



Office of the Auditor General of Canada  
Bureau du vérificateur général du Canada

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# **Wrongdoing and Fraud Risks**

## A Guide for Performance Audits and Special Examinations

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## Introduction

### Purpose of guide

This audit guide is intended to raise auditors' awareness of wrongdoing and fraud in government operations and programs. This guide also encourages auditors to take appropriate action in response to evidence of wrongdoing and fraud when conducting audits. In particular, this guide has been developed to

- help auditors assess the risks of wrongdoing and fraud;
- help auditors detect possible incidents of wrongdoing and fraud; and
- suggest actions to take when auditors suspect wrongdoing and fraud, including when to consult the Internal Specialist.

This guide can be used in making informed decisions about selecting audits (s. 1510 of PA manual) and/or in making risk-based planning and scoping decisions (s. 41010 and S.40402).

### Applicability and audience of the guide

This guide is applicable to Performance Audits and Special Examinations. Its intended audience is engagement leaders and their respective OAG teams.

### Auditor's responsibilities

The auditor's responsibilities are to identify and evaluate the risk of fraud where the risk is significant. The auditor must also determine audit procedures in response to those risks.

The auditor needs to maintain a professional skepticism during the planning phase and during the entire audit because, typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the entity.

When conducting audits, the auditor should maintain an awareness of the possibility of wrongdoing and fraud in the entity's sector of activity. The auditor should be aware of the common types of wrongdoing and fraud in the sector and should also be aware of the fraud indicators.

Audit standards require

- that the engagement leader (principal) and the team have adequate knowledge of the subject matter, and that they assess risks. At the beginning

- of the audit, the audit team conducts research to gain an understanding of the entity and the subject matter of the audit and evaluate the risks, including the risks of fraud;
- that the engagement leader informs the engagement team about important matters—these matters include fraud risks;
  - that the engagement leader determines audit responses to engagement risks including the fraud risks; and
  - that the engagement leader consults and has adequate knowledge of wrongdoing and fraud. This means knowing in what situations the involvement of the Wrongdoing and Fraud Internal Specialist is required and what his/her specific involvement should be for each situation.

[Appendix A](#) lists the specific CPA Canada Assurance standards from which these requirements are derived.

## Background and context

### What is wrongdoing and fraud?

<p><b>Wrongdoing</b></p>	<p>Wrongdoing is defined as improper conduct or inappropriate activities, such as</p> <ul style="list-style-type: none"> <li>• abusing or exceeding authority,</li> <li>• conflicts of interest,</li> <li>• gross administrative abuse,</li> <li>• improper contract or contribution awards,</li> <li>• intentional non-compliance with authorities,</li> <li>• misuse of funds or assets, and</li> <li>• unethical behaviour.</li> </ul> <p>Wrongdoing does not include matters that are solely issues of economy, efficiency, and effectiveness, nor solely matters of the environment and sustainable development.</p>
<p><b>Fraud</b></p>	<p>Fraud is defined as an intentional act by one or more individuals among employees, management, those charged with governance, or third parties involving the use of deception to obtain an unjust or illegal advantage, such as</p> <ul style="list-style-type: none"> <li>• breach of trust,</li> <li>• collusive awarding of grants and contributions,</li> <li>• collusive bidding or awarding on contracts,</li> <li>• deceit,</li> <li>• dishonest acts,</li> <li>• false representation,</li> <li>• fraudulent concealment,</li> </ul>

	<ul style="list-style-type: none"><li>• illegal acts of a similar nature,</li><li>• intentional misstatements,</li><li>• irregularities,</li><li>• kickbacks,</li><li>• secret commissions, and</li><li>• theft.</li></ul> <p>The primary factor that distinguishes fraud from error is whether the underlying action is intentional or unintentional. Unlike error, fraud is intentional and usually involves deliberate concealment of the facts. It may involve one or more members from management, employees, or third parties.</p>
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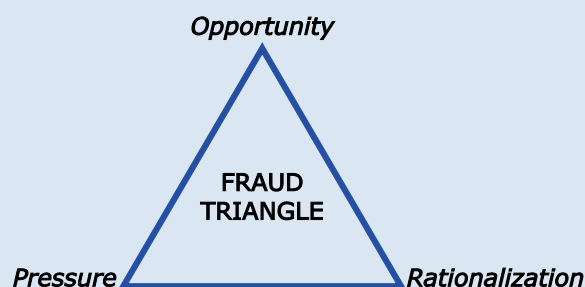
## General fraud risk factors

### Fraud risk triangle

Fraud involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act. See Exhibit 1.

- Incentive or pressure to commit fraud may exist when
  - management is under personal or organizational pressure, from sources outside or inside the entity.
- An opportunity to commit fraud may exist when
  - the control environment is weak,
  - the controls are deficient or could be overridden, and
  - an individual is in a position of trust or has knowledge of specific deficiencies in internal control.
- Rationalization is a necessary step for an individual to commit fraud.

#### Exhibit 1 Fraud triangle



Source: *Occupational Fraud and Abuse*, Joseph T. Wells, CFE, CPA

Examples of risk factors are

- lack of involvement from senior management regarding fraud (including the risk identification, assessment, and monitoring);
- no policy on fraud exists in the entity; and
- no action has been put in place to prevent fraud in the entity.

### Internal vs. external fraud risks

<b>Internal risks</b>	The internal risk of fraud mainly comes through occupational wrongdoing and fraud, from employees and/or management.
<b>External risks</b>	External risks of fraud exist. Those risks vary with the entity's sector of activities.  For example, Employment Insurance could be subject to fraud from beneficiaries. Export Development Canada (EDC) could be subject to fraud on loans.

### An entity's responsibility in relation to wrongdoing and fraud risks

Management is responsible for creating a culture of honesty and ethical behaviour including

- setting the proper tone;
- creating a positive workplace environment;
- hiring, training, and promoting appropriate employees;
- requiring periodic confirmation by employees of their responsibilities; and
- taking appropriate action in response to actual, suspected, or alleged fraud.

Through oversight of management, the entity establishes and maintains internal control to provide reasonable assurance regarding

- reliability of reporting;
- effectiveness and efficiency of operations;
- compliance with applicable laws and regulations; and
- management's responsibility to establish a control environment and maintain policies and procedures to help ensure, as far as possible, the orderly and efficient conduct of the entity's business.



## Audit guidance

### 1. Assessing risks of wrongdoing and fraud

An auditor's response to the identified fraud risks is influenced by the nature and significance of the risks identified and the entity's programs and controls that address these identified risks. This section provides guidance to audit teams in three areas:

- Steps to acquire knowledge of the entity and evaluate the risk of fraud
- Discussing wrongdoing and fraud with the engagement team
- Overall response to identified fraud risks

#### Steps to acquire knowledge of the entity and evaluate the risk of fraud

- Refer to sections on fraud in the annual audit TeamMate file (if applicable)
  - risks assessment in the financial audit,
  - risks assessment of previous audits, and
  - OAG global risks assessment.
- Discuss fraud risks in the planning phase
  - Consider open discussions about risks of fraud with your team members (all levels) because this allows sharing the knowledge and completing the identification of fraud risks.
- Inquire about what the entity has in place to address the risks of fraud, including oversight
  - Consider the following aspects:
    - Entity's assessment of fraud risk and its response
    - Presence of a code of ethics
    - Fraud-related oversight
    - Anti-fraud policy
    - Presence of a whistle-blowing mechanism
    - Communication of the anti-fraud structure to employees
- Evaluate and document the team's knowledge and experience in fraud assessment, detection, and response (team competency) to help determine the level of consultation with the Wrongdoing and Fraud Internal Specialist.

## **Discussing wrongdoing and fraud with the engagement team**

Teams are encouraged to discuss wrongdoing and fraud with the entire engagement team. This item could be added to the team kick-off meeting agenda. Such a meeting

- provides an opportunity for more experienced engagement team members to share their insights about how and where there may be risks of wrongdoing and fraud that could impact the audit;
- enables the auditor to consider an appropriate response to such risk and to discuss if additional procedures are required; and
- permits the auditor to determine how professional skepticism will be factoring in the fraud risk assessment process.

The discussion should cover the following:

- Reviewing with the entire team, any fraud risk conditions identified in the fraud risk assessment process. An exchange of ideas among engagement team members about the fraud risk assessment, including any fraud risk conditions identified.
- The internal and external fraud risks factors to be considered in assessing risk of fraud.
- A consideration of the types of circumstances that, if encountered, might indicate the possibility of fraud.
- A consideration of the known external and internal fraud factors affecting the entity or subject area that may create an incentive for, or a pressure on, management or others to commit fraud, provide the opportunity for fraud to be perpetrated, and indicate a culture or environment that enables management or others to rationalize committing fraud.
- A consideration of how third parties could perpetrate and conceal fraud.
- A consideration of any allegations of fraud that have come to the auditor's attention.
- A consideration of any unusual or unexplained changes in behaviour or lifestyle of management or employees that have come to the engagement team's attention.
- Discussion of evidential fraud risk factors to be aware of at all times during the audit.
- Reaffirm the need for auditors to have professional skepticism at all times and to be alert to changes to the risk of fraud at each stage of the audit.
- Consideration of tone at the top of the organization.

## Overall response to identified fraud risks

In determining overall responses to address significant identified risks of fraud, teams should

- (a) evaluate the need to consult the Wrongdoing and Fraud Internal Specialist in designing the audit procedures to cover the identified fraud risks (see also the section on when to consult the Internal Specialist); and
- (b) design audit procedures in response to the identified fraud risks.

Determining overall responses to address the identified risks of fraud generally includes the consideration of how the overall conduct of the audit can reflect increased professional skepticism, for example, through

- specifically designed audit procedures to address the identified risk of fraud,
- increased sensitivity in selecting the documentation to be examined in support of our line of enquiry,
- increased recognition of the need to corroborate management information provided, and
- increased sensitivity to fraud indicators that may arise during the audit.

The auditor may respond to identified risks of fraud by consulting the Wrongdoing and Fraud Internal Specialist, depending on the level of the risk assessed.

To reduce the engagement risk, the audit team needs to incorporate tailored audit procedures in order to respond to an identified risk of wrongdoing and fraud after considering the entity's activities and the potential impact of that risk on the line of inquiries.

In relation to an identified fraud risk, the auditor can better establish the nature of the risk and develop improved responses by considering what is driving that risk. The audit team will need to consider the impact of this fraud risk on the overall engagement.

Some unpredictability should be introduced in the tailored audit procedures. No specific level of unpredictability is required; however, engagement teams should document those procedures that are deemed to be unpredictable in nature.

The engagement team should discuss how to incorporate the specific audit procedures into the audit.

The auditor shall include the following in the audit documentation of the auditor's responses to the identified risks of fraud:

- (a) the overall responses to the identified risks of fraud and the audit procedures designed to cover those risks, and
- (b) the results of the audit procedures designed to cover those risks.

## Examples of possible responses to identified fraud risks

If a significant fraud risk was identified on a specific area/topic/sector, the team should include specific audit procedures to reduce the engagement risk. Analysis could identify anomalies that are key to identifying wrongdoing and fraud. Irregularities should be considered as fraud indicators. Cases of wrongdoing and fraud usually exhibit such fraud indicators. Knowledge of these fraud indicators provides auditors with a significant head-start in recognizing potential wrongdoing associated with the risk identified.

<b>Example 1: Contracting wrongdoing and fraud risks</b>	An analysis of the contracting information on a contract change resulting in substantial increased charges may indicate an anomaly.
<b>Example 2: Grants and contributions wrongdoing and fraud risks</b>	An analysis of a contribution agreement identifies terms and conditions that deviate from the norm—unreasonably favouring a recipient and broadening the scope for permitted expenditures may indicate an anomaly.

## 2. Detecting incidents—wrongdoing and fraud risk indicators and red flags

### General fraud indicators

Fraud may be concealed by

- withholding evidence,
- misrepresenting information in response to inquiries,
- falsifying documentation,
- collusion among management, employees, or third parties, and
- management override of controls that otherwise may appear to be operating effectively.

The following are examples of circumstances that may indicate the possibility of fraud:

Risk indicator	Examples of specific red flags of wrongdoing and fraud
Conflicting or missing evidence	<ul style="list-style-type: none"> <li>• Missing documents.</li> <li>• Documents that appear to have been altered.</li> <li>• Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist.</li> <li>• Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures.</li> <li>• Unusual discrepancies between the information received by</li> </ul>

Risk indicator	Examples of specific red flags of wrongdoing and fraud
	<p>various sources.</p> <ul style="list-style-type: none"> <li>• Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.</li> </ul>
Problematic or unusual relationships between the auditor and management	<ul style="list-style-type: none"> <li>• Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.</li> <li>• Undue time pressures imposed by management to resolve complex or contentious issues.</li> <li>• Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.</li> <li>• Unusual delays by the entity in providing requested information.</li> <li>• An unwillingness to address identified deficiencies in internal control on a timely basis.</li> </ul>
Other	<ul style="list-style-type: none"> <li>• Unwillingness by management to permit the auditor to meet privately with those charged with governance.</li> <li>• Practices and policies that appear to be at variance with industry norms.</li> <li>• Tolerance of violations of the entity's code of conduct.</li> </ul>

### **Specific wrongdoing and fraud indicators in the public sector**

Additional guidance is provided on specific fraud indicators in [Appendix B](#), Specific Wrongdoing and Fraud in the Public Sector. This appendix covers indicators related to wrongdoing and fraud in the following areas:

- contracting;
- grants and contributions (also applies to other government funding arrangements such as alternative funding arrangements, collaborative arrangements, joint ventures, partnerships, and special foundations);
- non-tax revenues (i.e., investments, including consolidated Crown corporations and other government business enterprises, foreign exchange transactions, disposal of surplus assets, and user fees; and
- wrongdoing and fraud in other vulnerable areas:
  - acquisition cards/credit cards,
  - expense accounts,
  - payroll and human resources, and
  - assets.

## Data mining to detect wrongdoing and fraud

Data mining may be very helpful in identifying fraud indicators in large databases. Data mining refers to using special computer software programs to search for fraud indicators. Data mining software programs are designed to search large databases and report on identified items (hits) that may suggest irregularities or fraud. Auditors can use data mining software to identify fraud indicators in large databases and between different databases that would probably never be uncovered otherwise. The auditor analyzes the report of hits for possible wrongdoing and fraud.

Computer programs can be designed to search or mine data and report on exceptions that may suggest wrongdoing and fraud. The following table provides samples of data mining searches.

Area	Data mining may involve searching for the following types of things:
<b>Payroll and Personnel</b>	<ul style="list-style-type: none"> <li>• contract payments sent to the same addresses as employees;</li> <li>• large payments made to employees;</li> <li>• employee payments that differ from paycheque to paycheque;</li> <li>• employee overtime patterns (and analyzing them);</li> <li>• employee payroll payments that have no withholding taxes; employment insurance deductions, or other basic deductions;</li> <li>• employees who have the same address;</li> <li>• employees who have the same social insurance number;</li> <li>• invalid social insurance numbers;</li> <li>• employees who have the same bank account number; and</li> <li>• matches of active payroll files with disability insurance, pension, or worker’s compensation files.</li> </ul>
<b>Disbursements</b>	<ul style="list-style-type: none"> <li>• duplicate payments (by same amount, supplier, dates);</li> <li>• unusual payments to employees that are not made through normal payroll;</li> <li>• payments made to a supplier who has the same address or phone number as an employee or another supplier;</li> <li>• payments mailed to a post office box address;</li> <li>• suppliers where government employees are family members;</li> <li>• contractors who were unsuccessful bidders, but who are now subcontractors;</li> <li>• supplier payments that were initiated or paid outside the usual system;</li> <li>• disbursements in which no GST was charged;</li> <li>• discovering sequentially numbered supplier/contractor invoices, which could indicate a phantom supplier; and</li> <li>• transactions that are slightly below authority approval thresholds.</li> </ul>
<b>Revenue and Accounts Receivable</b>	<ul style="list-style-type: none"> <li>• all write-offs, voids, refunds, and other credit receivable adjustments (and analyzing trends, similarities, or anomalies).</li> </ul>

Area	Data mining may involve searching for the following types of things:
Other	<ul style="list-style-type: none"><li>• Other types of data mining may involve</li><li>• searching for duplicate addresses and phone numbers in different databases;</li><li>• identifying transactions that are odd as to time, frequency, places, or amounts;</li><li>• identifying negative balances and transactions; and</li><li>• listing all manual payments.</li></ul>

### 3. When to consult the Internal Specialist

Involvement of the Wrongdoing and Fraud Internal Specialist is recommended in planning, as part of identifying and assessing risks of wrongdoing and fraud related to the entity and/or the subject being audited. At this stage, the Internal Specialist can provide assistance with

- conducting a preliminary screening for wrongdoing and fraud risks by advising about the specific fraud possibilities in the entity's specific sector or activities and/or area under audit);
- assessing the level of risks if a preliminary screening indicates the potential for significant fraud risks related to the entity and/or the subject being audited; and
- identifying the considerations for scoping the audit and developing an overall audit strategy in response, if needed.

Involvement of the Wrongdoing and Fraud Internal Specialist is needed

- at any point in the audit if
  - fraud indicators are noticed, or
  - a fraud is uncovered.
- during examination and reporting, where significant fraud risks have been identified. Following a formal consultation with the Wrongdoing and Fraud Internal Specialist related to developing an audit team's response to risks of fraud, the audit team must ensure that the Wrongdoing and Fraud Internal Specialist
  - reviews and approves relevant audit programs,
  - reviews and approves relevant audit conclusions,
  - reviews the PX and DM drafts before they are issued, and
  - reviews the entity's response to OAG's recommendations.

The Wrongdoing and Fraud Internal Specialist can also support audit teams in other ways. For example:

- participating in (or even facilitating) team meetings where fraud risk is discussed;
- preparing or assisting in interviewing management or other key entity staff about matters relevant to fraud risk;
- identifying fraud-related business and audit risk at any stage of the audit;
- assessing controls designed to counter fraud risk, whether for regulatory purposes, or simply in response to high entity expectations in this regard;
- evaluating the quality/reliability of audit evidence from a fraud perspective at any stage;
- assessing the results of the interim audit or any other pre-final work in terms of findings related to fraud risk;
- assessing results of audit procedures carried out by other members of the audit team;
- overall assessing the results of audit testing as a whole or in relation to one area and of the sufficiency and appropriateness of the audit evidence obtained regarding addressing fraud risk;
- where significant frauds have occurred during the year, which have been investigated either internally or by another firm, the Wrongdoing and Fraud Internal Specialist can help evaluate the investigation carried out, the validity and completeness of its conclusions, and its impact, if any, on the audit scope and/or conclusions;
- where any audit procedure brings evidence to light that indicates the possibility of fraud, the Wrongdoing and Fraud Internal Specialist can plan appropriate steps to determine the extent of fraud and its impact on the audit; and
- at any stage of the audit, the Wrongdoing and Fraud Internal Specialist can help communicate with the entity on fraud risk issues, for example: explaining the risks and the approach to those risks; explaining specific tests and inquiries; and communicating sensitive findings.



## Appendix A: CPA Canada Assurance Standards Relevant to Auditors Responsibilities Including Those Related to Wrongdoing and Fraud

**5025.30** The practitioner and any other persons performing the assurance engagement should collectively possess adequate knowledge of the subject matter.

**5025.48** The practitioner should consider the concept of significance and the relevant components of engagement risk when planning and performing the assurance engagement.

**5025.51** Engagement risk is the risk that the practitioner will express an inappropriate conclusion in his/her report. This consists of the following:

- (a) Risks that are beyond the control of management and the practitioner (inherent risk).
- (b) Risks that are within the control of management (control risk).
- (c) Risks that are within the control of the practitioner (detection risk). The practitioner would plan and perform the engagement so that in his/her professional judgment engagement risk is reduced to an appropriate level for the type of engagement.

**5025.52** The extent to which the practitioner considers the relevant components of engagement risk will be affected by the nature of the subject matter and the level of assurance to be provided.

**5030.23** The practitioner should be satisfied that the assurance team collectively has the necessary competencies, resources, and time to perform the assurance engagement in accordance with professional standards and regulatory and legal requirements, and to enable the issuance of a practitioner's report that is appropriate in the circumstances.

**5030.28** Planning also includes informing the members of the assurance team of their responsibilities and of important matters related to the assurance engagement, for example: the nature of the entity's business; significant legislative and regulatory requirements; accounting and risk-related issues; and other issues that may affect the assessment of risk or the performance of the engagement.

In addition, the PS 5400, PS 6410 and PS 6420, CAS 240, CAS 315, and CAS 330 requirements inspired this section. More specifically, CAS 330 requires the auditor to determine overall responses to address the identified risks and shall design and perform audit procedures to respond those risks.

## Appendix B: Specific Wrongdoing and Fraud Indicators in the Public Sector

This appendix explains the following:

- How wrongdoing and fraud related to contracting, grants and contributions, non-tax revenue, and other vulnerable areas may occur in the public sector.
- Examples of what to look for (fraud indicators) related to contracting, grants and contributions, non-tax revenue, and other vulnerable areas when a risk of fraud has been identified.
- The types of documentation to review when a significant risk related to fraud has been identified.

### Wrongdoing and fraud in contracting

When conducting audits, the auditor should maintain an awareness of the possibility of wrongdoing and fraud in contracting practices. The auditor should be knowledgeable on the common types of contract wrongdoing and fraud and should also be aware of the fraud indicators that may indicate possible contract wrongdoing and fraud.

#### How contract wrongdoing and fraud may occur

The following are common methods of perpetrating contract wrongdoing and fraud:

- **Bribery and kickbacks**—a contractor gives a government employee money, gifts, or other favours in order to obtain business or favourable treatment.
- **Change order abuse**—changes are made to the original contract conditions, resulting in a need for more funds than were provided in the original contract. Change orders may be issued throughout the life of the contract to compensate a contractor who initially submitted a low bid. For example, the contractor may be requested to do additional phases of the project that were not part of the original contract.
- **Collusive bidding, price fixing, or bid-rigging**—a group of prospective contractors may make an arrangement to eliminate or limit competition. For example, they may agree that one of them will bid lower than the other contractors. Part IV of the *Competition Act*, which identifies several offences, including conspiracy to limit competition and bid-rigging, may apply in these situations.
- **Co-mingling of contracts**—a contractor bills for the same work under more than one contract. For example, a one-time demolition service may be billed more than once under separate contracts (e.g., the demolition fee could be invoiced four times under separate contracts for the construction of foundations, walls, ceilings, and floors).

- **Conflict of interest**—contracts are awarded to organizations that employ government employees or their families, or to companies in which government employees or their families have an undisclosed financial interest. For example, printing contracts are awarded to the brother-in-law of a government employee.
- **Defective pricing**—a contractor submits inflated invoices that do not comply with the costs/prices specified in the contract.
- **Duplicate invoices**—a contractor submits separately two copies of the same invoice and is subsequently paid twice.
- **False invoices**—a contractor submits invoices for goods that have not been delivered, or the invoice does not reflect the contract terms. For example, the contract sets out a fixed-price, but the contractor invoices at a cost-plus.
- **False quality and performance representations**—a contractor makes false representations about the quality of the products to be supplied or qualifications to perform the requested services.
- **Local purchase order abuse or split purchases**—the total cost of purchasing goods and services exceeds the local authority limit, or a competitive process is required to provide such goods or services. To bypass these rules, the purchases are split into multiple segments.
- **Phantom contractor**—a contractor submits an invoice from a non-existent company to support fictitious costs contained in a government cost-plus contract.
- **Product substitution**—a contractor fails to deliver the goods or services as specified in the contract. The contractor may substitute an inferior product without informing the government. Typical examples include delivering products manufactured by foreign suppliers when the products are supposed to be produced in Canada, or when tests are not conducted to ensure product quality, as required by the contract.
- **Progress payment abuse: front-end loading or advance payment**—under government contracts, payments are made as work progresses. The payments are based on the costs incurred, the percentage of work completed, or the completion of particular stages of work. Progress payment fraud normally includes falsified certification of the work completed in order to receive payments prior to the work being done. The contractor may inflate the costs of the initial work so that, when the percentage of completion billing method is applied, the contractor would receive higher cash flows relative to the actual work completed. The cost of subsequent contract work would be understated with the anticipation that change orders would be approved for additional compensation.
- **Purchases for personal use**—a government official purchases items for personal use, or makes excess purchases of which some items are diverted for personal use. For example, a government employee, who operates a family advertising business, purchases materials via the government to be subsequently used in a personal advertising business.

- **Short bidding time limits**—the lead-time for responding to a proposal is unusually short so that only bidders with inside knowledge will be able to prepare a proposal on time. There is no compelling reason to justify a markedly reduced response time.
- **Tailored specifications**—a government official establishes unnecessary or highly restrictive product specifications that only one contractor can meet. For example, a contract may specify a type of equipment that only one contractor can provide.
- **Unauthorized information disclosure**—a government employee releases unauthorized information to a contractor to help that contractor win the contract.
- **Unnecessary purchases**—goods or services that have been previously purchased are purchased again when there is no additional need.

### **Screening Government Contracts**

One of the keys to identifying wrongdoing and fraud is the ability to spot anomalies. These irregularities should be considered fraud indicators. Cases of wrongdoing and fraud usually exhibit such fraud indicators. Knowledge of these fraud indicators provides auditors with a significant head-start in recognizing potential wrongdoing. Auditors should be aware of fraud indicators, know when to use them, and understand their strengths and limitations.

The process of screening contracts involves examining for different things in each of the three contracting stages:

- Stage 1—contract requirements definition;
- Stage 2—contract acquisition, bidding, and contractor selection (includes anti-competition activities and sole source contract); and
- Stage 3—contract administration, performance, and evaluation (includes fixed-cost, cost-plus, and cost-per contracts).

When screening contracts for wrongdoing and fraud, the auditors should review the following documents, which are usually associated with contracts:

- plans and reports defining requirements and needs,
- work specifications,
- records of conversations between the tendering agency and bidders,
- requests for proposals or other bid solicitation records,
- copies of the tenders,
- copies of the assessments of tenders,
- contract acceptance records,
- the approved contract,
- progress reports,

- receipts and invoices,
- payment schedules and records,
- contract amendments and change orders,
- quality assurance and contractor performance reports, and
- all approval sign-offs required under the *Financial Administration Act*.

#### *Stage 1—contract requirements definition*

This stage involves assessing an entity's requirements and justifications for purchasing certain goods and services. Wrongdoing and fraud schemes usually involve misusing administrative discretion by defining contract requirements so that the contract can be directed to a specific contractor. Inadequate needs analysis is usually an indication of administrative deficiency, but in certain cases it is also an indicator of wrongdoing and fraud. Some fraud indicators for contract requirements definition are as follows:

- **Narrow requirements specifications.** The requirements have been defined so narrowly that only one specific contractor can do the job.
- **Technical experts were not consulted in drawing up specifications for technical contracts or purchases.** Needs must be specified in a way that will facilitate the assessment of alternatives. Without adequate technical advice, bid specifications will be unclear, giving more discretion to contracting authorities.
- **There is unusual senior management involvement.** A senior official, who is not usually involved in the contract process, takes a hands-on approach to preparing the needs analysis.
- **There is an inadequate review to determine if goods, services, or information to be purchased are already owned.** For contracts involving the purchase of proprietary information, trade secrets, or other technical information, there is no indication that attempts were made to determine whether the government already owns that information. For contracts involving the purchase of goods or services, the contracting unit failed to determine if the requisitioned goods or services had already been purchased.
- **Limited information about available resources to supply products or services.** A government employee chooses the first name easily available for goods or services and does not seek other providers.
- **The needs analysis is rushed.** The time allocated to conduct the requirements definition stage is minimal when compared with the estimated costs and technical complexity of obtaining the goods or services. Rushed timing may indicate that someone is trying to find a way around the normal contracting process.
- **The needs analysis is product oriented rather than performance oriented.** Needs assessments describe the product to be acquired rather than justifying the performance needs and specifications. The contract defines a solution rather than a need, and material has already been selected.

- **Excessive stock is acquired.** There is inadequate information on usage patterns or the inventory available substantially exceeds projected usage needs. Large amounts of the same materials are routinely acquired from the same contractors.
- **Information on potential sources of materials is provided to only one bidder.** This may indicate that the needs analysis was prepared with the intention of directing the contract to a specific bidder.
- **The replacement period for goods has been shortened.** Goods are replaced in a much shorter time frame than indicated in manufacturer or entity standards.
- **Surplus materiel in good operating condition is being replaced.** Goods in operating order are declared surplus but are subsequently replaced.
- **A consultant who helped develop contract needs specifications is permitted to bid.** Statements of work or specifications are developed by, or in consultation with, a contractor who can tailor the requirements to fit his specific product or unique capabilities.

*Stage 2—contract acquisition, bidding, and selection*

This stage involves inviting or not inviting bids on prospective contracts. Government Contract Regulations set out the conditions under which contracts can be awarded without a competitive process. Further, the selection process can vary substantially depending on the complexity of the contract. Wrongdoing and fraud at this stage may involve collusion between a government employee and a contractor or collusion between contractors bidding on the contracts. Some fraud indicators for contract acquisition, bidding, and selection are as follows:

- **Failure to comply with authorities.** Before any contract is entered into, government officials have to follow the Government Contract Regulations to solicit bids.
- **Bid specifications are unclear.** When bid specifications are vague, government officials may exercise considerable discretion in selecting a contractor. Unclear bid specifications also enable the contractor to try to recoup losses that would not otherwise be compensated, by falsely classifying the losses as increased costs due to inadequate specifications.
- **There is unusual involvement by a senior official.** Senior government officials take an unusual interest in whether or not a particular contractor is awarded a contract. For example, they may request specific details about the contract, or take a hands-on approach during the bidding and selection stage.
- **The relationship between the contractor and government officials responsible for selecting the contractor is questionable.** Here are some examples:
  - A government employee has close professional or personal ties with the company or its officials. These ties influence the selection of the contractor.

- A government official who selected the contractor joins the contractor's company shortly after the contract was awarded.
- A consulting agency or its employees, engaged to help develop contract requirements, accepts employment with a potential bidder and discusses the requirements definition that they helped develop.
- **Confidential information is released.** Confidential contract information is released in advance, or released selectively, to certain contractors. Or, consultants or companies hired by the government release information to competing contractors prior to the tendering process.
- **There are unusual bidding patterns.** A review of potential contractors may indicate that
  - certain contractors always bid against each other or, certain contractors never bid against each other;
  - bid prices drop when a new or infrequent bidder submits a bid;
  - a contractor bids substantially higher on certain contracts, although no obvious cost difference can account for the variance;
  - certain qualified contractors never or infrequently bid on federal government contracts;
  - a bid is accepted from a contractor who lacks the necessary skills and experience set out in the bid specifications;
  - a contractor with a history of poor performance is awarded a contract;
  - certain contractors are consistently successful in a particular territory;
  - the same contractor is always the successful bidder when contracting with a particular entity, yet usually is not successful with other agencies.
- **Few bids are submitted.** Few bidders show an interest in a contract. This may indicate that specifications were written so that only certain contractors could compete.
- **Evaluation of contractors is inconsistent in relation to their previous performances.** Contractor capabilities were overrated or underrated when compared to deficiencies reported in previous contract performance evaluations.
- **The review of bids is rushed.** The call for tenders had an unusually short closing date without a reasonable explanation. This may indicate that certain officials exercised discretion to limit the time allowed for contractors to prepare and submit proposals. Only those who may have received advance information have enough time to prepare their bids or proposals.
- **Bids are evaluated by one person instead of a panel.** This could indicate that a contractor was chosen because of his/her connection to the person selecting the contractor, rather than on the merits of his/her bid.

- **The contractor gave benefits to government officials.** Information indicates that the successful contractor provided gifts, parties, meals, or any other benefits to a government official connected with the contract.
- **Several small contracts are issued sequentially to the same supplier.** This may indicate that contracts have been split to keep the contract values low and avoid a competitive process. Officials have more discretion in awarding small contracts. By splitting a large contract into several smaller ones, an official may be able to direct the contract to a specific supplier.
- **Exceptions are made to the tender deadline.** Tenders were opened prior to the deadline. Tenders received after the closing date were not disqualified.
- **Bids are changed after they are submitted.** Information indicates that changes were made to bid documents after they were submitted.
- **Changes are made to the contract specifications after the contract is awarded, but before it is signed.** New contract specifications were developed because of a consultation with the successful bidder and were incorporated into the final contract. These specifications result in additional charges, over and above those originally specified in the call for tenders documentation.
- **The request for proposal contains a mistake that invalidates the call for tenders or request for proposal.** If a mistake is found in the bid specification document after the submissions have been evaluated, it may indicate that an official wants to invalidate the competition because the wrong contractor was about to win the bid.
- **The lowest bidder is not selected.** There is no adequate explanation for not accepting the lowest bid when the lowest bid proposal meets all other contract requirements.

#### **Anti-competition activities in the bidding process**

In a competitive process, bid specifications are prepared to provide potential bidders and government selection officials with a common basis for preparing and accepting bids. These specifications provide

- specific criteria about the eligibility of contractors,
- a description of the work to be performed or the type of goods to be delivered, and
- a complete guide about how bids are to be prepared and submitted.

Wrongdoing and fraud in the bidding process may involve collusion among contractors including such anti-competition activities as bid-rigging and price-fixing. The collusion involves informal arrangements or agreements intended to limit competition.

Collusion between bidders is more likely when certain market characteristics exist such as industries where products or services are homogeneous, where there are few



sellers, or where competition is based primarily on price. The following are examples of the types of businesses susceptible to anti-competition activities:

- dredging;
- building construction;
- asphalt paving;
- roofing;
- household goods shipping;
- waste disposal; and
- suppliers of electrical equipment, lumber, and fuel.

Examples of common anti-competitive activities include the following:

- **Bid suppression**—one or more contractors agree to refrain from bidding on a contract, or to withdraw a previously submitted bid so that another contractor's bid will be accepted.
- **Complementary bidding**—contractors submit token bids that are too high to be accepted, or that include terms that are unacceptable. Such bids are submitted to give the appearance of competitive bidding.
- **Bid rotation**—contractors take turns submitting the low bid. These bids may follow a cyclical pattern, or may be related to the size of the contract.
- **Market division**—a group of contractors agree to split a particular market and limit competition. Markets may be divided according to government entities, customers, or geographic areas. As a result, contractors will bid only in their designated market and will either not bid or submit only complementary bids when bidding in a market not assigned to them.

Fraud indicators that may indicate anti-competition activities are as follows:

- **An analysis of bidders and contract awards indicates patterns.** The bidders are always the same. No bidder wins consecutive contracts. Certain bidders always win in certain regions of the country.
- **Competition is restricted.** The request for proposal was not published in a newspaper. Rather it was expressed orally to a few contractors, or was announced in obscure publications, or during a holiday period or weekend.
- **Bids refer to industry-wide pricing practices.** Bidders may collude to fix prices. Indicators include a reference in a bid to an industry price list or price agreements, or to association price schedules, industry price schedules, industry-suggested prices, industry-wide prices, market-wide prices, or market share.
- **Correspondence with contractors suggests possible collusion.** Letters, notes, or memos by government employees, former employees, or competitors indicate only a particular company sells in a particular area, or that it is not that company's turn to receive a contract.

- **There are unusual withdrawals of tenders.** The lowest bidder withdraws his/her bid after it has been submitted, or a bidder withdraws from the contracting process and the justification for doing so is vague.
- **Bid details are peculiar or different bids display similarities.** A review of the bids reveals certain anomalies. Or, identical amounts, calculations, or spelling errors appear in two or more competing bids.
- **The successful contractor uses competitors as subcontractors.** If the winning contractor uses competing bidders, it may indicate collusion. Auditors should be aware of situations where
  - a low bidder withdraws from the contracting process but subsequently becomes a subcontractor of a higher bidder,
  - the successful bidder repeatedly subcontracts work to companies that submitted higher bids or to companies that qualified to act as prime contractors but did not submit a bid,
  - a contractor's tender package includes the bids of subcontractors who are actually competing for the main contract, and
  - the successful contractor uses unsuccessful bidders as subcontractors for the same project.
- **Bids are higher or lower than expected.** Final bids are higher or lower than preliminary cost estimates, previous bids by the same firms, published price lists, or comparable bids of other buyers in the same or similar markets.
- **Related companies submit individual bids.** Related companies submit bids for the same contract and do not disclose their relationship.
- **There are few bidders and only one qualified contractor because dummy bids are submitted.** Only one bidder has submitted a bid that meets the necessary specifications and requirements. Other bids do not respond to the contract's requirements.
- **Bids include labour costs that are too high or too low.** Manipulating labour costs may be one way colluding bidders can rig bids.

### Wrongdoing and fraud in sole-source contracts

*Government Contract Regulations* are based on the belief that competitively awarded contracts will provide the best quality and price. There can be a conflict between competitiveness and efficient, economical acquisition. Therefore, the *Regulations* set out limited conditions under which contracts can be awarded on a sole-source basis without a formal bidding process.

Other mechanisms to reduce the time and effort required to make acquisitions include standing offers and local purchase orders. Standing offers are agreements with suppliers to provide goods and services on demand according to a set of terms and conditions; a contract is struck when a department or agency makes a "call-up" against an offer. Local purchase orders give departments and agencies the authority to purchase goods and services, up to certain dollar values, directly from suppliers

rather than using the procurement services of Public Works and Government Services Canada.

These mechanisms are subject to abuse, such as

- bribery and kickbacks,
- conflict of interest,
- local purchase order abuses,
- purchases for personal use, and
- unnecessary purchases.

Fraud indicators for sole source contracts are as follows:

- **A contract is changed from competitive to sole source.** A contract that was initiated using the competitive process is converted into a negotiated contract.
- **The documentation used to justify sole source contracting is inadequate.** Documentation in the file in support of a non-competitive contract does not justify sole-sourcing. Such situations may also indicate intervention by officials who would not normally be involved in this type of contract.
- **Contracts are repeatedly awarded to the same contractor.** Alternative sources of goods or services are not developed; purchases are repeatedly made from a single source. Or, goods or services are purchased from the same source or contractor over a long period of time without verifying market price changes or other producers of the product or service.
- **Several small contracts for some goods or services are issued sequentially to the same supplier.** Contracts may have been split to bypass government financial authority, and to avoid several review levels.
- **Use of standing offers is unusual.** Unusual use of standing offers, for example, for large purchases where a competitive process may be justified, could indicate that a supplier is being unduly favoured.
- **Local purchase orders (LPOs) are valued beyond approved dollar limits.** Using local purchase orders to make many small purchases from the same supplier may indicate that a supplier is being unduly favoured. Auditors do not usually audit LPOs because of their low levels of materiality. However, auditors should consider reviewing local purchase orders because they are not well controlled.

### *Stage 3—contract administration, performance, and evaluation*

This stage refers to how contracts are administered and managed to ensure the fulfillment of the contract. The types of wrongdoing and fraud committed in this stage are generally related to the pricing method of the contract. Three common pricing methods are fixed-cost, cost-plus, and cost-per contract.

## **Fixed-cost contracts**

Fixed-cost contracts are contracts where the total price payable is set and the contractor must fulfill the contract at the agreed-upon price. Wrongdoing and fraud generally involve the contractor trying to deviate from the fixed price of the contract. Fixed-cost contracts are particularly vulnerable to

- change order abuse,
- duplicate payments,
- false representations, and
- product substitution.

Fraud indicators for fixed-cost contracts are as follows:

- **Changes are made to a contract after it is awarded, resulting in substantially increased charges.** The government entity changes the definitions of the required services after the contract has been awarded. This enables the supplier to submit charges for losses, which the contractor blames on government-mandated changes.
- **Change orders are issued without adequate explanation or as a result of circumstances that should have been foreseen.** Change orders are issued that are inadequately justified or that may have been caused by problems that the contractor should have known about. For example, during a demolition contract, hazardous materials are uncovered resulting in more costly requirements to demolish the building. The contractor charges additional costs to the organization that should have been foreseen before awarding the contract.
- **A contract is unexpectedly extended.** An unexpected contract extension is granted allowing the contractor to complete the project beyond the termination date specified in the contract and/or in the requirements definition.
- **A contract has significant cost overruns.** The amount invoiced by the contractor significantly exceeds the contract amount; the justification provided is questionable. This situation may result from poor bid specifications, which enable the contractor to recoup losses that would not otherwise be compensated.
- **Contractor invoices are not reviewed.** The contractor's invoices are not compared to previously submitted invoices or to project schedules to determine whether they have already been paid by the government. Or, invoices are not reviewed to ensure they meet project specifications.
- **Test certification documentation is inadequate or missing.** No original test results or reports appear in the contract file even though they are required by the contract specifications. Or, a test certification by an independent test agency is missing, although it is required.

- **Inspection reports are inadequate or missing.** PWGSC or other government inspections appear inadequate, or inspection reports are incomplete or missing.
- **Complaints or disclosures are received about the inferior quality of the goods and services provided.** Documentation or interviews show that there is concern about the supply of inferior quality goods or services.
- **Certification under section 34 of the *Financial Administration Act* is missing or incorrect.** Section 34 requires that an authorized person certify that the work has been performed, the goods supplied or the service rendered in accordance with the contract. There is no section 34 certification on file or the person signing does not have the authority to sign.

### Cost-plus and cost-per contracts

Cost-plus-a-fee pricing may be necessary where defining requirements is difficult. Cost-per contracts are priced per unit of labour, materials, or other measureable unit. Wrongdoing and fraud generally involve situations in which contractors take advantage of the price variable nature of the contract. For example, contractors may

- charge the government for costs that are not allowed in the contract,
- charge the government for costs that are unreasonable, or
- charge the government for costs that cannot be directly or indirectly allocated to the contract.

These types of wrongdoing and fraud are done by concealing or misrepresenting costs as allowable costs, or hiding them in certain accounts that are not closely audited.

The types of wrongdoing and fraud that are most likely to occur in cost-plus and cost-per contracts include

- defective pricing,
- false invoicing,
- front-end loading,
- phantom contracting, and
- unwarranted progress payments.

Fraud indicators for cost-plus and cost-per contracts are as follows:

- **There are inadequate inspections at each stage of the contract.** There is no qualified government inspector on site to confirm that, at each stage of the contract, the work that has been billed was completed.
- **Rates charged are higher than those stipulated in the contract.** The contractor charges higher rates than allowed, or submits charges for services that are not included in the contract or the bid specifications.

- **Photocopies are submitted to support charges.** The contractor submits photocopies of invoices for charges to the government on a cost-plus contract.
- **There is evidence of double billing.** Invoices for the same goods and services are submitted more than once.
- **Invoices provide inadequate information about the contractor.** Contractor or subcontractor invoices lack telephone numbers and/or have only a post office box address.
- **Invoices are questionable.** Information is crossed out or correction fluid has been used on the original document. Products listed on the invoice are only referenced by a number.
- **Invoices are not certified as paid.** The contractor does not certify that third-party invoices submitted to the government have been paid.
- **The contractor's employees or subcontractors do not have the required skills.** The contractor uses untrained employees when skilled personnel are required.
- **Labour costs appear high.** Labour costs are most susceptible to misrepresentation because employee labour can be readily shifted to any contract by falsifying time cards. The contractor may charge hours worked on other projects to the contract.
- **Charges for overtime seem unreasonable.** Overtime is charged when it was not incurred, or it is charged at rates significantly higher than those stipulated in the contract.
- **Quality assurance is weak or does not exist.** Examples of weak quality assurance include the following:
  - the entity has minimal or no inspection and quality assurance programs;
  - goods and materials have not been tested as required in the contract specifications;
  - foreign products were provided when domestic products were required;
  - the contracting entity relies entirely on the contractor to ensure that goods and services meet government specifications; or
  - government employees rely on the contractor's word that testing has been carried out, or that tests have met government requirements.
- **Incomplete cheques are submitted as proof of payment.** The contractor submits photocopies of only the front side of a cheque to indicate that the invoices supporting the charge on a cost-plus contract were paid.
- **The timing of progress payment charges do not coincide with plans.** Progress payments do not appear to coincide with the contractor's plans.

- **Claims are made for materials that are not purchased.** Progress payment claims are made for materials that are not supported by a paid invoice.

## Wrongdoing and fraud in grants and contributions

Although the focus of this section is on grants and contributions, auditors should apply these auditing principles to other government funding arrangements that are designed to transfer funds to various entities under specified accountability arrangements or other authorities. Examples include

- alternative funding arrangements,
- collaborative arrangements,
- joint ventures,
- partnerships, and
- special foundations.

### How grant and contribution wrongdoing and fraud may occur

The following are common types of grant and contribution wrongdoing and fraud:

- **Bribery and corruption**—giving gifts, money or other rewards to influence an official act. In the context of grants and contributions, a company provides a government employee with season tickets to hockey games in exchange for favourable consideration of its application for funding.
- **Conflict of interest**—having undeclared private interests that could affect, or be perceived to affect, the independence and objectivity of an individual in carrying out official duties. For example, a government official recommends that a contribution be made to the organization that employs his/her spouse without declaring that a potential conflict of interest exists.
- **Embezzlement**—taking money that has been lawfully received and using it, without the knowledge and consent of the provider of the funds, for other purposes. For example, a person uses the grant money that is intended for a particular project and uses it to satisfy their gambling debts.
- **False representation**—knowingly making false or misleading statements to gain an improper advantage. In the context of grants and contributions, this could involve making false statements to persuade the government to award funding to an organization. For example, an applicant misrepresents an organization's history, its financial position, or the viability of the proposed program. Or, a foreign organization claims to be incorporated in Canada and Canadian-owned, and applies for a grant or contribution for which Canadian ownership is a requirement.
- **False claims**—submitting false documents in order to continue receiving periodic contribution payments. For example, a funding recipient materially

represents his in-kind contributions or third-party financial assistance in order to satisfy conditions set in the funding agreement.

- **Fraudulent concealment**—knowingly hiding information that is necessary and important to the funding decision. For example, an applicant seeking funding to undertake certain research fails to disclose that it previously received government funding under a different business name to undertake the identical research.
- **Improper or unusual approval authorities**—those approving funding applications do not have the required delegated authority. Or senior officials, who would not normally be involved in the approval process, take a special interest in the approval of the funding application.
- **Misuse of funds or assets**—a recipient of government funds or assets uses them for purposes for which they were not intended. For example, the recipient of a government grant uses the funds for personal purposes or for a project other than the one specified in the agreement.
- **Quality substitution**—the government receives an alternative product or service that is inferior to that specified in the grant or contribution agreement. The substitution is concealed from the government.
- **Questionable or fraudulent performance reporting**—a funding recipient does not submit all the performance information required by the funding agreement. Or the quality and completeness of the performance is so poor that there are suspicions about how funds were used. Minimum or no performance information may indicate that government funds were diverted to other unauthorized projects or used for personal benefit.

### **Screening grants and contributions**

One of the keys to identifying wrongdoing and fraud is the ability to spot anomalies. These irregularities should be considered fraud indicators. Cases of wrongdoing and fraud usually exhibit such fraud indicators. Knowledge of these fraud indicators provides auditors with a significant head-start in recognizing potential wrongdoing. Auditors should be aware of fraud indicators, know when to use them, and understand their strengths and limitations.

It is important that auditors understand the normal process for grants and contributions to be able to spot fraud indicators that may indicate wrongdoing and fraud. The grants and contributions process comprises the following four stages:

- Stage 1—proposal, application, and selection
- Stage 2—establishing the agreement and initiating funding
- Stage 3—reporting and monitoring compliance with terms and conditions
- Stage 4—post-agreement review and subsequent events



Initially, auditors should ask the following two questions when screening grants and contributions:

1. Did the department or agency act appropriately when seeking the necessary approvals including, where applicable, Treasury Board approval?
2. Did the department or agency and the recipient organization properly exercise their authority and responsibilities regarding fulfilling the terms and conditions of the agreement?

Answers to these questions may indicate fraud indicators that may require further investigation.

### **Assessing the risk of wrongdoing and fraud**

Given the non-accountable nature of grants, obtaining grant funds fraudulently only requires falsifying documents at the application stage. Because the recipients of grants are subject to limited scrutiny, there is usually little chance of detecting wrongdoing and fraud after the agreement has been established.

In contrast, there is a greater likelihood of detecting wrongdoing and fraud related to contributions because

- there are more accountability mechanisms built into contribution agreements,
- funding for contributions occurs on a scheduled payment basis, and
- monitoring and audit are standard practices.

When auditing grant and contribution agreements, auditors should assess whether all necessary authorizations have been received. These authorizations are

- Parliamentary authority to fund the program via government estimates or legislation;
- Treasury Board approval of the terms and conditions of the program, where required;
- appropriate approvals of agreements by authorized departmental or agency officials; and
- approvals of amendments by authorized departmental or agency officials and, if necessary, by the Treasury Board.

Auditors should also assess whether the recipient of funding meets the conditions, both program conditions and financial reporting conditions, established by the Treasury Board and the department or agency.

### **Conflict of interest**

Auditors should be sensitive to conflict of interest issues. Public servants must comply with the Treasury Board's conflict of interest and post-employment measures, which include being impartial and objective. This policy does not apply to

recipients of government grants and contributions. If a conflict of interest issue arises concerning third-party recipients of government grants and contributions, auditors should determine the significance of the conflict and the OAG's authority to look into the matter. If the OAG does not have a mandate to look into the matter, the auditor should determine whether departmental auditors have the authority to audit recipients. If so, the matter should be referred to the departmental auditors for review and action.

### **Reviewing documentation for grants and contributions**

In order to properly screen grant and contribution arrangements for wrongdoing and fraud, the auditor may need to review the following documentation:

- applications for funding including supporting information such as the organization's annual audited financial statements, and annual reports;
- feasibility studies, business plans, and/or other related reports;
- records or documents that outline the decision-making process for awarding grants or contributions;
- the signed funding agreement and any supporting documents required by the agreement such as the entity's organizational structure, financial and budgetary reports, and terms and payment schedule;
- agreement amendments;
- sign-offs as required under the *Financial Administration Act*;
- cheque requisition documentation in support of the initial payment;
- an organization's progress reports submitted to justify continued progress payments; and
- the records showing the final accounting of funds received and used, and the supporting documentation.

#### *Stage 1—proposal, application, and selection*

The objective of the first stage is to ensure that those who receive grants or contributions meet the program's eligibility and other assessment criteria. Detecting wrongdoing and fraud at this stage is easier because applicants generally submit a lot of documentation to justify their eligibility for funding. The auditor can review this information to determine whether recipients satisfy the assessment criteria. The auditor should also review the assessments of the applications of non-successful applicants to determine whether the selection process was reasonable. Fraud indicators for the proposal, application, and selection stage are as follows:

- **There is no application for funding in the agreement file.** There is no evidence on file of the recipient's application and justification for funding. There is no evidence of the selection process followed or the selection occurred after the funds had been issued.
- **Proposals or business plans are vague.** The less detail provided, the greater the likelihood of lack of oversight over program expenditures.

- **There may be a conflict of interest between a government employee and an applicant.** Generally, conflict of interest is difficult to substantiate. If it appears that a recipient would not normally be eligible for funding or it is not clear how the recipient was selected, the possibility of a relationship between the applicant and a government employee should be considered.
- **The organization funded has no previous financial history or has a history of limited success.** When there is little known about an organization's history, the organization may be concealing information that would have jeopardized its application for funding.
- **Audited financial information on the organization funded is limited or missing.** The terms and conditions of a funding agreement may require that the recipient pay certain expenses with its own funds. The organization may try to hide its limited liquidity by providing limited financial information. If the assessment of proposals is done properly, the lack of financial information should be questioned.
- **An organization regularly receives funding under the program.** Government officials may become lax in their scrutiny of applications and proposals when an organization repeatedly submits funding applications. As well, the more trust and familiarity that develops between the parties, the greater the need to ensure that substantive documentation is detailed and well scrutinized.
- **An organization barely meets the eligibility criteria for funding or has little experience in the field.** An organization's eligibility may be weak or below the acceptable level. The project is to be carried out by parties who lack the required expertise. The involvement of unusual or inappropriate parties, without adequate justification, should be investigated further.
- **An organization's matching funding is misleading or incorrect.** An organization may need to match government funding with funding from another source. Organizations may try to overstate their matching funds. Indicators of potentially overstated or non-existent matching funding include the following:
  - repeated use of donations-in-kind,
  - financial statements that deviate from the norm or are awkwardly presented,
  - the use of amounts receivable from organizations affiliated with the applicant as a main source of matching funding, and
  - matching funding that is provided for a short period by an organization affiliated with the applicant and is withdrawn once the government funds are received.
- **The viability of the proposal is suspicious because of unsupportable claims.** Claims made by the applicant about the project, which cannot be supported by documentation, should be treated with suspicion.

*Stage 2—establishing the agreement and initiating payments*

Once the applications have been reviewed and the funding awarded, the agreement between the government and the recipient is prepared. Although the risk of wrongdoing at this stage is low, there may be indications that the recipient does not intend to comply with the purposes of the agreement. Fraud indicators for establishing the agreement and initiating funding are as follows:

- **The agreement is vague.** A vague agreement opens the door to wrongdoing and fraud. Measuring the performance of the recipient will be difficult and the likelihood increases that the recipient could claim expenditures that are not really for the intended purposes of the project.
- **Certain terms and conditions unreasonably favour the recipient and broaden the scope for permitted expenditures.** Terms and conditions that deviate from the norm, especially generous provisions for allowable expenditures, should be investigated. Favourable conditions could also indicate bribery or kickbacks.
- **The name or address on the funding agreement is different than on the initial application for funding.** This could indicate that the recipient organization is different than the applicant for funding. Or, the initial name may have been fictitious or the applicant materially misrepresented its circumstances. Corporate registry searches of company names may be required to obtain incorporation documents or general information on businesses.

*Stage 3—reporting and monitoring compliance with terms and conditions*

The objective of Stage 3 is to ensure that funds are used in accordance with the terms and conditions of the agreement. Recipients of funding under contribution agreements submit reports that government departments and agencies use to make decisions about continuing funding.

The risks of wrongdoing and fraudulent reporting are high in Stage 3 because recipients may be motivated to alter documents to hide their inappropriate actions in order to continue to receive funding. The opportunities to identify possible wrongdoing and fraud also increase during Stage 3 because it involves more monitoring of the recipient's performance.

Weaknesses in monitoring activities by departments and agencies can increase their risks of exposure to wrongdoing and fraud. Auditors should review the adequacy of these activities with a view to identifying any significant weaknesses. At a minimum, departments and agencies should be carrying out the monitoring activities specified in the agreement. Fraud indicators for reporting and monitoring compliance with terms and conditions are as follows:

- **There are complaints from users about the recipient's services.** Repeated complaints about the quality of the service provided by the recipient could indicate that funding is being used for other purposes or has been misappropriated. Financial information may not show any indicators of this

occurring. Third-party independent verification may be necessary to confirm such abuse.

- **Subcontractors or suppliers are not getting paid.** Subcontractors or suppliers are complaining to the department or agency that they have not been paid or notification is received that the funding recipient is being sued by sub-trades for work performed on the project.
- **The department or agency does not adequately monitor contribution agreements.** The funding agreement gives the department or agency the right to audit the recipient, but this right is never used. Financial statements submitted by recipients are not audited by third parties as required.
- **Recipient's performance and financial reports seem exaggerated or inconsistent.** For the recipient to continue to receive funding, performance and financial reports must demonstrate that work has been done. If a recipient is experiencing difficulties, there is a high risk that performance reports may be falsified to ensure that funding continues. If a recipient claims ineligible expenses, there is a strong likelihood that financial reports will be overstated and performance reports may be exaggerated to correlate with the expenditures. Inconsistent reported results may also indicate that the work is not progressing well and the reports have been falsified.
- **The recipient becomes insolvent or bankrupt shortly after receiving government funding.** The recipient declares bankruptcy and the government funding goes toward paying off creditors. This may indicate that there was never an intention to fulfill the purposes of the funding agreement, but that the real purpose was to divert the funds to pay off creditors.
- **Most of the funding has been spent but the purpose of the agreement is far from achieved.** When a recipient has gone through most of the funding provided and yet the purpose of the agreement is far from being achieved, it may be that funds are being misappropriated. Diverting funds for personal use is tempting when large sums are available. It may involve funnelling funds to affiliated organizations or taking small amounts of cash at regular intervals to avoid detection.
- **The valuation of in-kind matching funding appears to be unreasonable.** Sometimes, when a contribution agreement requires recipients to match federal funding with funding from other sources, the matching funding may take the form of contributions of goods or services. If the valuation of these goods or services seems high, it may have been overstated to justify that the recipient's contribution matches the government funding. In-kind contribution valuation cannot easily be verified.
- **Matching funding provided by third parties is misrepresented.** A recipient overstates matching funding provided by third parties or reports matching funding from third parties that was never provided.
- **Payments are made without sufficient verification that the work has been performed.** Normally, after the initial payment specified in the agreement, contributions are paid as reimbursements of costs or expenses incurred by the recipient. Any payments without evidence that the recipient

has incurred the expenses should be questioned. Year-end payments without support frequently occur.

- **An adverse event has suddenly brought into question the success of the project.** Information previously submitted by the recipient may have concealed the situation from the government so that funding for the project would continue.

#### *Stage 4—post-agreement reviews and subsequent events*

Auditors are generally looking at grants and contributions that have been completed. At this stage, the auditor can assess the recipient's overall performance and the department's or agency's compliance with authorities. Fraud indicators for post-agreement reviews and subsequent events are as follows:

- **The project described in the final report is different than the one described in the original agreement.** Auditors should determine whether changes have been made to the original agreement and, if so, why the changes were made and whether the proper approvals were obtained. The final project may look reasonable but any significant departure from the terms of the original agreement may indicate misuse of funds.
- **Specific requirements of the contribution agreement are not met.** For example, all sources of funding are not disclosed to the department or agency, or the recipient's financial statements are not audited as required.
- **Expenditures are not approved by the appropriate people.** Auditors should investigate any transactions that have not received proper authorizations. Even if expenditures are within budget and appear reasonable, this does not eliminate the requirement that they be authorized.
- **Changes to the original agreement are not approved by the appropriate people.** Generally, amendments to agreements require the approval of the original parties to the agreement. Auditors should follow up on any changes made to agreements that are not properly authorized.
- **Treasury Board approval of changes and/or expenditures is not obtained, when required.** Transactions that exceed predetermined thresholds require Treasury Board approval. If Treasury Board is not given the opportunity to review a transaction, it could indicate that someone wanted to avoid scrutiny.
- **Total actual costs are significantly over budget, under budget, or close to the original budget.** Some cost overruns or shortfalls can be expected, but significant budget variations may indicate improper activities. Overruns could indicate that ineligible expenditures have been claimed. Under budget results may indicate that inferior or insufficient goods or services were provided. A project that is close to budget may also raise suspicions. It may be that the project was under budget but additional, non-allowable expenditures or personal items were charged to the project to use up the funding. To determine the reasonableness of expenditures, auditors may need to seek the advice of specialists.

- **The final report is significantly delayed or is lacking critical information.** Because the final payment is contingent upon receiving the final report, recipients normally want to ensure it is submitted as promptly as possible. A late submission may indicate extra time was needed to develop a report that would be acceptable. Auditors should review the final report for completeness and compliance with the terms and conditions of the agreement.
- **Repayable portions of contributions are not recovered.** Some contributions (for example, where the objective is investment in economic development) may include provisions for repaying a portion of the contribution. In such cases, the auditor should ensure that such repayments are recovered.
- **The final payment is made before all the terms and conditions of the agreement have been met.** The final payment of grants and contributions should only be made after all required information has been received and approvals have been provided to release the balance of funds.

## Wrongdoing and fraud in non-tax revenue

In addition to taxes, the government earns revenues from its investments, including consolidated Crown corporations and other government business enterprises, from foreign exchange transactions, from the disposal of surplus assets, and from user fees charged for a variety of products or services, rights or privileges, or access to government-owned resources. For example, the government earns revenues from things such as

- inspection services fees,
- fees for use of federal testing facilities,
- drug evaluation fees,
- passport fees,
- consular service fees,
- import and export licenses,
- spectrum communication fees,
- commercial fishing licenses,
- mineral rights,
- patent fees, and
- copyright fees.

Wrongdoing and fraud involving non-tax revenues can easily go undetected in government entities because entities and auditors focus on expenditures and tend to monitor and control expenditures rather than monitor and control non-tax revenues.

### **How non-tax revenue wrongdoing and fraud may occur**

- **Accounts receivable write-offs**—an employee writes off as uncollectible, accounts receivable that are not really in arrears or will likely be collected. This is done to conceal the theft of accounts receivable payments or the future theft of payments. Third parties may also conspire with government employees to write off their outstanding receivables in exchange for a percentage of the write-off.
- **Appropriation of unusual sources of revenue**—manufacturers or wholesalers sometimes issue discounts or rebates for large purchases or volume purchases. These discounts or rebates are usually issued annually, as a separate cheque. As a large purchaser, the government may qualify for a discount or rebate. A government employee does not record the amounts received in the accounting system and steals the cheques. These amounts can be easily stolen and hard to detect because there is no record of the amounts ever being receivable.
- **Bribery or kickbacks**—an individual gives a government employee money or gifts in order to receive preferential treatment. For example, an individual gives money to a government employee to obtain surplus Crown assets at a low price.
- **Collusive bidding, price-fixing**—prospective buyers of government goods or rights to exploit publicly-owned resources reach an agreement among themselves, the effect of which is to eliminate or limit competitive bidding.
- **Conflict of interest**—a government employee has an undisclosed personal interest that may affect, or be perceived to affect, his/her independence and objectivity in carrying out his/her job responsibilities. In the context of non-tax revenues, a government official sells goods or services to a company that employs his/her spouse at lower prices or on more favourable terms than those that could have been negotiated with another company.
- **Disposal of assets for personal gain**—a government employee with a personal interest in government assets could identify those assets as surplus goods even though they still have a government purpose. The sole reason the employee identifies those assets as surplus is to purchase them for personal benefit.
- **False disclosure**—an organization makes false disclosures to the government to maximize its profits. For example, an organization could obtain the right to use Crown lands in return for paying set fees on the lumber or minerals removed. The organization submits false information on the quantity and quality of the resources to minimize the fees it must pay. Or, an organization obtains the right to use Crown-owned intellectual property in return for paying the government a percentage of future earnings from its commercial application. The organization submits false information concerning the revenues earned from its commercial application resulting in a loss of revenue to the government.
- **Information theft**—a government employee releases information to a third party without charge when the information should have been sold.



- **Theft of accounts receivable**—an employee steals a payment received. Or an employee enters only part of the payment received in the accounting records and pockets the difference. To avoid being detected, the employee posts B's payment to A's account, C's payment to B's account, etc. This process, called lapping, requires continuous manipulation and monitoring of many accounts and transactions.
- **Unrecorded or under-recorded sales**—an employee sells government goods or services to an outside party and immediately steals the payment without creating any record of the sale. Or, an employee sells government assets, which are subsequently forgotten or recorded as stolen items. An employee can also record part of the payment by showing a lower amount on the government copy of the invoice than on the third party's invoice. When payment is subsequently received, the employee can steal the difference.

### Screening non-tax revenues

One of the keys to detecting wrongdoing and fraud is the ability to spot anomalies. These irregularities should be considered fraud indicators. Cases of wrongdoing and fraud usually exhibit such fraud indicators. Knowledge of these fraud indicators provides auditors with a significant head-start in recognizing potential wrongdoing. Auditors should be aware of fraud indicators, know when to use them, and understand their strengths and limitations.

The screening of non-tax revenues for fraud indicators associated with wrongdoing and fraud is done in the course of regular audit work. Auditors should be aware of an entity's risk factors for this type of wrongdoing and fraud. Increased review and testing of the non-tax revenues should be undertaken where the risks of wrongdoing and fraud are high.

To screen non-tax revenue for wrongdoing and fraud, auditors should review the following:

- invoices related to the sale of goods or services,
- contracts for leases of Crown lands,
- agreements for the issuance of rights and privileges,
- agreements for the use of Crown-owned intellectual property,
- contracts for the disposal of surplus Crown assets,
- accounts receivable aging,
- accounts receivable write-offs and credit memos, and
- bank reconciliations for all specified purpose accounts.

Fraud indicators for non-tax revenues are as follows:

- **Appropriate approvals are not obtained.** Transactions are approved by government employees who do not have the required authority.

- **There is unusual involvement by senior officials.** Particular attention should be given to transactions where senior officers, who are not normally involved in such transactions, are actively involved.
- **The arm's length relationship is questionable.** Any indicators of a relationship between a government employee and an organization doing business with the government should be questioned. An example of a questionable relationship is one where a consultant who identified surplus Crown assets also bids to buy some of those assets.
- **There are unusual trends in revenues.** Revenues generated by the government entity are flat or do not reflect the overall strength of the economy, with no corresponding reason. Revenues from the licence of Crown-owned intellectual property for commercial application are falling without explanation.
- **Revenues do not compare with provincial revenues.** Revenues generated from fees for the removal of lumber or minerals from federal Crown lands do not correspond with fees paid to provinces for the use of similar lands in the same vicinity.
- **Few bids are received for rights to use Crown lands.** Companies may have colluded to divide up the country into regions. To keep prices low, companies only bid in their own region.
- **Crown assets are sold as surplus and replaced soon afterward with similar new assets.** A government employee may have declared the assets surplus in order to purchase the surplus assets for personal benefit or assist a third party in obtaining assets at low prices.
- **The lead time for disposing of surplus Crown assets is very short.** If the period for bidding on surplus Crown assets is very short, with no apparent justification, it may indicate that only bidders with inside knowledge will be able to submit a bid.
- **There is little or no advertising of the disposal of Crown assets.** Limited advertising is done to dispose of large or unique surplus Crown assets, such as lands or buildings or large pieces of equipment.
- **Surplus Crown assets are resold by the purchaser within a short period of time at a significant profit.** If the purchaser can resell the assets at a substantially higher price, the government did not receive fair market value.
- **Fees charged are less than fair market value.** Government fees for goods and services are priced significantly lower than fair market value, or are below government posted prices at other locations in the country.
- **Receivable postings do not match deposits.** If credits to receivable accounts do not match deposits, this could indicate theft of payments received.
- **There is poor segregation of duties for accounts receivable.** Logging of payments received and recording payments in the accounts receivable ledger should be assigned to different employees. Where one employee is

responsible for both functions, additional supervision of the employee may be required.

- **Accounts that are not in arrears are sent to a collection agency to be recovered.** A government employee may be in collusion with a collection agency. For example, an account that can reasonably be expected to be recovered, is sent to a collection agency in return for a kickback from the collection agency.
- **The accounts receivable ledger does not reconcile with the control account.** When ledgers do not reconcile with other controls, it may indicate that entries have not been recorded, or that funds have been misappropriated.
- **There is poor collection of receivables.** An organization that has a history of poor collection on its accounts receivable may have an employee who is stealing payments and subsequently writing-off the accounts receivable.
- **There are unexpected changes in accounts receivable.** If previously good accounts now have amounts overdue or if the total amount of overdue accounts receivable is unusually high, an employee may have misappropriated payments.
- **Write-offs of accounts receivable are not properly approved.** An employee, who does not have the proper authority, writes off accounts receivables, or the required two approvals for write-offs have not been obtained. Writing-off accounts receivable is a means of concealing theft of payments.
- **There are unusual write-offs of accounts receivable.** Accounts that appear to have been good accounts are written off. This may suggest funds have been misappropriated.

## Wrongdoing and fraud in other vulnerable areas

This section discusses aspects of wrongdoing and fraud in other vulnerable areas. It covers specific areas in government operations where wrongdoing and fraud may also take place and that were not previously discussed in other parts. The other vulnerable areas where wrongdoing and fraud can occur are

- acquisition cards/credit cards
- expense accounts
- payroll and human resources
- assets

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Auditors should be aware of fraud indicators, know when to use them, and understand their strengths and limitations.

## **Acquisition cards or credit cards**

### **How acquisition card/credit card wrongdoing and fraud may occur**

Acquisition card/credit card frauds occur when the cards or their credit numbers are used to purchase goods or services for non-government purposes or for unauthorized uses. This kind of fraud also includes card use as a means to appropriate funds directly from the government. The risk of acquisition card fraud is high because

- it is an easy way to make purchases;
- there is a large number of government credit card holders;
- government credit cards are accepted by millions of merchants; and
- purchase slips or monthly statements are inconsistently reviewed by cardholders, finance personnel, or auditors.

The following are some types of acquisition card/credit card fraud:

- **Personal purchases**—a government employee cardholder purchases goods or services for personal use on his/her government credit card, without authority to do so, and allows the department or agency to pay for these goods or services without reimbursing the employer. This fraud can go undetected if the goods and services appear to be normal government purchases such as computers, automobile fuel, and travel and hospitality expenses.
- **Unauthorized billings**—an individual who, intentionally and without the cardholder's knowledge, permits the billing of personal or non-government items on a government credit card and does not reimburse the government for these purchases. This fraud is often undetected if the government cardholder does not verify all charges on the credit card statement before authorizing the payment of the outstanding balance.
- **Unauthorized charges by retailers, wholesalers, and contractors**—in this kind of fraud, businesses will process charges against government credit cards for goods and services that were never authorized or never provided. This kind of fraud also includes inflating charges on government credit cards that do not reflect the agreed upon amount for the goods and services provided. This fraud goes undetected if the government cardholder does not verify all charges on the government credit card statement against invoices or purchase orders and permits the outstanding credit card balance to be paid.

### **Screening acquisition cards/credit cards for wrongdoing and fraud**

To screen acquisition card/credit card purchases for wrongdoing and fraud, auditors should review the following documentation:

- acquisition card statements,

- acquisition card purchase flimsies,
- merchant invoices,
- hospitality and travel expense claims,
- vacation and other leave records, and
- government and entity acquisition card policies.

Fraud indicators for acquisition cards/credit cards wrongdoing and fraud are as follows:

- **Multiple purchases are made at the same vendor or on the same day.** Goods are purchased for personal use, or purchases are split so that the cardholder does not go over his/her transaction limit. Amounts are kept small to avoid inquiries into the purchases.
- **Purchases are made with an odd business vendor or it is unusual to use credit cards with a particular vendor.** This could indicate that purchases have been made for non-government purposes. For example, credit card purchases at a clothing store, stereo and electronics store, or furniture store would be odd. Also unusual would be a credit card purchase with a contractor who would not normally accept a credit card payment from commercial or government clients.
- **Receipts to support statement transactions are incomplete or non-existent.** Information about what was purchased is vague. This could indicate vendor abuse or purchases made for personal use.
- **Monthly acquisition card statements are not reviewed by finance personnel.** If card holders do not expect their purchases or monthly statements to be reviewed, the risk of fraud increases.
- **Cardholders make purchases on weekends, during their vacation time, or on special leave.** This could indicate purchases were personal, or that a retail merchant is billing the government for non-government purchases.
- **The cardholder has personal financial difficulties.** The risk of abuse can increase when a cardholder has a poor credit rating, has his/her wages garnisheed, or is involved in bankruptcy proceedings.

## Expense accounts

Expense account or expense claim wrongdoing and fraud normally involve reimbursing overstated, fictitious, or duplicate expenses. The risk of expense account and expense claim wrongdoing and fraud is high because clerks who manage the claims do not feel comfortable challenging expense reports and claims, particularly those submitted by senior officials. Even though there are very detailed Treasury Board guidelines on claimable employee expenses, expense accounts are easily and frequently abused.

### **How expense account wrongdoing and fraud may occur**

The following are some examples of expense account abuses and frauds:

- **Personal expenses are submitted as business expenditures**—an employee submits personal expenses such as computer accessories, automobile fuel purchases, or personal meals as business expenses.
- **Expenses are submitted twice**—an employee is reimbursed more than once for the same expenses or items that have been purchased and paid for by the entity, and also claimed in an expense report or claim. For example, the government may prepay an expense such as an airline ticket. The ticket is changed and a new ticket is issued for a nominal charge; the employee submits the total charges of the revised airline ticket for reimbursement.
- **A claim for expenses that someone else paid for is submitted for reimbursement**—for example, three government employees share a taxi and all three submit the taxi fare on their expense reports. Or, a meal already paid for under a hospitality expense or conference is subsequently claimed by an employee as part of his/her daily meal allowance.
- **A false claim for automobile kilometre charges is submitted**—an employee submits a claim for automobile kilometres that is higher than the actual kilometres driven.
- **An invoice is submitted for an item that was returned for a refund**—for example, an employee submits a copy of the purchase invoice for a computer accessory, when a refund for the item was subsequently received.

### **Screening expense accounts for wrongdoing and fraud**

To screen expense accounts or claims for wrongdoing or fraud, auditors should review the following documentation:

- the expense account or claim,
- hospitality expenses and travel claims,
- entity acquisition card monthly statements,
- time cards or travel itineraries,
- vacation leave and other types of leave, and
- travel and hospitality policies.

Fraud indicators for expense account wrongdoing and fraud are as follows:

- **Expense receipts are missing.** This may indicate that the expense was not incurred.
- **Detailed expense receipts are missing.** Only a credit card slip is provided, without the corresponding detailed receipt.
- **Photocopied receipts or invoices are submitted.** This may indicate duplicate, altered, or fictitious invoices.

- **The date on a receipt is old or missing.** This may indicate that expenses were previously submitted.
- **An employee submits an expense report even though he or she has an entity credit card.** The entity pays for the employee's credit card expenses and the employee also submits an expense report for the same expenses.
- **Receipts do not match the employee's travel, plans, work schedule, or time sheets.** This may indicate fictitious receipts or personal expenses are being submitted for reimbursement.
- **The purpose of the expense is not indicated.** This may indicate that the expense was not for business purposes.
- **Entity credit card statements are not checked against expense reports.** Checking statements against reports will highlight items that are claimed in an expense report and that may have already been paid for with an entity's credit card.
- **The expense report review process is inadequate.** If employees are aware of the inadequacy of the expense review process, the risk of fraud may be increased.
- **A T4A is not issued for taxable benefits.** An employee makes a false representation to his entity so that a T4A is not issued. For example, an employee may state that there is no personal use of the government automobile when in fact there is substantial personal use of the government automobile.
- **Code of Conduct or ethics policies are weak, do not exist, or are not enforced.** When senior management does not create, adhere to, or enforce appropriate policies, a poor example is provided to employees and can result in increased risks for wrongdoing and fraud.

## Payroll and human resources

Payroll and human resources wrongdoing and fraud involve interfering with the payroll system so that the organization unknowingly makes a fraudulent payroll disbursement. Organizations that have poor controls over payroll and human resources functions are susceptible to fraud.

### How payroll and human resources wrongdoing and fraud may occur

The following are common types of payroll and human resources fraud:

- **Staffing and classification abuse**—managers who are behaving inappropriately may gain the cooperation and loyalty of their staff by reclassifying positions to higher salary levels or changing casual or term positions to indeterminate positions.
- **Overtime abuse**—employees are responsible for approving their own overtime without supervisory oversight. Sometimes supervisors and employees collude in overtime abuse by splitting the overtime payments.

- **Annual leave cash out**—an employee cashes out his/her annual leave, even though he/she took leave throughout the year, but did not submit leave notices. For example, travel claims may show personal leave being taken before or after business trips.
- **Overpayment**—an employee is paid at a higher rate of pay than he/she is entitled to and does not disclose the errors.
- **Severance pay**—an employee receives severance pay even though he/she is still working for a department/agency, or is ineligible to receive such payments.
- **Ghost employees**—a fictitious employee is put on a department's or agency's payroll, and payments for that employee are deposited into the perpetrator's bank account or the account of one of his/her family members. With electronic payroll deposits, it is more difficult to uncover ghost employees.
- **Terminated employees are not deleted from the payroll system**—payments continue to be made to terminated or retired employees, those who have resigned, or those who are on medical leave. Payroll payments are deposited into the perpetrator's bank account or the account of one of his/her family members.
- **Employment insurance fraud**—false records of employment are issued to an employee so that he/she can meet the eligibility requirements of the employment insurance program.

### Screening payroll and human resources files for wrongdoing and fraud

Staffing and classification auditing need extensive file review. Auditors also review performance files and reports on leave and overtime.

To screen payroll accounts for wrongdoing and fraud, auditors typically use computer-assisted techniques, such as data mining. Data mining refers to using special computer software programs to search for fraud indicators. Data mining software programs are designed to search large databases and report on identified items (hits) that may suggest irregularities or fraud. Auditors can use data mining software to identify fraud indicators in large databases and between different databases that would probably never be uncovered otherwise. Auditors analyze the report of hits for possible wrongdoing and fraud.

See below the heading *Data mining to detect wrongdoing and fraud* on page 14 for examples of data mining searches.

Fraud indicators for payroll and human resources wrongdoing and fraud are as follows:

- **There is poor internal control of payroll and personnel functions.** Payroll and personnel wrongdoing and fraud require manipulation of the organization's systems. Control weaknesses, such as poor segregation of duties or poor controls on access to payroll systems, invite wrongdoing and fraud.



- **Senior officials cash-out vacation leave on a regular basis.** Because no one questions senior officials' absences from the office, it is easy for unethical senior officials to take personal leave and request a cash-out of leave that has already been taken. A significant amount of annual leave is not taken and is cashed-out each year. There is also an inappropriate link to cashing out vacation leave as compensation for overtime.
- **There is a high proportion of reclassifications upwards or other unusual trends in staffing actions.** Managers may use staffing actions to reward employees who tolerate inappropriate behaviour by management. There may also be duplicate or ghost positions to favour friends or relatives. Promotion near retirement date or a retroactive promotion especially at executive level may indicate wrongdoing.
- **Staffing action without competition.** A person hired as a casual employee assumes a term position under a personal service contract and is finally hired in an indeterminate position to avoid the need for open competition.
- **Performance management does not comply with Treasury Board policies.** There are no performance agreements or appraisals on the personal files of executives. The bonuses given to them are higher than the Public Service Standard.
- **There is excessive use of overtime.** Overtime is not approved in advance or there is no justification for the high amount of hours declared as overtime. Compensatory leave for executives is not documented.
- **There are duplicate or illegitimate social insurance numbers.** When more than one employee uses the same social insurance number or the number is unacceptable, it could indicate ghost employees or employees who do not have income tax taken from their employment income.
- **There are duplicate addresses or identical bank accounts.** Ghost employees may be indicated when more than one employee is using the same bank account for their payroll deposits, or when the same address is used for more than one employee.
- **Payroll amounts are missing basic deductions.** Ghost employees will often have no withholding taxes, insurance, or other normal deductions taken from their pay.
- **Notices are received from CRA that payroll taxes are delinquent.** Notices from the Canada Revenue Agency may indicate that payroll deductions have been borrowed, even for a short period of time, prior to being remitted to the Canada Revenue Agency.
- **There is a high number of manually prepared cheques.** Where a payroll process is automated, manually prepared cheques may indicate fraud.

## Assets

The risk of wrongdoing and fraud increases when an organization has assets that can be abused or easily removed from its premises. The risk is high when an organization lacks a proper system of counting, tagging, and identifying assets. In some cases, employees may create false documentation or tamper with inventory

records to conceal missing assets. Outside third parties may be accomplices in the wrongdoing and fraud of assets.

### **How asset wrongdoing and fraud theft may occur**

The types of asset wrongdoing and fraud include the following:

- **Employees take assets for personal use**—an employee misappropriates an organization’s assets for his/her personal use or sells assets for cash without recording the disposal.
- **Assets are sold at less than fair market value**—assets are sold or disposed of at less than fair market value to someone related to an employee. Or, asset disposal may be recorded at a value less than what was received, and the employee misappropriates the difference.
- **Asset requisitions or shipping documents are used to move assets to another location to facilitate theft**—an employee overstates the amount of supplies and materials needed for a project and takes the excess. Or, false shipping documents are used to deliver assets to the employee or to an accomplice.
- **Purchasing and receiving functions are manipulated**—an employee receiving goods on behalf of the organization falsifies incoming shipping documents and takes part of the shipment.

### **Screening assets management**

Fraud indicators for asset wrongdoing and fraud are as follows:

- **There is poor segregation of duties in asset management.** Poor segregation of duties provides opportunities to misappropriate assets or proceeds of sales of assets. Requisitions are not approved by someone other than the person making the requisition. Or, an employee responsible for asset disposal receives the proceeds of disposition.
- **The assets are not well monitored. Inventory is not counted annually.** Or, the inventory count is not well-supervised and verified. No one has been assigned responsibility for the custody of assets.
- **Assets are delivered to questionable addresses.** The delivery address is different than the billing address on the invoice. Or, shipping documents indicate unusual movement of goods. This could indicate that goods are being moved to facilitate wrongdoing and fraud.
- **Write-offs of assets or sales are not well-controlled.** Writing-off inventory is one way of removing assets from the books so that their theft can be concealed. Or, the perpetrator of theft may record a false sales transaction so that it appears missing goods have been sold.
- **Proper authorizations and valuations are not obtained for disposal of assets.** Authorizing the disposal of assets is one way of concealing wrongdoing or fraud. Or the value of an asset for disposal may be significantly understated so that it can be sold to an accomplice for far less than fair market value.