted that once a matter has been referred to the investigative or vigilance agencies, the responsibility and scope of audit is to provide the information and assistance sought by them in accordance with the extant instructions. The matter may, however, be followed up through discussions in formal meetings with the investigative or vigilance agencies.

6.21 Additional instructions

Memorandum/ Certificate of Assurance to be obtained from the Audit Party

- 6.21.01** The Principal Accountant General may require the Audit Party to provide a Memorandum/ Certificate of Assurance which should include *inter alia* examination of issues relating to fraud and corruption and compliance with the provisions of this Standing Order and other applicable instructions by the Principal Accountant General supported by detailed documentation.

Database

- 6.21.02** Each field office should establish a database of fraud or corruption related audit issues for building a linkage across functional groups to identify red flag items. Change in mode of audit investigation is required to bring out system deficiencies in greater detail rather than mentioning only money value. Red flagged items should bring out the intention and failure of internal control irrespective of money value. The data base should be transparently reviewed by the Principal Accountant General every quarter for further strategy and directions to the field audit parties.

Objection Book

- 6.21.03** Cases of fraud or corruption etc should also be recorded along with cases of misappropriation defalcation etc in an Objection Book in accordance with the instructions contained in the Comptroller and Auditor General's Manual of Standing Orders(Audit) as amended from time to time.

Skill development

- 6.21.04** The field offices should have an adequate inventory of skills to deal with cases of fraud and corruption and for this purpose arrange for training of their officials at the Regional Training Centres/ Institutes .

Developing sector specific guidelines checklists.

- 6.21.05** Accountants General should develop sector specific guidelines/ checklists to deal with cases of fraud and corruption in the audit of entities belonging to specific sectors for the guidance of the field staff deployed in such audits and furnish a copy of such guidelines checklists to Director General (Audit).

Reporting to Headquarters

- 6.21.06** The field offices should send half yearly reports on cases of suspected material fraud and corruption noticed by them to the Headquarters Office.
- 6.21.07** In view of the ongoing rationalization process of Management Information System (MIS) the half yearly reports may be sent electronically or placed on local intranet in such manner as may be prescribed upon completion of the rationalization of MIS.
- 6.21.08** The existing provisions in the Manual of Standing Orders (Audit) relating to reports on defalcation or loss of public money or property and action to be taken thereon shall continue to be in force.

Appendix-A

(Referred to in Paragraph 6.06)

Illustrative fraud and corruption in contracting for goods and services

Bribery and Kickbacks -Money or any other form of reward or favour is exchanged between a public functionary and a provider of goods and services in order to obtain some benefit e.g. acceptance of substandard goods or obtaining unauthorized information.

Changes in Original Contracts - Changes are made in the original contract requiring flow of additional funds from the government to the contractor or supplier which may affect the basis on which the contract was awarded to the contractor or supplier in the first instance. This may also involve front-loading of contract in the hope of increasing the price of the original contract through change orders or subsequent modifications to the contract.

Duplicate Payments -The contractor or supplier claims and receives payment for the same service or work done or goods supplied under the same or different contracts.

Collusive or Cartel Bidding - Contractors or suppliers form cartels to fix artificially high prices for goods and services supplied by them.

Conflict of Interest -Contracts are awarded on the basis of vested interests of the decision makers.

Defective Pricing -The contractor or supplier submits inflated invoices.

False Invoices - The contractor or supplier submits invoices for goods that have not been delivered or do not properly represent the quantity or quality of goods and services supplied or work done as per contracted specifications.

False Representations - The contractor falsifies the goods specification or his ability to provide certain services.

Splitting of Purchases - The purchases of goods and services are split either to avoid open competition or having to seek the approval of higher authority.

Phantom Contractor - Purchase are made from a fake supplier or contractor.

Pilferage of Public Assets - Public funds are used to acquire goods for personal use or public assets pilfered by officials.

Tailored Specifications -Specification and time limits are manipulated to favour ascertain contractor or supplier.

Supply Orders - in excess of or without the requirement/ need and much ahead of the actual requirement

Appendix-B

Some indicators (red flags) for possible fraud and corruption (illustrative) Procurement and contracting of goods and services. Requirements defining stage:

- Inadequate needs analysis;
- Inadequate information about potential suppliers;
- Inadequate review of existing and required inventory;
- Unduly short supply period;
- Needs analysis is product centric rather than needs oriented;
- Someone other than the user defines the user requirements; and
- Unwarranted involvement of senior officials.

Bidding and selection stage;

- The specifications are not clearly defined;
- A very limited number of offers is received;
- Documentation indicates unusual involvement of an official;
- Suspicion about conflict of interest;
- Evidence of early receipt of information by some contractors or suppliers;
- Request for proposal is not properly advertised;
- Unusual handling of the bidding process;
- Evaluation criteria is not consistent for different offerors;
- Exceptions to the tender deadlines;
- Changes in the bids made after their formal receipt;
- Lowest responsive bidder is not selected;
- Contractor or supplier submits unrealistic bid indicating collusion or bid rotation;
- Unusual withdrawal of bids;
- Re-bid results identical to original bids;

- Successful contractors or suppliers use competitors as sub- contractors or sub-suppliers; and
- Justification for single source procurement is inadequate. etc

Contract performance and evaluation stage:

- Changes in a contract result in the large increase in the cost of goods and services;
- Changes made without adequate explanations;
- Unwarranted contract extension;
- Complaints about the quality of goods and services received;
- Inadequate inspections and quality assurance of goods and services received;
- Evidence of overcharging and duplicate billings;
- Dubious invoices;
- Insufficient pre-audit of contractor payments;
- Contracts repeatedly awarded to one contractor; and
- Unduly high labour payments etc.

Accounting records

- Missing vouchers;
- Production of photocopies of documents instead of originals;
- Alterations and erasures in accounting records;
- Any unusual accounting entries;
- Discrepancies between control accounts and subsidiary records;
- Discrepancies between predicted figures and actual figures during analytical review procedures; and
- Employees in sensitive posts not taking leave etc.

Performance Information

- Performance information about delivery of goods/ services, assets creation etc. not supported by original documents and downstream data;
- Theoretical calculations not supported by actual measurements, muster rolls, inspection notes, quality reports, etc.
- Non-production of basic records *viz.* asset register, muster roll, measurement books, etc.
- Non-availability of transparent evidence of expenditure and receipts into Government Account; and
- Inconsistency between financial and physical information about progress of scheme/ work.

(Note- These are only illustrative examples. Principal Accountants General may please prepare a comprehensive list of 'Red flag' items in audit of various Department/ sectors and establish procedures to ensure that such items are reckoned while planning the audits, transparently documented and evidence of addressing all such items and their treatment are recorded and retained).

Appendix-C

(Referred to in Paragraph 6.15.15)

Extracts from the Provisions of General Financial Rules, 2005

Rule 33. Report of Losses:

(1) Any loss or shortage of public moneys, departmental revenue or receipts, stamps, opium stores or other property held by or on behalf of Government irrespective of the cause of loss and manner of detection shall be immediately reported by the subordinate authority concerned to the next higher authority as well as to the Statutory Audit Officer and to the concerned Principal Accounts Officer even when such loss has been made good by the party responsible for it. However the following losses need not be reported;

(i) Cases involving losses of revenue due to-

(a) mistake in assessments which are discovered too late to permit a supplementary claim being made.

(b) under assessments which are due to interpretation of the law by the local authority being overruled by higher authority after the expiry of the time-limit prescribed under the law and

(c) refunds allowed on the ground that the claims were time barred:

(ii) Petty losses of value not exceeding Rupees two thousand.

(2) Cases involving serious irregularities shall be brought to the notice of Financial Adviser or Chief Accounting Authority of the Ministry or Department concerned and the Controller General of Accounts, Ministry of Finance.

(3) Report of loss contemplated in sub-rule(1) & (2) shall be made at two stages-

(i) An initial report should be made as soon as a suspicion arises that a loss has taken place.

(ii) The final report should be sent to authorities in sub rule(1) & (2) after investigation indicating nature and extent of loss, errors or neglect of rules by which the loss has been caused and the prospects of recovery.

(4) The Complete report contemplated in sub-rule(3) shall reach through proper channels to the Head of the Department who shall finally dispose of the same under the powers delegated to him under the Delegation of Financial Power Rules, 1978. The reports which he cannot finally dispose of under the delegated powers shall be submitted to the Government.

- (5) An amount lost through misappropriation, defalcation, embezzlement etc may be redrawn on a simple receipt pending investigation recovery or write off with the approval of the authority competent to write-off the loss in question.
- (6) In cases of loss to Government on account of culpability of Government servants, the loss should be borne by the Central Government Department or State Government concerned with the transaction. Similarly, if any recoveries are made from the erring Government officials in cash, the receipt will be credited to the Central Government Department or the State Government who sustained the loss.
- (7) All cases involving loss of Government money arising from erroneous or irregular issue of cheques or irregular accounting or receipts will be reported to the Controller General of Accounts along with the circumstances leading to the loss, so that he can take steps to remedy defects in rules or procedures, if any, connected therewith.

Rule 34. Loss of Government property due to fire theft, fraud : Departmental Officers shall in addition to taking action as prescribed in Rule 33, follow the provisions indicated below in cases involving material loss or destruction of Government property as a result of fire, theft, fraud etc.

All losses above the value of Rupees ten thousand due to suspected fire, theft, fraud etc. shall be invariably reported to the Police for investigation as early as possible.

Once the matter is reported to the Police Authorities, all concerned should assist the Police in their investigation. A formal investigation report should be obtained from the Police Authorities in all cases which are referred to them.

Rule 37. responsibility for Losses: An officer shall be held personally responsible for any loss sustained by the Government through fraud or negligence on his part. He will also be held personally responsible for any loss arising from fraud or negligence of any other officer to the extent to which it may be shown that he contributed to the loss by his own action or negligence. The departmental proceedings for assessment of responsibility for the loss shall be conducted according to the instructions contained in Appendix 1 and those issued by the Ministry of Personnel from time to time.

Rule 38. prompt disposal of cases of loss: Action at each stage of detection reporting write off final disposal in cases of losses including action against delinquents and remedial measures should be completed promptly with special attention to action against delinquents and remedial measures taken to strengthen the control system.

(Note:-The corresponding provisions in the earlier General Financial Rules are Rules 16, 17, 18, 19 and 21 which should be checked for compliance in relevant cases.)

Appendix-1

Instructions for regulating the enforcement of responsibility for losses, etc.

1. The cardinal principle governing the assessment of responsibility is that every Government officer should exercise the same vigilance in respect of expenditure from public fund generally as a person of ordinary prudence would exercise in respect of the expenditure and the custody of his own money. While the competent authority may in special cases condone an officer's honest errors of judgement involving financial loss if the officer can show that he has acted in good faith and done his best up to the limits of his ability and experience. Personnel liability shall be strictly enforced against all officers who are dishonest, careless or negligent in the duties entrusted to them.

2. In cases where loss is due to delinquencies of subordinate officials and where it appears that this has been facilitated by laxity of supervision on the part of a superior Officer, the latter shall also be called strictly to account and his personal liability in the matter carefully assessed.

3. (a) The question of enforcing pecuniary liability shall always be considered as well as the question of other forms of disciplinary action. In deciding the degree of an officer's pecuniary liability it will be necessary to look not only to the circumstances of the case but also to the financial circumstances of the officer since it should be recognized that the penalty should not be such as to impair his Future efficiency.

(b) In particular if the loss has occurred through fraud, every endeavor should be made to recover the whole amount lost from the guilty persons and if laxity of supervision has facilitated the fraud the supervising officer at fault may properly be penalized either directly by requiring him to make good in money a sufficient proportion of the loss or indirectly by reduction or stoppage of his increments of pay.

(c) It should always be considered whether the depreciated value of the Government property or equipment lost, damaged or destroyed by the carelessness of individuals entrusted with their care should be recovered from the delinquent official. The depreciated value of the stores may be calculated by applying the depreciation at the rate of 20 per cent in the case of vehicles including cycles and 15 per cent in the case of calculating machines on the reduced balance every year. The amount to be recovered may be limited to the Government servant's capacity to pay.

4. When a pensionable Government servant is concerned in any irregularity or loss the authority investigating the case shall bear in mind the provisions contained in Central Civil Services (Pension) Rules 1972 as amended from time to time and immediately inform the Audit Officer and or the Accounts Officer as the case may be responsible for reporting on his title to Pension or Death-Cum-Retirement Gratuity and the authority competent to sanction pension or Death-Cum-Retirement Gratuity and it will be the duty of the latter to make a note of the information and see that the Gratuity or Death-Cum-Retirement Gratuity is not paid before a conclusion is arrived at as regards the Government servant's culpability and final orders are issued thereon.

5. The fact that Government servants who were guilty of frauds or irregularities have been demobilized or have retired and have thus escaped punishment should not be made a justification for absorbing those who are also guilty but who still remain in service.

6. It is of the greatest importance to avoid delay in the investigation of any loss due to fraud, negligence, financial irregularity etc. Should the administrative authority require the assistance of the Audit Officer in pursuing the investigation, he may call on that officer for all vouchers and other documents that may be relevant to the investigation and if the investigation is complex and he needs the assistance of an expert Audit Officer to unravel it, he should apply forthwith for that assistance to Government which will then negotiate with Audit Officer concerned for the services of an investigating staff. Thereafter the administrative authority and the Audit authority shall be personally responsible within their respective spheres for the expeditious conduct of the enquiry. In any case in which it appears that recourse to judicial proceedings is likely, the Special Police Establishment or the State Police should be associated with the investigation .

7. Depending upon the results of the inquiry departmental proceedings and/or prosecution shall be instituted at the earliest moment against the delinquent officials concerned and conducted with strict adherence to the Central Civil Services (Classification Control and Appeal) Rules and other instructions prescribed in this regard by Government.

(Authority: vide CAG's circular No. 126/Audit (AP)/1-2006 dated 6.9.2006)