

**Practice Advisory 1210.A2-2:
Auditor's Responsibilities Relating to Fraud Investigation, Reporting, Resolution
and Communication**

**Interpretation of Standard 1210.A2 from the
*International Standards for the
Professional Practice of Internal Auditing***

Related Standard

1210.A2 -The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

Nature of this Practice Advisory: *Internal auditors should consider the following suggestions related to fraud. This guidance is not intended to represent all the considerations that may be necessary. Instead, it recommends a minimum level of knowledge about fraud and some actions that may be undertaken. The level of training and experience required by an internal audit department and individuals within the department will vary, depending on the role established for them in the department charter and on the advisory and professional services expected from the chief audit executive by management and the board. Greater involvement requires a greater level of proficiency.*

This practice advisory should be read in conjunction with PA1210.A2-1, "Auditor's Responsibilities Relating to Fraud Risk Assessment, Prevention, and Detection".

INVESTIGATING FRAUD

This section of the practice advisory does not refer to the activity known as "auditing for fraud", defined as "an audit designed to proactively detect indications of fraud in those processes or transactions where analysis indicates the risk of fraud to be significant". This guidance refers to investigations initiated when a concern over control failures or suspicion of wrongdoing is raised within the organization. Suspicions can result from a formal complaint process, informal tips, or an audit, including an audit designed to test for fraud.

A fraud investigation consists of gathering sufficient information about specific details and performing those procedures necessary to determine whether fraud has occurred, the loss or exposures associated with the fraud, who was involved in it, and the fraud scheme (how it happened). An important outcome of investigations is that innocent persons are cleared of suspicion.

Investigations should be designed to discover the full nature and extent of the fraudulent activity, not just the event that may have initiated the investigation. Investigation work includes preparing workpapers/file documentation sufficient for a legal proceeding.

Internal auditors, lawyers, investigators, security personnel, and other specialists from inside or outside the organization are the parties that usually conduct or participate in fraud investigations.

Investigations and the related resolution activities need to be carefully managed in consideration of local law. Laws may direct how and where investigations are conducted, disciplinary and recovery practices, and communications. It is in the best interests of an auditor, both professionally and legally, to work effectively with the organization's legal counsel and to become familiar with the relevant laws. The guidance provided here is directed at an international audience and is therefore general in nature.

Management's Role

Management is responsible for developing controls over the investigation process, including developing policies and procedures for effective investigations and standards for handling the results of investigations, reporting, and communications. Such standards are often documented in a fraud policy, and internal audit may be involved in developing the policy.

Such policies and procedures must consider the rights of individuals involved, the qualification of those authorized to conduct investigations, and the relevant laws of the countries and local governments where the frauds occurred or were investigated. The policies should consider the extent to which management will discipline employees, suppliers, or customers, including taking legal measures to recover losses and civil or criminal prosecution. It is important for management to clearly define the authority and responsibilities of various roles within an investigation, especially the relationship between the investigator and legal counsel. It is also important for management to design and comply with procedures that minimize internal communications about an ongoing investigation, especially in the initial phases.

The policy should specify the role the investigator will have in making a determination that fraud has been committed. Management should consider whether the investigator or management reaches a conclusion of fraud, or whether the company refers the facts to outside authorities for their conclusion. A judgment that fraud has occurred may, in some jurisdictions, only be made by law enforcement or judicial authorities. The investigation may simply result in a conclusion that company policy was violated.

Internal Audit's Role

The role of internal audit in investigations should be defined in the internal audit charter as well as the fraud policies. For example, internal audit may have the primary responsibility for fraud investigations, may act as a resource for investigations, or must refrain from involving itself in investigations (because they are responsible for assessing the effectiveness of investigations). Any of these roles can be acceptable, as long as the impact of these activities on internal audit's independence is recognized and handled appropriately.

To maintain proficiency, fraud investigation teams have a responsibility to obtain sufficient knowledge of fraud schemes, investigation techniques, and laws. There are national and international programs that provide training and certifications for investigators and forensic specialists.

If internal audit is responsible for ensuring that investigations are conducted, it may conduct an investigation using in-house staff, outsourcing, or a combination of both. In some cases, internal audit may also use non-audit employees of the organization to assist.

It is often important to assemble the investigation team without delay. If the organization needs external experts, the chief audit executive should consider pre-qualifying the service provider[s] so that the external resources are available quickly.

In companies where primary responsibility for the investigation function is not assigned to internal audit, auditors may still be asked to help gather information and make recommendations for internal control improvements.

Investigator's Role (whether assigned to internal auditing or elsewhere)

An investigation plan must be developed for each investigation, following the organization's investigation procedures or protocols. The lead investigator should determine the knowledge, skills, and other competencies needed to carry out the investigation effectively and assign competent, appropriate people to the team. This process should include assurance that there is no potential conflict of interest with those being investigated or with any of the employees of the organization.

The plan should consider methods to:

- Gather evidence, such as surveillance, interviews, or written statements.
- Document the evidence, considering legal rules of evidence and the business uses of the evidence.
- Determine the extent of the fraud.
- Determine the scheme (techniques used to perpetrate the fraud).
- Evaluate the cause.
- Identify the perpetrators.

At any point in this process, the investigator may conclude that the complaint or suspicion was unfounded and follow a process to close the case.

Activities should be coordinated with management, legal counsel, and other specialists, such as human resources and insurance risk management, as appropriate throughout the course of the investigation.

Investigators must be knowledgeable and cognizant of the rights of persons within the scope of the investigation and the reputation of the organization itself.

The level and extent of complicity in the fraud throughout the organization should be assessed. This assessment can be critical to ensuring that crucial evidence is not destroyed nor tainted, and to avoid obtaining misleading information from persons who may be involved

REPORTING ON FRAUD

Fraud reporting consists of the various oral or written, interim or final communications to senior management and/or the board of directors regarding the status and results of fraud investigations. Reports can be preliminary and ongoing throughout the investigation. A written report may follow any oral briefing made to management and the board of directors to document the findings.

Section 2400 of the *International Standards for the Professional Practice of Internal Auditing* provides information applicable to engagement communications. Additional interpretive guidance on fraud reporting internally follows:

- A draft of the proposed final communications on fraud should be submitted to legal counsel for review. In cases where the organization is able to invoke client privilege, and has chosen to do so, the report must be addressed to legal counsel.

- When the incidents of significant fraud, or erosion of trust, have been established to a reasonable certainty, senior management and the board of directors should be notified immediately.
- The results of a fraud investigation may indicate that fraud may have had a previously undiscovered adverse effect on the organization's financial position and its operational results for one or more years for which financial statements have already been issued. Senior management and the board of directors should be informed of such a discovery.
- A written report or other formal communication should be issued at the conclusion of the investigation phase. It should include the basis for beginning an investigation, time frames, observations, conclusions, resolution, and corrective action taken (or recommendations) to improve controls. Depending on how the investigation was resolved, the report may need to be written in a manner that provides confidentiality to some of the people involved. The content of this report is sensitive, and it must meet the needs of the board of directors and management, while complying with legal requirements and restrictions and company policies and procedures.

RESOLUTION OF FRAUD INCIDENTS

Management is responsible for resolving fraud incidents, not the internal auditor, nor the investigator. Resolution consists of determining what actions will be taken by the organization once a fraud scheme and perpetrator[s] have been fully investigated, and evidence has been reviewed.

Internal Auditors should assess the facts of investigations and advise management relating to remediation of control weaknesses that lead to the fraud. Auditors should design additional steps in routine audit programs or develop "auditing for fraud" programs to help disclose the existence of similar frauds in the future.

Management's fraud policies and procedures (mentioned earlier in the practice advisory) should define who has authority and responsibility for each process. Internal auditors may be involved as advisors in the following processes, as long as the impact of these activities on internal audit's independence is recognized and handled appropriately. Resolution may include all or some of the following.

- Providing closure to persons who were initially under suspicion but were found to be innocent
- Providing closure to those who reported a concern
- Disciplining an employee in accordance with company standards, employment legislation, or employment contracts
- Requesting voluntary financial restitution from an employee, customer or supplier
- Terminating contracts with suppliers
- Reporting the incident to law enforcement, regulatory bodies or similar authorities, and cooperating with their investigation
- Entering into civil litigation or similar legal processes
- Filing an insurance claim
- Filing a complaint with the perpetrator's professional association

In addition to advising clients, internal auditors may become involved in:

- Monitoring the investigation process to help ensure that the organization follows relevant policies, procedures, and applicable laws and statutes (where internal auditing was not responsible for conducting the investigation).
- Locating and/or securing the misappropriated or related assets.
- Supporting the organization's legal, insurance, or other recovery actions.
- Evaluating and monitoring the organization's internal and external post-investigation reporting and communication plans and practices.
- Monitoring the implementation of recommended control improvements to help ensure timeliness, effectiveness, and efficiency.

COMMUNICATIONS

To limit the risk of the unofficial dissemination of inappropriate and/or inaccurate information, the internal auditor can advise management in the design of a communication strategy and tactical plan, as early in the investigation as possible.

In addition to fraud reporting mentioned above, there are two types of communications that may result from an investigation: public communications that may arise and planned internal communications.

Any comments made by management to the press, law enforcement, or other external parties are best coordinated through legal counsel. Comments should be made only by authorized spokespersons.

Internal communications are a strategic tool used by management to reinforce its position relating to integrity, to demonstrate that it takes appropriate action when company policy is violated, and to show why internal controls are important. Such communications may take the form of a newsletter article, a memo from management, or the situation may be used as an example in the organization's integrity training program. These communications generally take place after the case has been resolved internally, and they do not specify the names of perpetrators or other specific investigation details that are not necessary for the message or that contravene laws.

An investigation and its results may cause significant stress or morale issues that may disrupt the organization, especially when the fraud becomes public. Management may plan interactive employee sessions and/or team building strategies for this contingency.

FORMING AN OPINION ON THE SYSTEM OF INTERNAL CONTROL RELATED TO FRAUD

The internal auditor may be asked by management or the board to issue an opinion on the organization's system of internal control related to fraud. Auditors should refer to various practice advisories in the 2410 series and other IIA practice aids, such as "Practical Considerations Regarding Internal Auditing Expressing an Opinion on Internal Controls", to determine whether they have sufficiently considered related information before expressing an opinion.