PUBLIC ACCOUNTS COMMITTEE
THE STATES OF GUERNSEY

# REVIEW OF THE STATES OF GUERNSEY'S FINANCIAL CONTROLS: FRAUD

## Stage 1: Review of the States of Guernsey's anti-fraud governance framework

**MAY 2013**

# 1. Chairman's Statement

When it was announced in July 2012 that the States of Guernsey had been defrauded of £2.6 million of taxpayers' money, there was understandable shock and anger throughout the community. That such a fraud did occur only highlights the fact that we must have the necessary frameworks in place to defend against this type of threat.

Whilst the public clearly have an interest in the details of the specific incident of fraud, it was as important to find out whether there was an underlying problem that led to the States of Guernsey being exposed to this unacceptable risk of fraudulent activity. Ernst & Young were commissioned by the Public Accounts Committee to undertake that piece of work.

A number of reports, spanning more than a decade, into the States' financial controls and risk management regime (of which an effective anti-fraud governance framework is a vital part) have highlighted numerous inadequacies. This, despite the fact that Guernsey has one of the most regulated and highly respected financial services industries in the world.

One of those reports was published by the previous Public Accounts Committee (PAC) in May 2012, just before the specific incident took place. The findings of the PAC report were confirmed by a States Internal Audit Unit report the same month, which stated that the anti-fraud governance framework was considered to be inappropriate.

However, the incident of fraud in July 2012 has been a catalyst for change. It should be acknowledged that a significant amount of work has been undertaken in the months following the incident and credit should be given to the States' Head of Assurance who is leading the implementation of the improvements.

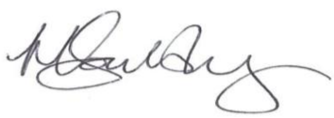
Political ownership has also been evidenced in the creation of a temporary Risk Steering Group comprising the Chief Minister and Ministers of Treasury & Resources and Public Services, but this momentum needs to be maintained to ensure that a risk management framework, that includes anti-fraud governance, is put in place and is appropriate to the size and complexity of the States of Guernsey.

This can only happen through a change in culture, from the top down.

Early indications are that real change is happening. However, this needs to continue to be led at political level and delivered operationally by senior staff within the States of Guernsey.

The Committee are concerned whether the Executive Leadership Team, overseen by the Risk Steering Group, will continue to be pro-active in ensuring planned actions are completed in a timely manner. The Risk Steering Group must support on an ongoing basis, the proposed Risk Management Framework and Strategy, the Corporate Fraud Lead when appointed and all those tasked with anti-fraud management.

The recent implementation of SAP and the Shared Transaction Service Centre (STSC) has had a major effect on the financial control environment within the States of Guernsey. The Committee is concerned that such a significant change has occurred prior to the development of an appropriate risk management framework and accordingly it has approved the commencement of Stage 2 of its Review of Financial Controls, focussing on those controls now in place.



**Deputy Heidi Soulsby**
**Chairman, Public Accounts Committee**

## 2. Executive Summary

2.1. The report from Ernst & Young confirms that prior to May 2012, the States of Guernsey had an inadequate risk management framework in place.

2.2. It is important to note that Ernst & Young completed its fieldwork on 17th December 2012 and their report therefore reflects the action taken by the States of Guernsey up to that point.

2.3. The Committee acknowledges that the States of Guernsey had taken steps to improve the framework in the period between May and December 2012 (the period which the Ernst & Young report covers) and that a number of workstreams remain in progress which should, if successfully implemented, improve the framework further.

2.4. However, it is clear that at this point in time the risk management framework of the States of Guernsey, which includes anti-fraud governance, remains inappropriate and further work is required.

2.5. The Ernst & Young report shows that the States of Guernsey has historically *"repeatedly failed to implement and embed a consistent, formal, comprehensive approach to general risk management"*[1]. The Committee firmly believes that the implementation of such, should be of the highest priority for the States of Guernsey during this political term.

2.6. Subsequent to the review by Ernst & Young, the establishment of the Shared Transaction Service Centre (STSC) and the implementation of the new SAP system have been completed.

2.7. As the implementation of both the STSC and SAP has had significant implications for financial management in the States of Guernsey, the Committee intends to commence Stage 2 of its Review of Financial Controls as soon as possible, focussing on the financial controls which are now in place.

## 3. Background to the review

3.1. On Wednesday 25th July 2012, the Treasury & Resources Department's Minister delivered a statement to the States of Deliberation announcing the States of Guernsey had been victim to a significant fraud. On 10th July 2012, the Department had been notified that a legitimate payment of £2.6m, which was due to Lagan Construction Limited, had been paid to a third party.

3.2. The Minister stated that while the Department did have internal controls in place, *"clearly these were inadequate in preventing this particular fraud from occurring. The internal controls were immediately changed to prevent a recurrence"*.[2]

[1] Paragraph 4.2: "Review of the States of Guernsey's anti-fraud governance framework" – Appendix I
[2] Treasury & Resources Department Minister's Statement July 2012 States Meeting: www.gov.gg/article/101651/Treasury-Ministers-statement-to-the-July-2012-States-Meeting

3.3. The Minister also confirmed "*that the Policy Council had agreed to commission an independent, external review into the financial controls in the States of Guernsey.*" He stated *"...this is an occasion where an impartial, third party investigation is absolutely essential to preserve public confidence in the ability of my Department to discharge its functions"*.[3]

3.4. The Public Accounts Committee was the appropriate body to oversee the investigation given its mandated role and the Policy Council was in agreement that the choice of who to carry out such investigations, should be a matter for determination by the Public Accounts Committee.

3.5. In September 2012, the Committee published the Terms of Reference[4] for a broad review of the effectiveness of financial controls in place across the States of Guernsey to minimise the risk of fraud against the organisation and safeguard States' assets. It was agreed that the review would take a staged approach and that the investigation into the circumstances surrounding the specific incident of fraud would not progress until completion of the police investigation. This investigation is still ongoing.

3.6. In November 2012, Ernst & Young was announced as the independent expert reviewer for the first stage of the Committee's review of the States of Guernsey's financial controls. This initial stage was to focus on the appropriateness of the States of Guernsey's anti-fraud governance framework before and after the specific incident of fraud committed against the States, which had been reported in July 2012.

## 4. Ernst & Young: "Review of the States of Guernsey's anti-fraud governance framework"

4.1. Ernst & Young undertook the review fieldwork in November and December 2012 and produced a report for consideration by the Public Accounts Committee. The Ernst & Young Report entitled "Review of the States of Guernsey's anti-fraud governance framework" is attached as Appendix I to this report.

4.2. It is important to note that Ernst & Young completed its fieldwork on 17th December 2012 and their report therefore, reflects the action taken by the States of Guernsey up to that point.

4.3. The key themes that the report covers are:

- The appropriateness of the States' anti-fraud governance framework pre-May 2012;
- The reasonableness of the recommendations and actions as set out in the States of Guernsey's Internal Audit Unit reports, issued in May 2012 and August 2012;
- The appropriateness of the States' anti-fraud governance framework subsequent to these recommendations and actions; and
- Ernst & Young's recommended next steps.

[3] Ibid

[4] Public Accounts Committee Review Terms of Reference: http://www.gov.gg/CHttpHandler.ashx?id=77701&p=0

4.4. Ernst & Young concluded that the States of Guernsey anti-fraud governance framework pre-May 2012 was **inappropriate** compared to an organisation of similar size and complexity. It found *"while there were elements of an anti-fraud governance framework, they were uncoordinated, inconsistent and not embedded culturally"*[5].

4.5. The recommendations and actions set out in the Internal Audit Unit (IAU) reports issued in May 2012 and August 2012 were determined to be "not unreasonable" by Ernst & Young.

4.6. Those recommendations and actions had been further developed in the October 2012 States' Fraud Risk Management Improvement Plan. The Ernst & Young report identified that subsequent to the successful completion and embedding of these further planned actions, the States' anti-fraud governance framework would be expected to move further towards a position having an 'established/advanced' framework.

4.7. At the completion of their fieldwork on the 17th December 2012, Ernst & Young concluded that while improvements had been implemented, some planned actions were still outstanding, therefore, the framework remained **inappropriate** compared to an organisation of similar size and complexity and additional actions were required.

4.8. Ernst & Young made a number of recommendations which it believes will support the States of Guernsey in determining future anti-fraud direction and development priorities.

4.9. It is important to note that whilst 42 recommendations are included in the report, a number of the recommendations are similar to, or an extension of, the recommendations and actions included in the October 2012 States' Fraud Risk Management Improvement Plan, which contained 32 action points.

4.10. However, it is clear that as at 17th December 2012, a number of the workstreams were still ongoing and further improvements were required. Section 6 of this report provides a further update on these activities.

## 5. Lack of action against historical reports

5.1. Section four of the Ernst & Young report details the number of previous reports commissioned over the last twelve years that have considered risk management within the States of Guernsey. All of those reports, including the previous Public Accounts Committee's review of the same subject in 2012, concluded that the risk management provision was inappropriate.

5.2. It is clear that the States has persistently failed to develop and implement a States wide approach to risk. The Ernst & Young report states *"as at May 2012, the States was still lacking a consistent, formal, comprehensive and corporate approach to general risk management. This had clear implications for the management of risk generally and fraud risk specifically"*[6].

[5] Paragraph 4.32: "Review of the States of Guernsey's anti-fraud governance framework" – Appendix I
[6] Paragraph 4.30: "Review of the States of Guernsey's anti-fraud governance framework" – Appendix I

5.3. The IAU's May 2012 report concluded that the States of Guernsey is in the bottom 5-10% of organisations across the UK in terms of its counter fraud maturity.

5.4. The present Public Accounts Committee has concluded, that the States of Guernsey has not appropriately prioritised this area historically and whilst proposals for change were previously considered and initially progressed, these lost momentum and the importance of risk management was not appreciated.

## 6. Actions taken post July 2012

6.1. Whilst acknowledging that recommendations have been made and actions have been taken to improve the States' anti-fraud governance framework, questions have arisen for the Committee over whether the Treasury & Resources Department has acted with appropriate expediency in taking action against the recommendations.

6.2. Following its August 2012 report, the IAU proposed a number of constructive and practical recommendations and actions which would significantly improve the States' anti-fraud governance framework.

6.3. These recommendations and actions now form much of the October 2012 States' Fraud Risk Management Improvement Plan. The Committee notes the positive contribution of the Internal Audit Unit in this area.

6.4. As part of this stage of the review, the Committee sought an independent evaluation of the IAU recommendations and actions, as set out in the 2012 reports. Ernst & Young concluded that these recommendations and actions were "not unreasonable" and their successful implementation should move the States' anti-fraud governance framework further towards a position of 'established/advanced'.

6.5. The Committee notes that the Ernst & Young report identified that the States' anti-fraud governance framework was still inappropriate due to a number of factors, including:

- Some planned actions were dependent on the identification of a Corporate Fraud Lead; *(at the time of writing a permanent Corporate Fraud Lead had still to be appointed).*
- Some planned actions were dependent on the new SAP system going live on 1st January 2013; and
- Other competing priorities, such as the Financial Transformation Programme.

6.6. Since Ernst & Young completed its report the following work has been initiated:

- A supplier selected to develop and implement a Risk Management Framework and Policy;
- The compilation of a draft Corporate Risk Register;
- Risk Identification and Mitigation workshops;
- The development of a revised Fraud Rule, Directive and Response Plan which has been drafted and circulated to Departments for consultation;
- A comprehensive authorisation policy devised, which is being reviewed for feasibility and appropriateness. It is intended that this is implemented in the near future and will then be included within the States Rules for Finance and Resource Management.

6.7. Whilst the above are all positive moves towards change, they do not fulfil all of the recommendations in the Ernst & Young report.

## 7. Oversight and accountability

7.1. The Committee fully concurs with the conclusion of Ernst & Young that *"The 'climate is right' to ensure that there is a robust and fully embedded anti-fraud governance framework across the States. Anti-fraud must be owned by staff at all levels, but the change must be driven by the right tone from the top"*.

7.2. Throughout this review, it has become evident to the Committee that the ownership and accountability of risk management within the States of Guernsey is not entirely transparent.

7.3. In future there needs to be clarity of where responsibility and accountability rests for successfully implementing both the States' Fraud Risk Management Improvement Plan and the recommendations made by Ernst & Young – at both a political and operational level.

7.4. Political ownership has been evidenced in the creation of a temporary Risk Steering Group comprising the Chief Minister and the Ministers of the Treasury and Resources and Public Services Departments, but this momentum needs to continue to ensure that a risk management framework is implemented that includes anti-fraud governance and is appropriate to the size and complexity of the States of Guernsey.

7.5. The Treasury and Resources Department and the Policy Council (working via the Executive Leadership Team and the Risk Steering Group), must also ensure that future planned actions are completed in a timely manner and that those charged with taking forward the workstreams have the necessary authority, resources and support to do so.

7.6. Currently, the responsibility lies with Treasury and Resources Department and the Committee would like to be satisfied that this is a logical place for this to sit, or whether it should become the responsibility of the Policy Council.

7.7. The Head of Assurance has taken the lead in managing the Corporate Risk Management improvement activity, including acting as the interim Corporate Fraud Lead, whilst also in the role of Head of Internal Audit, responsible for reviewing the adequacy of the risk management regime. The Committee needs to be assured that any potential conflicts between the roles of Head of Internal Audit and Head of Assurance are managed appropriately.

7.8. The Committee also needs to be assured that a cultural change has occurred and that risk management will now be embedded within the operations of the organisation, with roles and responsibilities clearly and appropriately defined.

## 8. Conclusion

8.1. The report from Ernst & Young confirms that prior to May 2012, the States of Guernsey had an inadequate risk management framework in place. However, improvements have been made and progress is ongoing, but it is clear that at this time, further work is required.

8.2. The Committee believes the States of Guernsey has taken some important steps in improving the States' anti-fraud governance framework, but it is crucial that the States does not falter, as it has done historically, and delivers a consistent, formal, comprehensive and truly corporate approach to risk management.

8.3. There is a vital role for the Committee to play in monitoring the progress being made in the development of an appropriate risk management framework. In addition, it is well aware of the fundamental changes to the financial control environment arising from the implementation of SAP and STSC and believes that it is essential that it undertakes a review of the financial controls in place. The Committee is keen to ensure that those who are tasked with delivering improvements are taking the necessary steps to achieve a consistent, formal and comprehensive approach to general risk management.