

# INTERNA REVIZIJA U CENTRALNIM BANKAMA

## INTERNAL AUDIT IN CENTRAL BANKS

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**Sadržaj:** Uvođenje predstavlja najvažnije zadatke Centralne banke i položaj interne revizije u njoj. Autor zatim ukazuje na vezu između interne revizije i istrage prevara i izloži izazove sa kojima se interni revizori suočavaju na poslu. Na kraju sumira neke dobre prakse interno-revizijskog tretmana prevare.

**Ključne reči:** *Centralna banka, interna revizija, prevare*

**Abstract:** *The introduction presents the most important tasks of a Central Bank and the position of internal auditing in it. The author then indicates the link between internal audit and investigation of fraud and exposes the challenges the internal auditors are faced with at work. At the end he elaborates some internal-audit fraud treatment good practices.*

**Key words:** *Central Bank, internal audit, fraud*

### 1. INTRODUCTION

We begin with an overview of the role and objectives of central banks. The fact is that central banks differ significantly – in the scope and nature of their functions, in their history and in the political and economic conditions in which they operate. What is suitable for one country will not be for another.

The role of central banks has changed significantly since the first one (the forerunner of today's Sveriges Riksbank) was established in 1668. Changes have often taken place in response to severe crises or persistent policy problems. For example the need to deal with chronic inflation in the 1970s and 1980s prompted the identification of price stability as a formal central bank objective. The global financial crisis that is now unfolding could well have equally important implications for central banks, particularly with respect to their role in fostering financial stability. Tasks and objectives today cluster around central banks' macroeconomic and financial stability objectives. At the same time, central banks have to be organised to carry out various other public policy and service tasks that variously meet the needs of government, the financial system and the public. [1]

The Act of Bank of Slovenia sets its tasks and also the existence of internal audit. Brief description of major tasks follows:

- Authorized to issue banknotes that are legal tender in the Republic of Slovenia.
- Performs tasks related to the implementation of monetary policy.
- Formulates, implements and controls the system of rules for safe and sound operation of banks and savings banks.
- Performs other tasks in accordance with the law
  - o manages the official foreign exchange reserves,
  - o keep accounts for the state and public authorities, entities,

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- lender of last resort,
- oversights payment and settlement systems,
- ...

The article 41 of the Act defines basic framework for the internal audit:

- shall be set up as an independent organizational unit, directly accountable to the Governor,
- shall conduct its tasks in accordance with professional principles and standards,
- shall report to the Governing Board of the Bank of Slovenia at least once a year.

As regards the standards the Bank of Slovenia and all other ESCB central banks are using the International Professional Practices Framework (IPPF) of the Institute of Internal Auditors (IIA). The IIA defines the internal auditing as "*an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*" [2]

Lately, few weeks ago, there was a shift in the IPPF. They put in front the Mission of Internal Audit, which articulates what internal audit aspires to accomplish within an organization. The mission is "*To enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight.*"

When the International Monetary Fond (IMF) provides a loan to a country, a due diligence exercise is carried out to obtain assurances that the country's central bank receiving IMF resources is able to adequately manage the funds, and provide reliable information. While the internal audit is part of bank's corporate governance, it is also part of this exercise. Therefore the IMF defined the internal audit function and its definition is practically the same as the one of the IIA. [3]

## **2. INTERNAL AUDIT AND FRAUD**

### **Fraud definition**

Many fraud definitions can be found. Most appropriate for the use of internal auditors is the IIA definition that states fraud is "*any illegal act characterized by deceit, concealment, or violation of trust. ... Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.*"

Another, widely accepted definition is the one by the Association of Certified Fraud Examiners (ACFE). By ACFE fraud can, in the broadest sense, encompass "*any crime for gain that uses deception as its principal modus operandus.*" [4]

Put simply, fraud is an act of deception intended for personal gain or to cause a loss to another party. [5]

### **Fraud and Central Banks**

No organization is immune to fraud. In Ireland the Central Bank is understood to have been fooled in 2015 into transferring up to €1.4m to a bogus online account believing it was a standard invoice payable to Danske Bank. However the money was actually sent to a bogus bank account in Galway, Ireland. The bank realised something suspicious was occurring before the full amount was transferred and halted the transaction. The Central Bank has confirmed that up to €32,000 is still missing. [6]

In Nigeria six central bank officials and 16 commercial bank staff were arrested in connection with currency theft and recirculating naira banknotes intended for destruction. Instead of carrying out the statutory instruction to destroy the currency, they substituted it with newspapers neatly cut to banknote sizes and proceeded to recycle the defaced and mutilated currency. The Central Bank of Nigeria said the alleged fraud scheme was uncovered September 2014 when a routine audit revealed irregularities in the south-western city of Ibadan. [7]

In Albania the Central Bank discovered that around 713 million lek, or \$6.7 million, in cash had been stolen from the bank's reserves. One employee confessed to police that he had smuggled banknotes out of the building inside his clothes or old books. He told police he used the money to gamble, stealing notes daily. [8]

Bank of Greece recognized for internal purposes, based on the scheme used, the following types of fraud [9]:

- Falsified information or forgery meaning falsehoods or false information
- Identity theft
- Collateral (price and/or other) manipulation
- Theft of financial assets, namely stealing monetary funds belonging to the bank, such as cash, deposits, bonds, etc. Theft of non financial assets, i.e. stealing non-monetary property of the bank (fixed assets, e.g. cars, etc)
- Electronic fraud, i.e. unauthorized access, manipulation or disruption of systems, infrastructure or data, including denial of service attacks
- Plastic fraud

In the Bank of Slovenia fraud is not described so detailed and so sophisticated. The internal audit charter on very general level gives internal audit department some responsibility in relation to fraud:

- shall audit how protection against fraud is implemented, and
- in case of fraud an ad-hoc audit (investigation) shall be conducted.

### **Fraud and IIA standards**

The structure of the *Standards* is divided between Attribute and Performance Standards. Attribute Standards address the attributes of organizations and individuals performing internal auditing. The Performance Standards describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured. Implementation Standards are also provided to expand upon the Attribute and Performance standards, by providing the requirements applicable to assurance (A) or consulting (C) activities. Herein only those standards will be presented that deals with fraud.

Attribute standard 1210 – Proficiency, implementation standard 1210.A2: "*Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is*

*managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud."*

Attribute standard 1220 – Due Professional Care, implementation standard 1220.A1: "*Internal auditors must exercise due professional care by considering the ... probability of significant errors, fraud, or noncompliance ...*"

Performance Standard 2060 – Reporting to Senior Management and the Board: "*The chief audit executive must report periodically to senior management and the board .... Reporting must also include significant risk exposures and control issues, including fraud risks, ....*"

Performance standard 2120 – Risk Management, attribute standard, implementation standard 2120.A2: "*The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.*"

Performance standard 2210 – Engagement Objectives, implementation standard 2210.A2: "*Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.*"

### **3. CHALLENGES**

#### **Competency**

Internal auditors are, when dealing with fraud, facing many challenges. First one is competency. Do we really have appropriate skills to address fraud topics? What skills are needed? How to proceed when no appropriate knowledge and/or skills are available in your audit team?

To help internal auditors the IIA issued Practice Advisories, which is recommended guideline to be referenced during day-to-day business. [10]

Practice Advisories explains that internal auditor must have sufficient "*knowledge to identify the indicators of fraud*". And "*an appreciation of the fundamentals of business subjects such as fraud. An appreciation means the ability to recognize the existence of problems or potential problems and to identify the additional research to be undertaken or the assistance to be obtained.*"

Internal auditors must exercise due professional care, which "*involves being alert to the possibility of fraud, intentional wrongdoing, errors and omissions, inefficiency, waste, ineffectiveness, and conflicts of interest, as well as being alert to those conditions and activities where irregularities are most likely to occur. This also involves internal auditors identifying inadequate controls and recommending improvements to promote conformance with acceptable procedures and practices.*"

When internal auditor lacks knowledge and/or skills he or she can obtain external service providers to support or complement the internal audit activity. An external service provider is a person or firm, independent of the organization, who has special knowledge, skill, and experience in a particular discipline. External service providers include fraud investigators.

#### **Fraud investigation approach**

It is recommended to perform an investigation as quick as possible. All the preparatory work shall be done in strict confidentiality. Even innocent questioning can make a fraudster be alert and he/she can destroy any evidence.

The legislation in Europe in relation to privacy is quite demanding. Practically no investigation of employee's desk or computer can be done without his/her allowance, preferably written. It might be wise to ask the person under investigation for that personal data allowance not sooner than investigation team gets on-site. Otherwise potential perpetrator can destroy or hide evidence.

Additionally, too soon the potential key evidence can be destroyed or somehow contaminated by investigation team activities. For example: the computer, in use by potential fraudster, shall not be started by internal audit staff in order to examine the content of disks. This is due to the fact the Windows writes a lot to disks during start-up. Therefore some deleted files, which are still there, might be overwritten and unusable as a proof.

Anonimization of both, potential fraudster and the whistleblower must be in force, even after the investigation is finished.

There is a thin line which can easily be over crossed and in many cases depends on particular country legal framework and Central Bank internal legislation. Those questions are:

- How detailed can internal audit investigation be?
- Where is the line between internal and external investigation?
- When do you need to let police be involved?
- Any rules for investigators?

#### **4. BEST PRACTICES**

The IIA together with the ACFE and The American Institute of Certified Public Accountants (AICPA) issued a paper *Managing the Business Risk of Fraud: A Practical Guide*. [11]

The paper states that only through diligent and ongoing effort can an organization protect itself against significant acts of fraud. Key principles for proactively establishing an environment to effectively manage an organization's fraud risk include:

Principle 1: As part of an organization's governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

Principle 2: Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

Principle 3: Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

Principle 4: Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

Principle 5: A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

Fraud investigations involve a variety of steps designed to protect the business, minimize disruptions and preserve evidence. The process approved by the board should include a

tracking or case management system in which all allegations of fraud are logged. Designated senior management approved by the board and the board itself may be given access to this system if necessary to ensure that appropriate action is being taken. In Bank of Slovenia there are intensive efforts dedicated to set up appropriate fraud prevention system, which shall include whistleblower hotline and investigation procedures.

## LITERATURE

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