

# Fraud and irregularity update

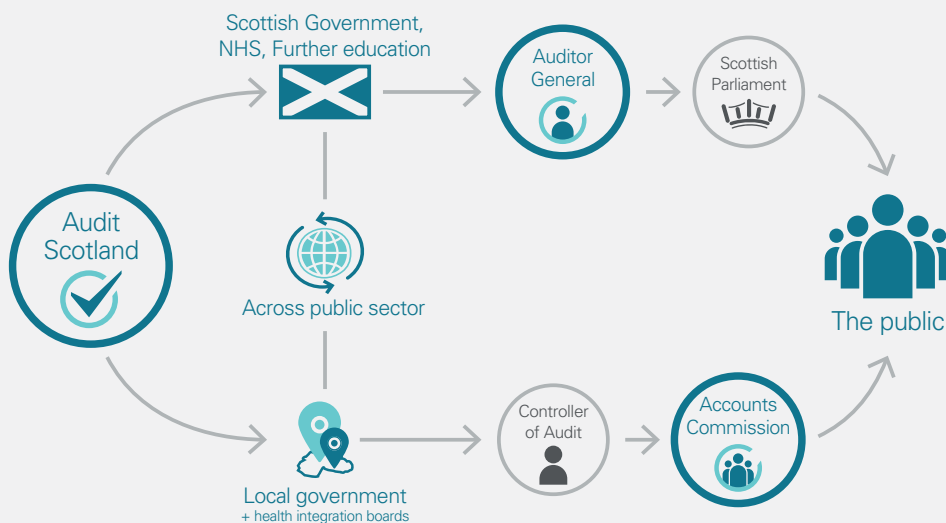
## 2018/19

Prepared for public bodies and auditors  
July 2019

# Who we are

The Auditor General, the Accounts Commission and Audit Scotland work together to deliver public audit in Scotland:

- **Audit Scotland** is governed by a board, consisting of the Auditor General, the chair of the Accounts Commission, a non-executive board chair, and two non-executive members appointed by the Scottish Commission for Public Audit, a commission of the Scottish Parliament.
- The **Auditor General** is an independent crown appointment, made on the recommendation of the Scottish Parliament, to audit the Scottish Government, NHS and other bodies and report to Parliament on their financial health and performance.
- The **Accounts Commission** is an independent public body appointed by Scottish ministers to hold local government to account. The Controller of Audit is an independent post established by statute, with powers to report directly to the Commission on the audit of local government.



## About us

Our vision is to be a world-class audit organisation that improves the use of public money.

Through our work for the Auditor General and the Accounts Commission, we provide independent assurance to the people of Scotland that public money is spent properly and provides value. We aim to achieve this by:

- carrying out relevant and timely audits of the way the public sector manages and spends money
- reporting our findings and conclusions in public
- identifying risks, making clear and relevant recommendations.

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# Summary

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## Key messages

- External auditors have reported a variety of fraud and irregular activities across a range of Scottish public bodies during 2018/19.
  - During 2018/19, external auditors reported 17 cases of frauds and irregularities valued at almost £674,000. The value of reported fraud and irregularity is small compared to Scottish public sector expenditure.
  - Common control weaknesses have contributed to the fraudulent and irregular activity reported during 2018/19.
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## Recommendations

- Public bodies should consider whether the weaknesses in internal control that facilitated the cases identified in this report may also exist in their own organisations and take the required corrective action.
  - Auditors should confirm whether internal controls at their audit clients are sufficiently strong to prevent the types of frauds and errors highlighted in this report.
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## Background

1. This report aims to share information about cases where internal control weaknesses in public bodies have led to fraud and irregularities, to help prevent similar circumstances happening again. It is based on information reported to Audit Scotland about significant frauds and other irregularities in public bodies during 2018/19. The level of fraud and irregularity reported is small compared to Scottish public sector expenditure of £44 billion.

2. A key objective of public audit is to deter fraud. The CIPFA [Code of Practice on Managing the Risk of Fraud and Corruption](#) explains that fraud can be prevented through the implementation of appropriate and robust internal control measures that safeguard assets. It follows that weaknesses in internal control increase the risk of fraud.

3. International Standards of Auditing (ISAs) include certain requirements relating to the auditor's consideration of fraud. Audit Scotland's [Code of Audit Practice](#) sets out additional responsibilities of public sector external auditors in respect to fraud, error and irregularities.

4. Appointed auditors in Scottish public sector bodies are required to consider the risks and the arrangements put in place by audited bodies to ensure that all material revenue is identified and collected, and that material payments are made correctly.

**5.** Historically, auditors of local government bodies and non-departmental public bodies (NDPBs) have provided Audit Scotland with details of cases of fraud and other irregularities discovered in those bodies. During 2018/19, we extended this to the college sector.<sup>1</sup> The focus in reporting cases is on highlighting fraud and irregularities caused by weaknesses in internal control and then sharing the learning from these reported cases in order to prevent similar circumstances from occurring.

**6.** Public bodies are encouraged to consider whether the weaknesses in internal control that facilitated cases in this report may also exist in their own arrangements and take the required corrective action.

**7.** Auditors should confirm whether internal controls at their audit clients are sufficiently strong to prevent the types of frauds highlighted in this report.

**8.** The cases in this report include instances where fraud is merely suspected. Such cases are likely to have been investigated internally, but it is not necessary for the police to have been involved or for it to have been proven as fraud in a court of law.

## About this report

**9.** This report has two parts:

- Part 1 ([page 6](#)) sets out some key factors that can lead to fraud.
- Part 2 ([pages 8 to 15](#)) sets out examples of the various different categories of fraud and irregularity reported during 2018/19 and the control weaknesses which have contributed to these cases.

**10.** The cases included in this report are based on reviewing documents and returns from external auditors. Our audit methodology is in the [Appendix \(page 16\)](#).

<sup>1</sup> NHS bodies report fraud and irregularities to NHS Scotland's Counter Fraud Service and central government bodies report cases to the Scottish Government.

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# Part 1

## Background

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### The fraud triangle

**11.** The fraud triangle is a well-used model to help explain why individuals may commit fraud (Exhibit 1). It suggests that the following are key factors:

- the individual has the opportunity – this may be through weak internal controls such as a lack of segregation of duties
- the individual is under some pressure – this may be personal financial pressures, or through addictions
- the individual can rationalise and justify the fraudulent behaviours in their mind – this may be the belief that they will pay the funds back or that they have been working hard and are due to be compensated.

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Fraud is the misappropriation of assets involving deception to obtain an unjust and illegal financial advantage

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### Exhibit 1

#### The fraud triangle



Source: Donald R. Cressey, *Other People's Money* (Montclair: Patterson Smith, 1973) p. 30.

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**12.** Auditors and management should be aware of key signs in financial records that may indicate fraud. These include:

- an increase in stock or equipment going missing or being written off
- missing documentation to support transactions or contracts
- multiple payments and duplicate payments
- frequent customer complaints about an employee or service, eg the good or service received is less than was requested, or payments are required in cash
- excessive adjustments or 'corrections' through the ledger.

**13.** There are also behavioural 'red flags' that are often witnessed when an employee is committing fraudulent activities. Organisations should have systems in place to identify and report any of these behaviours if they appear. These include employees:

- living beyond their means
- getting into financial difficulties or having addictions
- not taking leave
- rewriting records
- being unwilling to share their duties
- developing inappropriate close relationships with customers and suppliers.

**14.** Auditors continue to engage with audited bodies in order to identify and report fraud and irregularities. The aim is to identify and share events leading to control weaknesses and losses in order to aid learning and hopefully prevent similar events occurring in other audited bodies.

**15.** Audit Scotland's [counter-fraud hub](#) is available on our website and includes details of all of our counter-fraud work, for example, on the National Fraud Initiative, as well as details of the partners we work with.

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Management should consider whether the weaknesses in internal control that facilitated cases in this report exist in their own arrangements

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# Part 2



## Examples of fraud and irregularities reported in 2018/19

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### Key messages

- Fraud and irregularities reported during 2018/19 fall into the following key categories:
  - Six cases of fraud and irregularity involving expenditure have been reported. All six cases, amounting to £82,000, were the result of weaknesses around changing bank details of suppliers.
  - Auditors reported four cases of fraud involving income totalling £36,500.
  - Two cases of fraud involving payroll have been reported totalling £10,000.
  - Three cases of fraud involving theft and totalling £45,000 have been reported.
  - Two cases of misuse of assets fraud totalling up to £500,000 have been reported.
- Common control weaknesses were identified across organisations where fraudulent or irregular activity was identified.

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### Various types of fraud and irregularities were identified during 2018/19

**16.** The types of reported fraud and irregularities communicated by audit teams to Audit Scotland in 2018/19 include:

- expenditure frauds, where an organisation has incurred additional expenditure because of fraud
- income frauds, including the misappropriation of cash
- payroll overpayments or misappropriations
- theft of assets
- the misuse of assets for personal gain.

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This report focusses on fraud caused by weaknesses in internal control

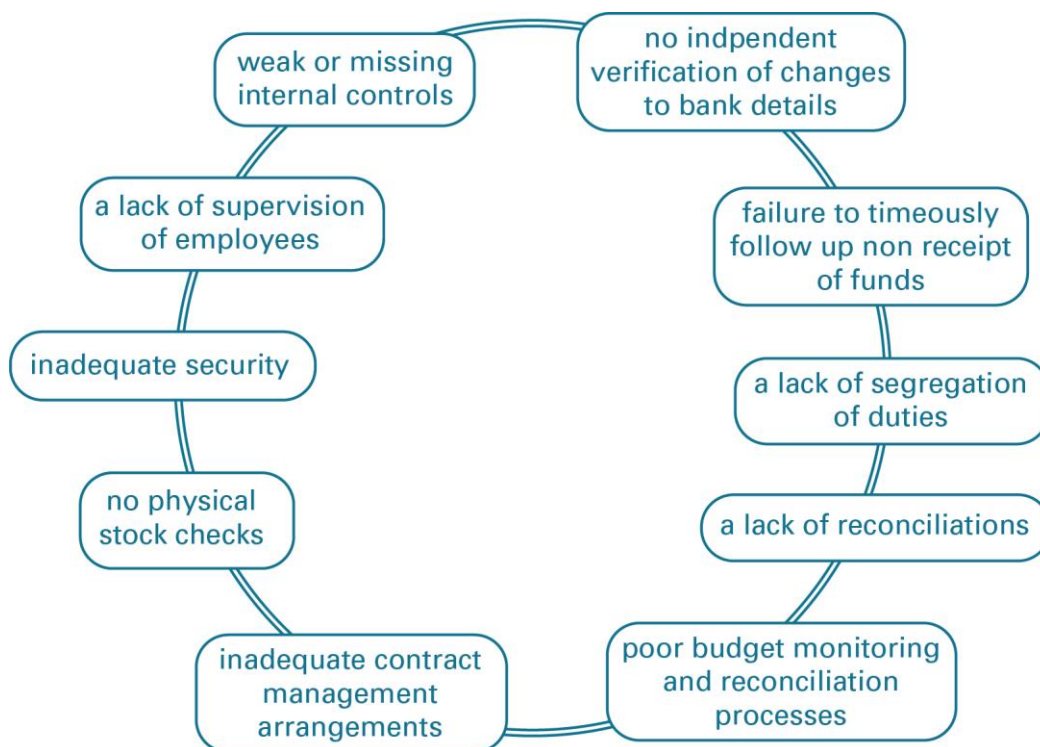
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**17.** Common control weaknesses have contributed to the fraudulent and irregular activity reported by external auditors ([Exhibit 2, page 9](#)).



## Exhibit 2

### Common control weaknesses



Source: Audit Scotland

### Expenditure

**18.** Expenditure frauds relate to cases where a body has incurred additional expenditure because of fraud, eg due to invalid suppliers, fictitious invoicing, or the redirection of payments intended for legitimate suppliers.

### Change of bank details

**19.** Third parties defrauded £82,000 from six public sector bodies by re-directing payments intended for legitimate suppliers.

### Key features

The organisations received emails which appeared to be from valid suppliers. The legitimate email addresses had either been hacked or the emails originated from an address very similar to the legitimate email address.

Emails from the fraudulent email addresses requested that bank details were amended. Subsequently a payment was made to the amended bank account.

It was later identified, often when the genuine supplier queried non-receipt of funds, that the new bank details were false.

One organisation was able to recoup £12,000 by promptly contacting Police Scotland and the bank as soon as the fraud was uncovered.

**Weakness: no independent verification of changes to bank details**

### Weakness in internal control

The frauds were possible as:

- no independent verification of the change was undertaken to confirm the change of bank account, eg a phone call to the supplier
- subtle differences from the usual email address were not spotted.

Source: Audit Scotland auditor returns

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### Income

**20.** Income frauds relate to cases where a body's income has been misappropriated, eg cash takings being re-directed, or invalid refunds processed.

### School fundraising

**21.** Over £6,000 of cash collected at a school fundraising event was misappropriated by a third party.

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## Key features

A council organised a fundraising event with one of its suppliers. One of the supplier's employees collected the money but failed to pay the funds to the school.

The head teacher identified that the cash had not been received six months after the event and notified the council's counter-fraud team.

The perpetrator was reported to their employer and the police. £1,200 of the funds have so far been recovered.

### Weakness in internal control

The fraud was facilitated by a failure to timeously follow up non-receipt of funds.

Source: Audit Scotland auditor returns

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**Weakness:**  
failure to  
timeously follow  
up non-receipt of  
funds

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### Admission ticket sales

**22.** Perpetrators defrauded £12,000 from an NDPB through fraudulent ticket sales.

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## Key features

The perpetrators purchased several tickets for overseas events using stolen credit card details, and then re-sold the tickets. The fraud was not identified until the genuine card holders queried the transactions and requested refunds. A subsequent review identified an unusual increase in refunds for disputed card transactions.

The NDPB has now moved to an enhanced card payment system. The IP addresses used for the fraudulent ticket sales have also been blocked.

### Weakness in internal control

The fraud was facilitated by a card payment system which did not include secondary authentication for payments.

Source: Audit Scotland auditor returns

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**Weakness:** the  
card payment  
system did not  
include  
secondary  
authentication for  
payments

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## Fraudulent refunds

**23.** An employee in a council's environmental services department defrauded £12,500 from the council by failing to bank income and by processing false refunds.

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### Key features

The employee legitimately sold refuse sacks to residents, but subsequently processed a refund and retained the cash. The individual also identified council tax and housing rent accounts that were in credit, processed a refund for the overpayment, and again retained the cash.

No issues were initially detected as the cash recorded in the ledger agreed to the cash in the till.

The fraud was identified following a review of transactions by the sales ledger team, who identified that it was unusual to expect refunds for refuse sacks. Further investigation identified that refunds were being processed by the same officer for council tax and housing rents payments.

The council has now introduced a daily review of all refunds processed. Council tax and housing rent account credit balances are now being identified and highlighted to customers.

### Weakness in internal control

The fraud was facilitated by the absence of regular reviews to highlight unusual items as well as inadequate segregation of duties.

Source: Audit Scotland auditor returns

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**Weakness:** an absence of regular reviews of ledger entries and a lack of segregation of duties

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## Failure to bank income

**24.** A housing officer defrauded £6,000 from a council by failing to bank income.

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### Key features

The officer did not record cash income on income records. The main control was to reconcile the income records to the bank statement, and therefore the missing income was not timeously detected.

The fraud was identified when a finance officer discovered that expected income was not in the relevant bank account. Following investigation, it was established that this income had not been banked and that the issue went back several years.

The council has reviewed its system controls to enable weaknesses to be identified and addressed.

### Weakness in internal control

The fraud was possible due to a failure in budget monitoring processes and the income reconciliation process relying upon income details being recorded in the income records.

Source: Audit Scotland auditor returns

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**Weakness:** poor budget monitoring and reconciliation processes

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## Payroll

**25.** Payroll frauds relate to cases where an organisation's payroll has been misappropriated, eg employees working elsewhere while claiming to be unfit.

### Working while claiming to be unfit for work

**26.** An occupational therapist defrauded £8,000 from a council by falsely claiming to be unfit for work.

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## Key features

The occupational therapist was on sick leave for ten months. The fraud was identified when colleagues advised the manager that the size of the employee's private business had expanded significantly during the period of absence. Covert surveillance by the council's counter-fraud team confirmed that the employee was working on a self-employed basis during their period of sickness absence from the council.

Recovery action is in progress. The employee has been dismissed and the case has been reported to the perpetrator's professional institute.

The council had controls in place to prevent this type of fraud, which included requiring employees to seek written permission if they wish to carry out other work whilst on sick leave and regular reviews for employees on long-term sickness absence.

However, despite having these controls in place, the employee was still able to commit the fraud because the employee withheld the fact that they were carrying out outside work and falsely exaggerated the symptoms of their illness at sickness absence reviews.

Source: Audit Scotland auditor returns

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## Diversion of salary payments

**27.** A college received a fraudulent request to change employee details for two employees from hacked email accounts. This led to a loss of £2,000.

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## Key features

The college's payroll team paid the salary of the two employees into the fraudsters' bank accounts instead of the employees' bank accounts. The fraud was uncovered when one of the employees alerted the payroll accounting officer about the non-payment of their salary. In one case, emailed payslips appear also to have been misdirected, revealing personal details.

### Weakness in internal control

Payroll did not seek a confirmation from the staff, either in person or on the phone, prior to making a change to bank account details.

Source: Audit Scotland auditor returns

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**Weakness:**  
failure to obtain confirmation of bank detail changes from employees

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**Theft**

**28.** Thefts of assets by third parties can be considered fraud if they are facilitated by poor security arrangements, eg theft of equipment or stores.

**Embezzlement of care home residents' funds**

**29.** The owner of a council-funded care home defrauded £38,000 from residents.

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**Key features**

The owner of a council-funded care home was not managing residents' funds through individual bank accounts, as required by the contract with the council, so that they could hide the fraudulent transactions.

A council employee responsible for managing the contract initially identified that residents were having financial difficulty and cash flow problems. A subsequent investigation of residents' funds identified unusual bank transfers with a lack of supporting information.

The business owner was reported to the Procurator Fiscal and is awaiting trial but has repaid the funds.

**Weakness in internal control**

The alleged fraud was facilitated by inadequate contract management arrangements.

Source: Audit Scotland auditor returns

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**Weakness:**  
inadequate  
contract  
management  
arrangements

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**Theft of school laptops**

**30.** An unknown third party allegedly stole laptops valued at £7,000 from a school.

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**Key features**

The equipment was allegedly stolen from a secure storage area within the school. The theft was discovered when an employee went to retrieve the equipment prior to use. The matter has been reported to the police.

**Weakness in internal control**

An internal audit investigation identified physical control weaknesses including:

- key boxes not being locked
- annual asset returns not being completed
- computer equipment not being security marked.

Source: Audit Scotland auditor returns

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**Weakness:** no  
physical checks  
of stock and poor  
security

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### Theft of prescription drugs

**31.** An employee stole prescribed drugs from a locked medicine cabinet in a council-run care home and replaced them with paracetamol.

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## Key features

Internal controls identified that the drugs had gone missing on a particular shift.

Following investigation, a member of staff admitted the theft and resigned. The individual was charged by Police Scotland and received a six-month suspended sentence.

### Weakness in internal control

The theft was possible as the keys to the cabinet were used by a number of staff on the shift.

Source: Audit Scotland auditor returns

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**Weakness:**  
inadequate  
security of  
prescription drugs

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### Misuse of assets

**32.** Misuse of assets relates to fraud where fraudsters use the assets of a public body for personal gain, eg the use of social housing by people who have no rights to occupy the accommodation

### Misuse of vehicles

**33.** Up to £500,000 was lost to a public body when employees used the body's assets for their own personal gain.

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## Key features

Employees used the body's vehicles to conduct unauthorised activities for cash payments that required inappropriate use of the vehicles and employee time. The misuse of the vehicles for the drivers' personal gain was discovered when a member of the public called the body's call centre to express his concerns regarding the employees' activities. These concerns were also substantiated by a whistle-blower. Four employees have left their employment as result of these activities. The body is currently assessing opportunities for recovery of the lost revenue.

### Weakness in internal control

An internal investigation identified the following weaknesses:

- too much flexibility given to the drivers in scheduling their work
- a lack of monitoring of the driver's activities and the vehicles movements.

Source: Audit Scotland auditor returns

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**Weakness:** a  
lack of  
supervision of  
employees and  
employees  
having  
inappropriate  
flexibility in  
respect to work  
schedules

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### Tenancy fraud

**34.** A council tenant was sub-letting their home.

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## Key features

The fraud was identified following receipt of an allegation of illegal sub-letting. An investigation identified that the tenant was sub-letting the property without proper authority. The property was recovered by the council.

Source: Audit Scotland auditor returns

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# Appendix

## Audit methodology

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Audit Scotland's [Code of Audit Practice](#) sets out the responsibilities of audit bodies and external auditors in respect to fraud, error and irregularities. The Code states that:

“Audited bodies are responsible for establishing arrangements for the prevention and detection of fraud, error and irregularities, bribery and corruption and also to ensure that their affairs are managed in accordance with proper standards of conduct by putting proper arrangements in place.

International Standards on Auditing (ISAs) include certain requirements relating to the auditor's consideration of fraud. The nature of public sector organisations means that there are specific fraud risks that are relevant to a public sector audit which should be considered when applying ISA 240. These include taxation receipts, welfare benefits, grants and other claims made by individuals and organisations on the public purse.

Appointed auditors should consider the risks and the arrangements put in place by audited bodies to ensure that all material revenue is identified and collected and that material payments are made correctly.

Audit work would include reviewing, concluding and reporting on areas such as: whether the body has established appropriate and effective arrangements for the prevention and detection of fraud and corruption.

Appointed auditors are required to report information on cases of fraud and irregularities in accordance with guidance from Audit Scotland. Appointed auditors should also review information about frauds disseminated by Audit Scotland and consider whether any action is required in relation to their own audit appointments.”

This report is informed by information provided by external auditors during 2018/19 in their fraud and irregularity returns to Audit Scotland.

External auditors are required to report frauds (or suspected frauds) where they are caused or facilitated by weaknesses in internal controls at local authorities or non-departmental public bodies. We extended this to the college sector in 2018/19.

Frauds and irregularities are considered significant where the value of the loss is over £5,000 or where it is of significant due to the nature of the activity.

Auditors of local authorities are not required to report cases of fraud perpetrated by claimants, for example, housing benefit claimants, unless the fraud was facilitated by the collusion of local authority staff or otherwise by weaknesses in internal control.



The cases included in this report are likely to have been investigated internally, but it is not necessary for the police to have been involved or for it to have been proven as fraud in a court of law.

NHS Scotland Counter Fraud Services (CFS) collates and investigates all cases of reported fraud and irregularity in NHS Scotland. CFS deals with the prevention, detection and investigation of fraud, embezzlement, theft, corruption and other irregularities against NHS Scotland.

The Scottish Government collates and ensures appropriate action is taken for all cases of reported fraud and irregularity in the Scottish Government and other central government bodies.

# Fraud and irregularity update

2018/19

This report is available in PDF and RTF formats,  
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