**Annual Dinner - School of Law - UCLan Cyprus - 16 February 2018**

**Speech by the Auditor General of the Republic**

**What is good governance, why does it matter, and how can it be achieved.**

**Ladies and Gentlemen,**

**Distinguished guests,**

Let me first express my gratitude for your kind invitation to address a speech in this year’s annual dinner of the School of Law of Uclan University. The presence of all distinguished guests is an honor for me. Most importantly, the presence of the students of your School of Law, puts on my shoulders the burden to convey to them the importance of ethical behavior and respect of public money.

Maxwell Communication Corporation plc, was a leading British media business established in 1964 by Robert Maxwell, a British media proprietor and Member of Parliament. It was listed on the London Stock Exchange and was a constituent of the FTSE 100 Index.

The Company acquired Macmillan Publishers, a large US publisher, in 1988. It went on to buy Science Research Associates and the Official Airline Guide later that year.

Robert Maxwell's death while cruising the Canary Islands in 1990 shone a spotlight on his company's affairs. A series of risky acquisitions in the mid-eighties had led Maxwell Communications into high debts, which were being financed by diverting resources from the pension funds of his companies. After his disappearance, it emerged that the Mirror Group's debts (one of Maxwell's companies) vastly outweighed its assets, while £440 million (GBP) were missing from the company's pension funds. Despite the suspicion of manipulation of the pension schemes, there was a widespread negative feeling in the City of London that no action had been taken by the UK or US regulators against the Maxwell Communications Corp. Eventually, in 1992 Maxwell's companies filed for bankruptcy protection in the UK and US.

At around the same time the Bank of Credit and Commerce International (BCCI) went bankrupt costing its depositors, shareholders and employees billions of dollars.

Another company, Polly Peck, reported healthy profits one year while declaring bankruptcy the next. For us here in Cyprus, Polly Peck is a well-known case. The company was a small British textiles company, established by a Turkish Cypriot named Asil Nadir, which expanded rapidly in the 1980s and became a constituent of the FTSE 100 Index before collapsing in 1991 with debts of £1.3bn. This eventually led to the flight of its CEO, Asil Nadir, to the occupied by Turkish troops northern part of Cyprus in 1993. Actually, Asil Nadir was hidden in an illegal quasi-state, trying to avoid been arrested in the UK. Seventeen years later, in 2010, Nadir returned to the UK to try to clear his name. Prosecutors alleged that he had stolen more than £150m from Polly Peck and he faced trial on thirteen specimen charges totaling £34m. Nadir was found guilty on 10 counts of theft totaling £29m. On August 2012, at the Old Bailey, he was sentenced to 10 years in prison.

Following these failures, Sir Adrian Cadbury chaired a committee whose aims were to investigate the British corporate governance system and to suggest improvements to restore investor confidence in it. The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange, and the accountancy profession. The report embodied recommendations based on practical experiences and with an eye on the US experience, further elaborated after a process of consultation and widely accepted. The final report was released in December 1992 and was applied to listed companies reporting their accounts after 30th June 1993. It covered financial, auditing and corporate governance matters, and made the following three basic recommendations:

* the CEO and Chairman of companies should not be the same person
* boards should have at least three non-executive directors, two of whom should have no financial or personal ties to executives
* each board should have an audit committee composed of non-executive directors

These recommendations were initially highly controversial, although they did no more than reflect the contemporary "best practices", and urged that these practices be spread across listed companies. In 1994, the principles were appended to the Listing Rules of the London Stock Exchange, and it was stipulated that companies need not comply with the principles, but, if they did not, had to explain why not to the stock market. . This is a rule known as “Comply or Explain”

Before long, a further committee chaired by the chairman of Marks & Spencer, Sir Richard Greenbury, was set up as a 'study group' on executive compensation. It responded to public anger, and some vague statements made by the then Prime Minister John Major that regulation might be necessary regarding over-spiraling executive pay, particularly in public utilities that had been privatised. In July 1995 the Greenbury Report was published. This recommended some further changes to the existing principles in the Cadbury Code:

* each board should have a remuneration committee composed, that would not include executive directors, but could possibly include the chairman
* directors should have long term performance related pay, which should be disclosed in the company accounts and contracts renewable each year

Greenbury recommended that progress be reviewed every three years and so, in 1998, Sir Ronald Hampel, who was chairman and managing director of ICI plc, chaired a third committee. The ensuing Hampel Report suggested that all the Cadbury and Greenbury principles be consolidated into a "Combined Code". It added that,

* the Chairman of the board should be seen as the "leader" of the non-executive directors
* institutional investors should consider voting the shares they held at meetings, though rejected compulsory voting
* all kinds of remuneration including pensions should be disclosed.

A further mini-report was produced the following year by the Turnbull Committee which recommended directors be responsible for internal financial and auditing controls. A number of other reports were issued through the next decade, focusing on what non-executive directors should do, and responding to the problems thrown up by the collapse of Enron in the US. Shortly following the collapse of Northern Rock and the Financial Crisis, the Walker Review produced a report focused on the banking industry, but also with recommendations for all companies. In 2010, a new Stewardship Code was issued by the Financial Reporting Council, along with a new version of the UK Corporate Governance Code, hence separating the issues from one another.

That’s the story of the famous UK Corporate Governance Code, a part of UK company law with a set of principles of good corporate governance aimed at companies listed on the London Stock Exchange.

So, what is “Corporate Governance”?

Corporate governance is the system of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of a company's many stakeholders, such as shareholders, management, customers, suppliers, financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure.

Bad corporate governance can cast doubt on a company's reliability, integrity or obligation to shareholders. Tolerance or support of illegal activities can create scandals like those mentioned before or the one that rocked Volkswagen AG in 2015. Companies that do not cooperate sufficiently with auditors or do not select auditors with the appropriate scale can publish spurious or noncompliant financial results. Bad executive compensation packages fail to create optimal incentive for corporate officers. Poorly structured boards make it too difficult for shareholders to oust ineffective incumbents.

On the contrary, Good Governance creates a transparent set of rules and controls in which shareholders, directors and officers have aligned incentives. Most companies strive to have a high level of corporate governance. For many shareholders, it is not enough for a company to merely be profitable; it also needs to demonstrate good corporate citizenship through environmental awareness, ethical behavior and sound corporate governance practices.

Good governance is fundamentally about improving transparency and accountability within existing systems. Many academic studies conclude that well governed companies perform better in commercial terms.

The board of directors is pivotal in governance, and it can have major ramifications for equity valuation.

Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place.

The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.

Corporate governance is therefore about what the board of a company does and how it sets the values of the company, and it is to be distinguished from the day to day operational management of the company by full-time executives.

Let’s see the major parts of a Governance Code, and let’s take as an example the UK Corporate Governance Code.

The first section deals with **Leadership.** It explains that every company should be headed by an effective board which is collectively responsible for the long-term success of the company.

There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company’s business. A clear distinction between directors and managers is important. The board of directors is responsible for providing intrinsic leadership. It also has to establish and then maintain its mission, values and vision. The future of the organization is determined by the directors. Moreover, directors also determine the structure and strategy of the organization and ensure that its assets and reputation are protected. They need to take decisions taking into account the effect on its stakeholders. Managers are concerned with implementing these decisions and the policies that are made by the board of directors and have to carry out the strategy on behalf of the directors.

In the board of directors, no one individual should have unfettered powers of decision.

The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.

As part of their role as members of a unitary board, non-executive directors should constructively challenge and help develop proposals on strategy.

The next section talks about **Effectiveness.**

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.

This morning I signed a letter to the President of the Republic with suggestions about the criteria for the selection of members of Boards of Directors for the semi-governmental organizations that will soon be replaced following the President’s re-election. We believe that there could be a great improvement in the governance of these organisations if the members are selected based on objective criteria ratherthan on their political or party origin.

There should be a formal, rigorous and transparent procedure for the appointments of new Boards of Directors.

All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively.

All directors should receive pertinent-induction skills upon joining the board and should regularly update and refresh their skills and knowledge.

The board should be supplied with information in a timely manner in a form and of a quality appropriate to enable it to discharge its duties.

The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

The third Section is about **Accountability**.

The board should present a balanced and comprehensible assessment of the company’s position and prospects.

The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.

The board should establish formal and transparent arrangements for considering how they should apply corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company’s auditor.

The fourth Section has to do with **Remuneration.**

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors’ remuneration should be structured so as to link rewards to corporate and individual performance.

There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his or her own remuneration.

In semi-governmental organizations of Cyprus, remuneration is usually very poor. Despite that, there is a real rush by hundreds of people to be selected. Probably this is because they have at the back of their minds, the hidden benefits such as the power to promote, nepotism, favoritism, clientelism, or patronage, not to mention other kinds of corruption.

The fifth Section provides for **relations with Shareholders**. As mentioned, there should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole bears the responsibility for ensuring that satisfactory dialogue with shareholders takes place.

The board should use the AGM to communicate with investors and to encourage their participation.

All of the above mainly cover the governance of private sector companies. But, what about state governance or governance of semi-governmental organizations?

Generally, public governance refers to the formal and informal arrangements that determine how public decisions are made and how public actions are carried out, from the perspective of maintaining a country’s constitutional values when facing changing problems and environments. The principal elements of good governance refer to accountability, transparency, efficiency, effectiveness, responsiveness and rule of law. There are clear links between good public governance, investment and development. The greatest current challenge is to adapt public governance to social change in the global economy. Thus the evolving role of the State needs a flexible approach in the design and implementation of public governance.

Good public governance leads to good management, performance and administration of public funds and, confidence through improved transparency. It encourages public participation and enables organizations to improve their services offered to the public and the citizens.

Codes of Public Governance are very similar to Corporate Governance Codes and have been issued in many countries. In Cyprus, the Institute of Certified Public Accountants issued such a code in 2011 and a new code is currently under preparation.

Good public governance can by no means be taken for granted, even in a prosperous and developed country. The fact that political and public interests are weighed up against a background of democratic legitimacy still does not provide any absolute guarantee. A Code of Public Governance will emphasize to the Council of Ministers and to the board of directors of semi-governmental organizations that they must ensure that the principles of good governance are actually applied and maintained in day-to-day practice; it also provides a frame of reference for others to hold them accountable.

Usually, these Codes do not include legally enforceable provisions since a large body of legislation and regulations which regulate the actions of the authorities usually already exist. However, the values on which the relevant legislation and regulations are based are made explicit in such Codes. They are the shared values that form the foundation on which public administration should operate.

So, we have corporate governance and public governance, and their importance. But what is the role of the Audit Office in promoting or safeguarding good and sound public governance?

As you may appreciate, nowadays, in all countries, an independent institution is responsible for auditing the executive power, ie the government, about how it manages and spends the taxpayers’ money. These institutions are globally called “Supreme Audit Institutions” – SAIs.

The International Organisation of Supreme Audit Institutions (INTOSAI) operates as an umbrella organisation for the external government audit community. INTOSAI is an autonomous, independent and non-political organisation. It is a non-governmental organisation with special consultative status with the Economic and Social Council (ECOSOC) of the United Nations. INTOSAI was founded in 1953. At that time, 34 SAIs met for the 1st INTOSAI Congress in Cuba. At present INTOSAI has 194 Full Members, 5 Associate Members and 1 Affiliate Member.

The Lima Declaration was signed during the IX INTOSAI Congress in 1977 held in Lima, Peru. This document is considered as the Magna Carta of government auditing, as it laid the foundation of public Control.

The principles established in the Lima Declaration have endured in time and have also been recognized by the United Nations General Assembly in Resolution 66/209 of 2011, named “Promoting the efficiency, accountability, effectiveness and transparency of public administration by strengthening supreme audit Institutions” and Resolution 69/228 of 2015, named “Promoting and fostering the efficiency, accountability, effectiveness and transparency of public administration by strengthening supreme audit Institutions”.

These United Nation Assembly resolutions represent milestones in the history of INTOSAI, as can be observed in the following statements:

**1.** Recognize that supreme audit institutions can accomplish their tasks objectively and effectively only if they are independent of the audited entity and are protected against outside influence.

**2.** Recognize the important role of supreme audit institutions in promoting the efficiency, accountability, effectiveness and transparency of public administration, which is conducive to the achievement of national development objectives and priorities as well as the internationally agreed development goals.

**3.** Take note with appreciation of the Lima Declaration of Guidelines on auditing precepts of 1977 and the Mexico Declaration on Supreme Audit Institutions of 2007.

**4.** Acknowledges the role of supreme audit institutions in fostering governmental accountability for the use of resources and their performance in achieving development goals.

These objectives are fundamental components of good public governance.

The public-sector audit environment is that in which governments and other public-sector entities exercise responsibility for the use of resources derived from taxation and other sources in the delivery of services to citizens and other recipients. These entities are accountable for their management and performance, and for the use of resources, both to those that provide the resources and to those, including citizens, who depend on the services delivered using those resources. Public-sector auditing helps to create suitable conditions and reinforce the expectation that public-sector entities and public servants will perform their functions effectively, efficiently, ethically and in accordance with the applicable laws and regulations.

In general public-sector auditing can be described as a systematic process of objectively obtaining and evaluating evidence to determine whether information or actual conditions conform to established criteria. Public-sector auditing is essential in that it provides legislative and oversight bodies, those charged with governance and the general public with information and independent and objective assessments concerning the stewardship and performance of government policies, programmes or operations.

All public-sector audits start from objectives, which may differ depending on the type of audit being conducted. However, all public-sector auditing contributes to good governance by:

* providing the intended users with independent, objective and reliable information, conclusions or opinions based on sufficient and appropriate evidence relating to public entities;
* enhancing accountability and transparency, encouraging continuous improvement and sustained confidence in the appropriate use of public funds and assets and the performance of public administration;
* reinforcing the effectiveness of those bodies within the constitutional arrangement that exercise general monitoring and corrective functions over government, and those responsible for the management of publicly-funded activities;
* creating incentives for change by providing knowledge, comprehensive analysis and well-founded recommendations for improvement.

Academic research reasserts that SAIs, among other factors, have positive effects for the quality of government (Rothstein and Tannenberg M., University of Gothenburg 2015)

New strategies for public governance, catalysed by the stress test of the financial crisis, economic deceleration and an emphasis on debt management, have compelled countries to take introspective reviews of the gamut of both government processes and their outcomes. A decline in citizens’ trust in government coupled with a surge in inequality has highlighted the need for public programmes to be effective and responsive to citizens’ needs. Doing more with less has required governments to make trade-offs based on a broader government vision. Yet this has proven difficult in the face of cross-governmental initiatives and varying policy priorities. Selecting the programmes and policy tools that bring value-for-money has highlighted the need for these trade-offs to be based on evidence. However, a more systemic understanding of what is effective and efficient will be critical to addressing long-term and complex policy challenges, such as climate change and a sluggish global economy.

SAIs have untapped potential to inform what works and what does not in public governance. Independent and professional SAIs are traditionally known and trusted for holding government to account for the use of public resources. Yet, their activities have evolved over recent decades to provide a broader, cross-cutting view on the functioning of both processes and programmes across government. There is potential for SAIs’ external, objective perspectives to strengthen the evidence based on which policy decisions are made in order to complement, but not displace, existing assessments of value-for-money.

If funds are misplaced and no one reports on it, then efforts are wasted and development initiatives remain unsustainable.

In 2015 a report named “SAIs and Good Governance – Oversight, Insight and foresight” was issued by OECD, the Organisation for Economic Co-operation and Development.. The report maps how ten leading SAIs are assessing key stages of the policy cycle and its outcomes (policies and programmes), building on the experience of the SAIs of Brazil, Canada, Chile, France, Korea, the Netherlands, Poland, Portugal, South Africa and the United States. By matching SAIs’ activities with governments’ good practices and policy challenges, the report also highlights that delivering value-for-money is a shared goal between the Legislature, the Executive and SAIs, that could be better addressed by leveraging all actors’ potential. The following are listed as key findings:

* The promotion of accountability through oversight remains a core activity of SAIs’ work. SAIs systematically provide oversight on the compliance of audited entities with rules and regulations.
* The ten participating SAIs are also active in assessing key functions required for policy and programme formulation, implementation and evaluation, as well as their outcomes (programmes and services). They tend to be more active in assessing achievement of good practice principles in traditional areas, including, budgetary planning and execution, and in internal control. They are less likely to assess efficiency and effectiveness in processes required for strategic whole-of-government steering or for communication and co-ordination.
* Moreover, the participating SAIs are increasingly using their expertise to provide insight and foresight. They are more taking a systemic view to pinpoint cross-cutting issues and trends in the short term, and to forecast implications and predict risks in the medium and long-term. For instance, some SAIs are providing insight into duplication, fragmentation and overlap across government, while others are assessing the preparedness of government to address long-term policy challenges such as climate and demographic change.
* This wealth of information is being produced and communicated in a wider variety of ways. SAIs are using financial, compliance and performance audits, evaluations that integrate value-for-money criteria, research, guidance and manuals, informational seminars with auditees and testimonials to relevant Legislative committees.
* The adoption of insight and foresight activities has not been systematic. In some cases the expansion of the audit portfolio to include these activities has been strategic and systematic. More often however, these activities are being undertaken in an ad-hoc manner, whether at the request of the Legislature or in response to high profile or citizen-sensitive cases, for instance.
* SAIs face limitations to undertaking certain work, and to linking it to the policy cycle. Yet, these challenges have more to do with internal limitations – a lack of resources and skills – than with limitations imposed from the external environment. However, they report that a lack of leadership in the Executive branch, and a lack of auditees’ skills, has limited their ability to undertake assessments of particular policy functions.
* SAIs need to be aware and prepared to remain relevant to policy challenges of the 21st century. The experiences of the ten participating SAIs provide key considerations for an SAI to make in considering the relevance of their existing, and any new, activities. The considerations centre around the strategic trade-offs that may be required internally (on skills and between activities), on the need to ensure quality and timeliness of audit work and on the impact of the SAIs work on the broader governance architecture and on the roles of other public institutions.

A number of INTOSAI standards, deal with good governance issues. I mention a few:

* Guidelines for Internal Control Standards for the Public Sector
* Guidance for Reporting on the Effectiveness of Internal Controls: SAI Experiences in Implementing and Evaluating Internal Controls
* Internal Control: Providing a Foundation for Accountability in Government
* Guidelines for Internal Control Standards for the Public Sector – Further Information on Entity Risk Management
* Internal Audit Independence in the Public Sector
* Coordination and Cooperation between SAIs and Internal Auditors in the Public Sector

According to INTOSAI auditing standards (the so called ISSAIs), there are three main type of audits: Financial Audit, Performance Audit and Compliance Audit.

We perform all these kind of audits.

First of all, we carry out financial audits as external auditors in order to express an opinion on whether the financial statements give a true and fair view at the end of each year and with respect to the results of that year, in accordance with the appropriate professional International Standards.

We also carry out Performance Audits and compliance audits, focusing on the economy, efficiency and effectiveness as well as the legality and regularity of the functions and transactions of our auditees in the public sector.

Technical audits are carried out too, mainly with respect to the public procurement procedures which need to be followed for projects, on a preventive as well as on an ex-post basis, in accordance with the relevant legislation. This is a special kind of audit, provided in Cyprus procurement legislation.

As a result, at the conclusion of each audit and after discussing the points arising with the auditees and receiving their comments, we publicize special reports and our Annual Report. Parliamentary Committees, especially the Public Accounts Committee, regularly discuss our reports, in the presence of the auditee management. These reports include our findings and recommendations submitted to the auditee management, based on the audit work we carried out, in an effort to improve the system of internal controls and also call to account all those charged with the power to use or manage public resources appropriately and to the best advantage of the citizens, in the public interest. These are the principles of transparency and accountability in the public sector, which the Auditor General and the Audit Office of the Republic uphold and will continue to uphold whatever the cost, simply because this is our mission.

**The issue of fraud – responsibility of management**

Moving on to issues such as fraud and corruption, that extinguish good governance, it should be noted that their prevention and their discovery, is neither the responsibility, nor the primary focus of the work of an external auditor, and it is also not the primary focus of our work in the Audit Office of the Republic. We do not perform audits having as our goal to discover or unveil cases of fraud and corruption, scandals, collusion, illegal/criminal acts and theft of public money. This is what the professional International Standards on Auditing stipulate as well. The external auditor plans his audit work and audits, on a sample basis, in order to obtain adequate evidence and assurance regarding the subject audited in order to be able to issue his professional report and express an opinion appropriately.

The primary responsibility for the prevention and detection of fraud rests with both those charged with the governance and the management of the auditee entity. It is important that management, while also overseeing those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. Overseeing those charged with governance includes considering the potential for overriding of controls or other inappropriate influences and taking preventive action accordingly.

This involves, above all, a commitment to create a culture of honesty and ethical behavior which can be reinforced by active overseeing, in practice, by those charged with governance. However, I am sure you do not need me to point out that, unfortunately, it is evident, that this commitment, this culture and this behavior which is so necessary, was and still is, seriously lacking in major respects in the public sector of Cyprus, and given that we live in such a corrupt society, it is imperative for such a culture to be created as soon as possible, for the sake of the new generation, for our children and for the future of our country.

**Responsibility of the Auditor**

As stated in the International Standards on Auditing, an auditor conducting an audit in accordance with the International Standards on Auditing is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Nevertheless, owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed.

It should be underlined here that, the risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false. The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those individuals involved. While the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas such as accounting estimates, or wrong interpretation and application of legal provisions, are caused by fraud or error.

Furthermore, the risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

**Actions of the auditor in cases of suspected fraud**

So, if the auditor identifies a fraud or has obtained information that indicates that a fraud may exist, the International Standard on Auditing require the auditor (it is not a choice, but a requirement) to communicate these matters in a timely manner to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. The auditor is required to communicate with those charged with governance any other matters related to fraud that are, in the auditor’s judgment, relevant to their responsibilities.

Also, if the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion, to a party outside the entity where the auditor’s legal responsibilities require him to do so.

In the public sector especially, as a rule, fraud and corruption thrive when transparency and accountability are absent. A good system of internal controls as well as the regular performance of the audit work itself, and the transparency and accountability which should always go hand in hand with it in the public sector, are an absolutely crucial preventive measure against fraud and corruption, given that then, there is always the fear on the side of the perpetrators, that, should they dare commit fraud, their fraudulent acts may well be uncovered and the consequences will surely follow.

**Fraud in the Public Sector:**

Fraud is an issue that all governments face regardless of their size, geographical area or culture, no matter how «clean» they appear to be. The term «fraud» commonly includes activities such as theft, corruption, conspiracy, money laundering and extortion. Among other types of wrongdoing, corruption is also associated with nepotism or favoritism, clientelism, cronyism and patronage. Fraud essentially involves using deception to dishonestly make a personal gain for oneself and/or create a loss for another.

Fraud and corruption are related but slightly different concepts. As van Stolk and Tesliuc (2010) pointed out, an important consideration is distinguishing corruption from fraud. In their conceptualisation, fraud is understood as intentional misleading action to gain a benefit while corruption refers to intentional action by staff or office holders. In other words, fraud does not require the involvement of a public official. And of course there is a difference between fraud and corruption on the one hand and error on the other, in the sense that in fraud and corruption there is presence of intention, while in errors there is not.

The consequence of fraud in the public sector is wider and goes beyond personal loss as it causes harm to the economy of a whole nation and its society and can have considerable social and psychological effects. More specifically, fraud and corruption result in the waste of resources and reduce economic growth and the quality of life, undermine government credibility and reduce its effectiveness. Public sector fraud, bribery and corruption have devastating effects, especially on the poorest citizens and that is why these have become leading concerns for legislators around the globe.

A recent European Parliament study (March 2016) reveals that corruption throughout Europe costs somewhere between 820 - 990 billion euro a year. The staggering sum, which equates to 4.9 to 6.3 per cent of the overall EU-28 GDP, is eight times higher than the estimate of €120bn included in the 2014 EU Anticorruption Report (EC 2014h). The difference is because the estimate in the EU ACR does not account for the indirect effects of corruption (it looks at costs in terms of lost tax revenues and foreign investment due to corruption). The EU Parliament study takes a broader range of effects of corruption into account. These indirect effects include changes in the behaviour and incentives of individuals and firms in light of widespread corruption, which can lead to lower productivity of labour, physical and human capital. The detrimental effects of corruption on the efficiency of resource allocation within an economy can operate through various channels (OECD 2013b):

• Corruption weakens market mechanisms. For instance, if investment is subject to government regulation, then corruption acts as a tax on investments, if businesses need to use bribery in order to get their requests granted. This makes investment activities more costly for firms, lowering profitability and hence lowering the overall level of investment.

• Corruption has a detrimental effect on competition. This arises in the form of weaker regulation and antitrust enforcement, as well as deterring new firm entries into markets and making entrepreneurship less attractive. This matters, as competition is considered an important driver of efficiency and innovation in modern economies.

• Corruption might affect economic performance by directing the composition and volume of government expenditures. For instance, the design of the tax system and its implementation may enable public officials and taxpayers to engage in corruption activities and therefore lower overall tax revenues.

The figures for some countries are extraordinarily high. For Cyprus, the cost of corruption as a percentage of GDP ranges between 5,8% and 9,2%, for Greece and Italy it ranges somewhere between 12,6 and 17,8%, and for Bulgaria and Romania it ranges between 14 and 22%. Amazing!!!

**Why fraud exists:**

The challenge that every government faces is: What needs to be done to reduce the threat of fraud? To answer this, first we need to understand: WHY do people commit fraud? Is it strictly a matter of character?

There is no single reason behind fraud and any explanation needs to take into account various factors. The major reason people commit fraud is because they are allowed to do so! So what needs to be done is NOT to allow people to commit fraud by eliminating the factors that result in fraudulent activities.

A common model that brings together a number of these factors is the «Fraud Triangle». The model is built upon the premise that fraud is likely to result from a combination of three factors: motivation, opportunity and rationalization.

* Motivation is typically based on either greed or need.
* Opportunity is high in cases where there is a weak internal control system, poor security over property, little fear of exposure and likelihood of detection, or unclear policies with regards to acceptable behavior.
* Rationalization is an act where some people may be able to rationalize fraudulent actions as necessary, harmless or fair, meaning that they feel they have been mistreated.

Therefore, the likelihood that a fraud will be committed is greatly decreased if the potential fraudster believes that the reward will be modest, that he will be detected or that the potential punishment will be unacceptably high. The main way of achieving this must be to establish a comprehensive system of control which aims to prevent fraud, and where fraud is not prevented, there is an increase in the likelihood of detection and also an increase in the cost for the fraudster.

As vividly described by Warren Buffett «there is seldom JUST one cockroach in the kitchen», meaning that if nothing is done to reduce the opportunity for committing fraud, then there will be a dramatic increase in fraudsters. Along the same lines, the «Broken Window Theory», developed by George Kelling and James Wilson, states that if a broken window is not immediately fixed, all windows will end up broken. We need to fight fraud and «fix the window» before it is too late. Governments need to take action to reduce the opportunity for fraud with the aim to increase the prosperity and well-being of their citizens. A society committed to combating fraud and corruption is also one associated with pursuing other public good and there is strong empirical data supporting a positive correlation between anti-corruption and other public good like global competitiveness, human development, civil liberties and democracy.

Unfortunately, the recent global financial crisis was a major drawback in this fight as it has increased all three factors described in the «Fraud Triangle». In the public service, for example, the reduction of staff and the restrictions imposed on new hiring led to reduced segregation of duties, in many cases, and reduced control and monitoring of suspicious transactions and activities. Also governments, in an aim to reduce expenses, are restricted in making sufficient investment in detection tools and good systems. These situations described increase the opportunity risk.

The reduction in salaries and benefits increase the motivation risk not only by employees but also by citizens who may deliver counterfeit documents so as to receive benefits that they are not entitled to or reduce the amount of taxes that they have an obligation to pay.

Rationalization is also increased because public employees and citizens feel they are unfairly mistreated due to the reduction of salaries, benefits and the increase in taxes.

The only good thing, is that in times of poverty, people are more awakened and alert and show less understanding or sympathy for officials accused of corruption. This increases the pressure for more severe penalties.

**Public Sector Fraud in Cyprus:**

Fraud and corruption has existed from ancient times. Bribery, it could be argued, is mankind's second oldest profession. Aristotle was referring to the bribing of judges, but nowadays the scandals regarding fraud and corruption incidents are rapidly increasing. Is this because people are more corrupt nowadays or because more opportunities are becoming available to commit fraud?

Based on «the fraud-control relationship», this is partly a result of increased control due to new legislation and improved standards of control that lead to this paradox, explained as follows: as the level of control rises, the more fraud incidents are revealed and therefore the more incidents of fraud are made known to the public.

There have been many attempts to measure the true extent of fraud, but compiling reliable statistics around fraud is not easy. As one of the key aspects of fraud is deception, it can be difficult to identify and survey results, which often only reflect the instances of fraud that have actually been discovered.

Fraud in the public sector is often perpetrated where a high amount of money is involved, and therefore high motivation exists, for example within a tender procedure or when calculating tax liability.

**Ways to reduce fraud – what the Government should do:**

Public sector fraud and corruption thrive when accountability and transparency are absent. Effective accountability is achieved through the implementation of good practices in transparency, reporting and audit.

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management so the tone must be set at the top. Governments need to develop effective strategies to manage the risk of fraud that will fit well within the boundaries of good governance and will consider both fraud prevention and fraud detection, although it is easier and more cost effective to deter and prevent fraud and corruption than to detect and investigate it.

The prevention of fraud should concentrate on limiting the fraud-risk factors which is described as any event or condition that tracks the three conditions of the «fraud triangle» that I mentioned earlier. That is to adopt methods that will decrease motive, restrict opportunity and limit the ability for potential fraudsters to rationalize their actions. Prevention techniques include the introduction of policies, procedures and controls, and activities such as training and fraud awareness. Although fraud risk factors do not necessarily indicate that fraud exists, they are often warning signals where it does. However, many governments do not have a formal approach to fraud prevention.

A fraud detection strategy should involve use of analytical and other procedures to highlight occurrences of fraud in a timely manner. A major issue is that once a fraud occurs, the likelihood of recovering stolen funds from the perpetrator is often relatively low.

In Cyprus a committee has been established, under the Ministry of Justice and Public Order, for designing «the National Strategy to educate, deter and prevent corruption in society, public administration and the private sector». The anti-corruption strategy will focus on:

* prevention, which aims to reduce corruption opportunities and to prevent its causes.
* education, through the design and implementation of appropriate educational and training programs, structures and instruments.
* Awareness, through attempting to change the behavior and perceptions of society on these issues by attempting to bolster their expectations of good management and accountability, and to help society resist and prevent corruption, which would, in turn strengthen the framework for non-public agencies to participate.
* effective enforcement of anti-corruption measures, such as strengthening the legal and control framework for combating corruption, increasing confidence in the quality and effectiveness of actions against corruption and increasing compliance with international standards and obligations.
* increased compliance to good governance rules and
* enhancing accountability of public and private entities, such as compliance with the legal and regulatory framework, compliance testing with established accountability standards and enhancement of professional standards in all institutions and public services.

In the Strategic Plan of INTOSAI for the years 2011-2016, in support of its four strategic goals, six strategic priorities were identified, one of which is associated with the fight against corruption. This places extra burden on the SAIs shoulders that are asked to contribute effectively to the prevention of fraud and corruption in their countries. INTOSAI published recently a new standard (ISSAI 5700) called «Guideline for the audit of Corruption Prevention in Government Agencies» and will require SAIs to create a strategy of combating corruption and other types of irregularities such as money laundering, fraud etc. Additionally, in 2007 INTOSAI formed a working group amongst its members that aims to support SAIs efforts in the field of fighting corruption and money laundering, broadening available concepts and best practices through developing guidelines, submitting training programs etc.

The approach of our office in detecting fraudulent activities and transactions within the government were previously restricted to detecting red flags or symptoms of fraud which were then referred to the Attorney General to conduct the necessary investigations. Currently, our office, when asked, supports the police investigators for analyzing bank accounts data of suspicious people.

Our office is also open to citizens’ reporting incidents of fraud or mismanagement which, if considered relevant to our work, we investigate further during our audits. This helps us identify risky areas that may not be detected in the normal course of our audit.

As the SAI of Cyprus we feel we do our best, with the resources available, to play an active role in raising awareness of the risks of fraud and corruption and fostering good governance and standards of conduct. Our aim is to minimize the expectation gap mentioned earlier and raise confidence and trust in our work both by the Parliament and the public.

Thank you very much for your kind attention.