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NSW INDEPENDENT COMMISSION  
AGAINST CORRUPTION

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**Dealing with Corruption,  
Fraud and the ICAC:  
the role of public sector Audit  
and Risk Committees**

September 2020

# Introduction

The purpose of this guidance by the NSW Independent Commission Against Corruption (“the Commission”) is to describe the role that NSW public sector Audit and Risk Committees (ARCs)<sup>1</sup> should play in managing the risk of fraud and corruption.

It should be read in conjunction with other guidelines and policies dealing with corruption prevention, fraud control, internal auditing and risk management and the conduct of ARCs; in particular, NSW Treasury’s *Internal Audit and Risk Management Policy for the NSW Public Sector* (TPP 15-03). Importantly, this is not a guide on how to manage the risk of fraud and corruption. Rather, it sets out the Commission’s views on where an ARC can fit within an agency’s overall integrity framework.

This guidance is intended to assist NSW public sector ARC chairs and members, as well as agency staff who support or advise ARCs. It explains how ARCs can safeguard integrity and control fraud and corruption through monitoring, reviewing and providing advice about an agency’s:

- fraud and corruption control framework
- investigations of suspected fraud and corruption
- internal audits
- risk management
- outsourced activities and supply chains
- external audit
- management of probity.

## The importance of independence and objectivity

As noted in TPP 15-03, independence and objectivity are essential for an ARC. According to the Association of Certified Fraud Examiners’ *2020 Report to the Nations*, having an independent audit committee is associated with a 33% reduction in the median cost of fraud.<sup>2</sup>

In an integrity context, the requirement for an ARC to be independent and objective is especially important because:

- managers can find it difficult to imagine corrupt conduct occurring within their business units, which might lead to the level of fraud and corruption risk being underestimated
- instances of corrupt conduct (or “near misses”) can be embarrassing for management. This might prompt under-reporting and a failure to take corrective action

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<sup>1</sup> Local councils use the term “Audit, Risk and Improvement Committee” or ARIC. For local government readers, a reference to an ARC in this publication can be read as a reference to an ARIC.

<sup>2</sup> Association of Certified Fraud Examiners, *Report to the Nations 2020 global study on occupational fraud and abuse*, 2020 . Viewed on 30 April 2020 from <https://www.acfe.com/report-to-the-nations/2020/>

- dealing with whistleblowers or evidence of misconduct can be mishandled by managers with a vested interest in minimising negative reports
- management can, at times, cause or participate in corrupt conduct. Managers may undermine ARCs by seeking to redirect their attention to less problematic areas of the agency to avoid scrutiny. They may attempt to mislead the ARC or try to alter the scope of an audit, as shown in case study 1.

#### **Case study 1: Management undermining the independence of internal audit**

In the Commission's Operation Ricco investigation, the chief financial officer (CFO) of a council allowed \$5 million worth of false and inflated invoices to be paid and misused the general manager's credit card to incur personal expenditure in excess of \$600,000.<sup>3</sup>

One reason why internal audit was unable to detect this wrongdoing was because the deputy general manager, who was a close friend and former romantic partner of the CFO, compromised the independence of internal audit.

She was aware that the CFO was misusing his financial position for his own benefit. She restricted the scope of audits and directed internal audit not to examine the financial aspects of the areas being audited. This limited internal audit's ability to detect the CFO's conduct. The Commission found:

*With financial transactions and associated financial loss representing one of the predominant risks faced by a council, this direction significantly impaired the effectiveness of the internal audit function.<sup>4</sup>*

Internal audit was also not independent of management because the internal auditor reported administratively and functionally to the deputy general manager rather than the ARC. This represented a conflict of interest because the deputy general manager was responsible for several business areas that were within internal audit's scope. In addition, the deputy general manager was responsible for the internal auditor's employment. The deputy general manager had considerable influence over the internal audit function, as she also selected which business areas would be audited from the council's internal audit plan, and directed the internal auditor to perform additional audits that were not on the plan.

The deputy general manager controlled the flow of information from internal audit to the ARC. She attended all ARC meetings and presented on internal audit's behalf and she read all internal audit reports before they were released to the ARC. This ensured that internal audit did not have a direct or independent reporting line to the ARC.

<sup>3</sup> NSW Independent Commission Against Corruption, *Investigation into the conduct of the former city of Botany Bay council chief financial officer and others* (Operation Ricco), July 2017.

<sup>4</sup> Ibid p. 76.

# A fraud and corruption control framework

Under the NSW Fraud and Corruption Control Policy (“the Policy”), all NSW public sector agencies are required to have a fraud and corruption control framework.<sup>5</sup> The Commission recommends that agencies not covered by the Policy, such as universities, local councils and state-owned corporations, ensure that they also have a sound fraud and corruption control framework.

According to the Policy, as a minimum, a fraud and corruption control framework includes:

- a fraud and corruption control policy
- clearly defined responsibilities for managing fraud and corruption
- risk-based preventative and detective controls
- policies, systems and processes to respond to, investigate and report suspected fraud and corruption
- employee awareness/education measures
- robust third-party management systems
- regular review of the fraud and corruption control framework and reporting.<sup>6</sup>

ARCs should play a role in assisting agencies to adhere to these minimum standards. In particular, the ARC plays a critical role by participating in the “regular review of the fraud and corruption control framework” and TPP 15-03 notes that ARCs should “review the agency’s fraud control plan and be satisfied that the agency has appropriate processes and systems in place”.

This review should entail at least an annual report from the officer or unit with primary responsibility for the framework. The Commission recommends that ARCs turn their attention to the real achievement of integrity objectives rather than “paper programs” that give the impression of good governance.

Agencies should also periodically audit their framework. The frequency of such an audit should align to audits of other risk frameworks. ARCs should also consider the need for deep dive reviews of parts of the framework, such as conflict of interest or gift and benefit procedures.

Integrity agencies such as the Commission periodically issue corruption prevention reports and guidance intended to assist agencies to maintain a sound fraud and corruption control framework. While ARC members are not responsible for implementing control improvements, it is recommended that the ARC obtain assurance that specialist areas, such as procurement or risk management have applied any applicable lessons. Similarly, the ARC can provide advice to the

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<sup>5</sup> Treasury Circular, 6 April 2018, TC 18-02 *NSW Fraud and Corruption Control Policy*.

<sup>6</sup> *Ibid.*

agency head<sup>7</sup> concerning the need for alignment with Commission and other better practice guidance.

### Summary – Fraud and corruption control

ARCs should obtain assurance that:

- a fraud and corruption control framework is in place that meets or exceeds the minimum requirement in the **NSW Fraud and Corruption Control Policy**
- the fraud and corruption control framework is periodically audited and kept under review
- the Commission’s applicable guidance and other better practice measures have been implemented.

**The topics below address some discrete issues that agencies should address as part of their overall framework.**

## Responding to suspected fraud and corruption

A fraud and corruption control framework includes having a robust complaint handling process. ARCs play an important role in assisting agencies to maintain policies and procedures for receiving and managing complaints. This includes compliance with the *Public Interest Disclosures Act 1994* (“the PID Act”).<sup>8</sup> In order to maintain independence, the Commission does not recommend that individual ARC members be designated as complaint handlers by their agency.

While not all complaints warrant further action, each public sector agency should be capable of investigating alleged fraud and corruption using either internal resources and/or by engaging an external expert.

ARCs can play an important role by assisting agency heads to maintain high quality investigations. Good practice is to ensure that a senior officer such as the chief audit executive (CAE), general counsel, investigations manager, conduct manager or an internal ombudsman is responsible for quality control of investigations and has reviewed investigation reports, including those prepared by external investigators. All investigators should be qualified and experienced.

As set out in Table 1 below, the ARC should not take control of individual investigations. It is, however, reasonable for ARCs to monitor broad trends in the agency’s complaint profile and

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<sup>7</sup> Also generally known as the “accountable authority” under the *Government Sector Finance Act 2018* or the “principal officer” under the *Independent Commission Against Corruption Act 1988* (“the ICAC Act”).

<sup>8</sup> See, NSW Ombudsman, Evaluation of policy, processes and practices, March 2015

[http://ombo.nsw.gov.au/\\_data/assets/pdf\\_file/0010/8479/Guideline\\_A4\\_Evaluation-of-policy\\_web.pdf](http://ombo.nsw.gov.au/_data/assets/pdf_file/0010/8479/Guideline_A4_Evaluation-of-policy_web.pdf)

investigative/disciplinary outcomes. ARCs can also give advice about the need for any internal controls improvements that arise from investigative work.

Ideally, the officer with responsibility for an agency's investigative function should also manage (or be involved in) liaison with the Commission's assessments and investigative divisions. This helps to manage the risk that a Commission investigation, which may involve covert procedures, could be compromised.

## Reporting matters to the Commission

Under s 11 of the ICAC Act, the "principal officer" of each public agency, "is under a duty to report to the Commission any matter that the person suspects on reasonable grounds concerns or may concern corrupt conduct".

Clearly, the chair of a public sector ARC is not the "principal officer" of an agency, nor are any of the ARC members. As a general rule, ARCs should not get involved in monitoring the way the principal officer exercises their s 11 obligations with regard to individual matters. However, an ARC can give advice about an agency's overall internal reporting and complaint management practices.

However, similar to any other person or public official, ARC members can report suspected corrupt conduct to the Commission and they are encouraged to do so if they believe a matter has not been properly addressed by the agency.

As ARC members carry out public duties, their own conduct falls within the Commission's jurisdiction. In addition, ARC members are public officials for the purposes of the PID Act and any properly made complaints about corrupt conduct are covered by the protections in that legislation.

Sometimes the Commission may need to make enquiries with the ARC chair or an ARC member; for example, this may occur when there are allegations about the head of an agency.

## Overview – Investigations of suspected fraud and corruption

**Table 1: public sector ARC responsibilities in relation to complaints handling and investigations**

Do	Don't
<ul style="list-style-type: none"> <li>• Monitor the agency's framework for receiving, assessing and investigating complaints about fraud, corruption and other forms of misconduct. This should include compliance with the PID Act and reporting obligations to the NSW Ombudsman</li> <li>• Seek assurance from the agency head and/or the CAE that investigative work is subject to quality control measures, carried out by properly trained/qualified staff and is in accordance with principles of procedural fairness</li> <li>• Monitor broad trends in the agency's complaint profile and investigative/disciplinary outcomes</li> <li>• Seek assurance about the implementation of control improvements and corruption prevention measures arising from investigations</li> <li>• Consider relevant lessons learned from investigations affecting other agencies (including Commission investigation reports)</li> <li>• Assist the Commission with any enquiries that it may initiate with the ARC</li> </ul>	<ul style="list-style-type: none"> <li>• Act as a complaint handler for the agency</li> <li>• Direct the agency head in relation to when and how to report matters to the Commission under s 11 of the ICAC Act (if ARC members are uncomfortable about a possible failure to report a matter, they are free to report it direct to the Commission themselves)</li> <li>• Require a day-to-day update on matters that are under investigation or being assessed</li> <li>• Get involved in conducting individual investigations or disciplinary matters</li> </ul>

## Internal audit

By its nature, internal auditing helps to prevent and detect fraud and corruption and competent auditors have regard to the risk of fraud and corruption<sup>9</sup>. The Association of Certified Fraud

<sup>9</sup> The *International Standards for the Professional Practice of Internal Auditing* (2017), published by the Institute of Internal Auditors, makes numerous references to fraud and states: "internal audit activity must evaluate the potential for the occurrence of fraud and how the organisation managed fraud".

Examiners study found that the presence of an internal audit unit is associated with a 50% reduction in median fraud losses.<sup>10</sup>

## Internal audits should cover three key areas

Internal audits should adequately cover (1) strategic matters, (2) operational activities and (3) projects. Organisations are more exposed to fraud and corruption when the focus on these areas is inadequate. In particular, the ARC should seek assurance that high-risk projects are included in the audit program.

In addition, corruption in procurement and purchasing is an area that is sometimes underestimated and therefore under-audited.

## Addressing fraud and corruption risk

Internal auditors know their work should be risk based, which includes having regard to the risk of fraud and corruption. This applies both in the preparation of the annual internal audit plan and the conduct of individual audits.

Most individuals who engage in corrupt conduct put some effort into planning their activities to avoid detection by management and auditors. A corrupt official is also likely to mislead an auditor. Consequently, audits that are designed to address the risk of fraud and corruption should:

- identify specific transactions, or patterns of transactions, that are non-compliant
- test the specific controls that purport to prevent and detect corrupt conduct. This can include “pressure testing”, where a simulated non-compliance is initiated and the internal audit determines whether controls operate as intended. If carefully planned, this can provide useful evidence of whether the organisation is resistant to fraud and corruption
- consider the need for additional/amended controls
- explore the rationale for any non-compliance or exploitation of loopholes.

## Visibility of other assurance work

Sometimes operational managers engage an external third party to review internal controls or otherwise provide assurance services. Conceptually, this is different from the work of the internal audit unit and some agencies encompass this “other” assurance work under a “three lines of defence” or “combined assurance” model.

While it may not be practical for all of an agency’s assurance activities to be centrally administered and reported in detail to the ARC, the Commission’s view is that opportunities for fraud and corruption are minimised if assurance activities across the agency are coordinated wherever possible. ARCs can provide advice about how this can be achieved and can also play a role in identifying assurance gaps where key anti-fraud and corruption controls have not been audited or reviewed.

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<sup>10</sup> Association of Certified Fraud Examiners, Op. Cit., p. 33.



Despite the Treasury guidelines requiring agencies to retain ownership of working papers of audits conducted by third-party auditors, this is not always done.<sup>11</sup> This can leave gaps in the audit assurance framework and raise doubts about the quality of the internal audit.

### Summary – Internal audit

ARCs should assist agency heads to ensure that:

- internal audits adequately cover key strategic, operational and project activities
- the audit plan addresses key integrity, fraud and corruption risks
- internal audits address integrity issues, including by testing the controls that purport to control corrupt conduct
- fraud and corruption-related audit recommendations are implemented by management
- assurance work that is performed across the agency is coordinated
- working papers produced by third-party auditors are owned by and accessible to the agency.

## Risk management

A key responsibility of the ARC is to assist the agency head to ensure that fraud and corruption risks are periodically assessed and continually managed. Formal periodic assessments of fraud and corruption risks are essential, whether undertaken separately or as part of a general risk assessment.

Unfortunately, sometimes risk assessments are reduced to a copy and paste of previous efforts. This weakens the effectiveness of any fraud and corruption prevention controls. In addition, better practice risk registers contain specific information about how fraud and corruption risks are, or will, be mitigated. For example, to address the specific risk of fraudulent invoice payments, possible risk mitigation strategies include:

- verifying the details of new suppliers to ensure that only genuine vendors are added
- using audit logs to monitor any changes to the vendor master file
- specifying segregations of duty
- performing a three-way match between the purchase order, invoice and receipt of goods or services.<sup>12</sup>

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<sup>11</sup> Treasury, Internal Audit and Risk Management Policy for the NSW Public Sector, TPP 15-03, July 2015, which states: “All internal audit documentation is to remain the property of, and able to be accessed by, the audited agency, including where the internal audit services are performed by an external third party provider”.

<sup>12</sup> For more information about controlling invoice payments, see NSW Independent Commission Against Corruption, *Safeguarding public money: the importance of controlling invoice payments*, November 2014.

With respect to fraud and corruption risks, the ARC can also provide advice about:

- risk ratings and the need for improved risk treatments
- adherence to the principles outlined in AS ISO 31000: 2018 *Risk Management – Guidelines*
- any fraud and corruption risk management treatments that have not been implemented
- programs that promote a culture of integrity and ethical conduct
- relevant risk tolerances for the agency.

It is also important to ensure that fraud and corruption prevention controls take into account operational processes so that they do not unnecessarily hinder the efficient functioning of the agency.

### Summary – Risk management

ARCs should assist agency heads to ensure that:

- the risk of fraud and corruption is assessed and managed in accordance with AS ISO 31000: 2018 and applicable guidelines
- proposed fraud and risk treatments are implemented
- risk management methodologies and registers adequately cover the agency's fraud and corruption risks
- measures are in place that promote a culture of integrity and ethical conduct
- where relevant, the risk of fraud and corruption is managed within the agency's stated risk tolerance.

## Outsourced activities and supply chains

ARCs should understand that when a public sector function is outsourced, the risk of corrupt conduct (including the reputational impact of corruption) remains with the agency. Consequently, a fraud and corruption control framework should have regard to activities that have been outsourced. ARCs can seek assurance and give advice about fraud and corruption controls and obligations that should be specified in contracts (which should extend to key subcontractors where appropriate).

In practice, ARCs can assist agency heads to ensure that:

- due diligence is performed on key contractors
- contracts contain right-to-audit clauses and, where relevant, the results of those audits are conveyed to the ARC
- the agency has a statement of business ethics or similar document that sets out the behaviour expected of contractors
- conflicts of interests are disclosed and managed and third parties refrain from offering gifts

- where necessary, contractors provide assurance about their own fraud and corruption control framework, which might, for example, require alignment to the agency's framework or published better practice.

## External audit

An agency's fraud and corruption control framework involves ensuring that the external auditor provides information to the ARC about:

- any suspected fraud and corruption
- control weaknesses that could allow, encourage or cause fraud and corruption
- limitations imposed on the auditor
- the achievement of the agency's other integrity objectives.

As shown in case study 2, it can be difficult to detect and respond to corruption when there is a breakdown in communication between external audit and the ARC.

### **Case study 2: External audit failing to provide information to the ARC**

In the Commission's Operation Ricco investigation,<sup>13</sup> management letters prepared by the external auditor revealed several serious and systemic control failings with the council's accounting systems.

These letters identified a lack of adherence to basic procurement and accounting processes and controls. While the management letters were sent to the general manager, they were not provided to the ARC. In addition, the ARC did not ask for these letters.

The management letters should have been independently sent to the ARC chair, the ARC work plan should have required its tabling, and the ARC should have had private meetings with external audit without the presence of management.

## Management of probity

Agencies often engage internal staff or external experts to assess and advise on the probity of key projects and transactions. Sometimes these probity engagements take the form of a formal audit, in which case, it is preferable that they be commissioned by the CAE.

But irrespective of whether or not probity engagements take the form of an audit, it is generally not the role of the ARC to review reports about the probity of individual matters. This is primarily because the ARC is not responsible for approving projects and transactions.

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<sup>13</sup> NSW Independent Commission Against Corruption, *Investigation into the conduct of the former city of Botany Bay council chief financial officer and others* (Operation Ricco), July 2017.

However, an agency's approach to managing probity should form part of its overall fraud and corruption control plan and ARCs can therefore play a useful role by:

- seeking assurance about policies and procedures for engaging and scoping probity work and ensuring the independence of personnel performing probity work
- monitoring trends or patterns in probity issues, possibly based on summary reports from the CAE
- reviewing instances where probity recommendations or advice were not followed by management
- monitoring any situation where a probity auditor/reviewer was removed, or a written report was not furnished.

## Further assistance

The Commission's corruption prevention staff are available to advise any public sector ARC or ARC member requiring information about controlling fraud and corruption. Telephone 02 8281 5999 or 1800 463 909, or email [icac@icac.nsw.gov.au](mailto:icac@icac.nsw.gov.au).