

Northern Ireland Water's Response to a Suspected Fraud





Northern Ireland Audit Office

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Published 12 March 2013

This report has been prepared under Article 8 of the Audit (Northern Ireland) Order 1987 for presentation to the Northern Ireland Assembly in accordance with Article 11 of that Order.

K J Donnelly

Northern Ireland Audit Office

Comptroller and Auditor General

12 March 2013

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For further information about the Northern Ireland Audit Office please contact:

Northern Ireland Audit Office
106 University Street
BELFAST
BT7 1EU

Tel: 028 9025 1100
email: info@niauditoffice.gov.uk
website: **www.niauditoffice.gov.uk**

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Contents

| | Page |
|--|------|
| Executive Summary | |
| Introduction | 9 |
| Key findings and recommendations | 9 |
| Overall Conclusion | 11 |
| Scope and methodology of the C&AG's review | 11 |
| | |
| Northern Ireland Water's response to a suspected fraud | |
| Background | 14 |
| There were exceptional circumstances in Northern Ireland Water at this time | 15 |
| Separate suspected fraud and disciplinary investigations were initiated on instruction from the Chief Executive | 16 |
| The disciplinary investigation commenced in advance of the suspected fraud investigation | 18 |
| Communication of the suspected fraud to internal and external stakeholders was not in line with guidance | 18 |
| A significant period of time elapsed between discovery of the potential fraud and the start of the suspected fraud investigation | 19 |
| The composition of the investigation team was problematic | 19 |
| NI Water did not engage either formally or informally with the PSNI | 20 |
| The suspected fraud investigation was limited in scope and extent because of inadequacies in NI Water's records | 21 |
| Departmental and NI Water officials charged with governance did not identify weaknesses in the investigative approach | 24 |
| There were major shortcomings in the disciplinary process | 25 |
| NI Water should consider further refinements to the Fraud Response Plan | 27 |

Abbreviations

| | |
|------|--|
| C&AG | Comptroller and Auditor General |
| CEO | Chief Executive Officer |
| DARD | Department for Agriculture and Rural Development |
| DFP | Department of Finance and Personnel |
| DRD | Department for Regional Development |
| ICE | Initial Confidential Enquiry |
| NIAO | Northern Ireland Audit Office |
| NICS | Northern Ireland Civil Service |
| PSNI | Police Service of Northern Ireland |

Executive Summary

Introduction

1. In January 2010, Northern Ireland Water (NI Water) launched an internal investigation into a case of suspected fraud. The investigation, which was led by NI Water's in-house Internal Audit unit, was prompted by its discovery in December 2009, of 'invoice slicing' in relation to one contract. Invoice slicing happens when a contractor, acting with one or more members of staff, limits the value of individual invoices submitted for payment. Where this occurs, payments above a certain value which should be authorised by a senior member of staff, are not subject to that high level check. In April 2010 the internal investigators reported that they "*could not confirm any indicators of fraudulent activity from the work they had performed*".
2. This report examines the scope and methods of the NI Water investigation and makes a number of recommendations for the conduct of future fraud investigations.

Key findings and recommendations

3. In our opinion NI Water should not have started a disciplinary process in advance of completion of the internal fraud investigation undertaken by NI Water's internal auditors. Evidence had not been secured and there was a real risk of suspects being alerted (**Paragraph 30**).
4. The Department for Regional Development (the Department), which is the sponsoring department for NI Water, failed to inform the Comptroller and Auditor General (C&AG) of the suspected fraud in accordance with Department of Finance and Personnel (DFP) Guidance. This is a serious breach of a long established and important accountability control (**Paragraph 34**).
5. NI Water was slow to react to the suspected fraud. Best practice indicates that management's response to suspected fraud must be prompt, ensuring that suspects are not alerted, evidence is secured early and assets are protected (**Paragraph 38**).
6. The fraud investigation team, selected by the former Chief Executive Officer (CEO), had limited experience of fraud investigations (**Paragraph 39**).
7. NI Water did not seek advice from the Police Service of Northern Ireland (PSNI) or other public sector counter fraud specialists in this suspected fraud investigation (**Paragraph 43**).
8. The investigative work undertaken was not sufficiently detailed and rigorous, given the extent of the serious control weaknesses uncovered and the significant level of expenditure under the contract (£3.9 million in total) (**Paragraphs 46 to 50**).
9. As no formal follow-up audit had been carried out by Internal Audit, we were unclear as to whether the recommendations, relating to the serious control weaknesses identified, had been implemented by management. During our review, NI Water collated a Completed Actions Report which summarised management's response to, and

Executive Summary

implementation of, the recommendations highlighted by the investigation report in April 2010 (**Paragraph 52**).

10. The Department was not involved in the conduct of the investigation but was kept advised of its progress. We consider that the Department should have done more to ensure the guiding principles for suspected fraud investigations were being followed and are surprised that the Department did not identify that the terms of reference for the suspected fraud investigation were inadequate (**Paragraph 56**).
11. Those charged with governance/oversight of the investigation, including the former Chief Executive and the Audit Committee, did not identify or address weaknesses in the scope of the investigation and the methodology adopted. We are however, aware that the period during which the investigation took place was a particularly difficult one for the organisation (**Paragraph 57**).
12. There were significant shortcomings in the disciplinary hearing process. Crucially, formal disciplinary letters issued to two members of staff contained an error of fact, which may not have been identified until the disciplinary hearing. In our view, the error led directly to the disciplinary panel's conclusion that the employees concerned had no case to answer (**Paragraph 62**).

Summary of recommendations

In any investigation of fraud or suspected fraud, it is important that communications with internal and external stakeholders are handled effectively. The process for achieving this should be clearly documented: who needs to know, when, why and how. This requirement should never be set aside.

As a rule, management should not expect that internal auditors have the expertise to investigate fraud or suspected fraud. We recommend that fraud investigations should be carried out by fully trained and experienced investigators with a working knowledge of interviewing suspects and collecting evidence in accordance with the provisions of the Police and Criminal Evidence (Northern Ireland) Order 1989 (PACE). Ideally a fraud investigation should be led by an experienced counter fraud specialist.

We recommend that organisations that do not have counter fraud expertise in-house should seek early advice from PSNI and, if required, public sector counter fraud specialists. Informal contact at the outset with the PSNI can help to inform the investigation approach and evidence requirements.

We consider that there would be considerable merit in establishing a Northern Ireland public sector fraud investigation service. We understand that DFP is considering this idea as part of its ongoing review of Internal Audit services in the Northern Ireland Civil Service (NICS).

We recommend that, in future, the Audit Committee's monitoring of audit recommendations should include consideration of recommendations arising from fraud and suspected fraud investigations. It is particularly

important in fraud cases that control weaknesses are strengthened immediately and that management provides a formal assurance to the Audit Committee that this has happened.

Fraud and suspected fraud investigations should be wide-ranging from the outset and should exploit a range of investigative methods. In our opinion, it is a serious mistake to decide that a limited fraud investigation will be conducted initially and the scope will only be widened if new evidence is found.

We recommend that two further amendments are made to the NI Water Fraud Response Plan - the action flowchart should require that:

- Internal Audit is informed of a suspected fraud, by the Head of Corporate Governance, at the same time as the Director of Finance and the Chair of the Audit Committee are informed; and
- the written Initial Confidential Enquiry Report should be produced by the Head of Corporate Governance within 24 hrs (48 hours at present) of the initial verbal report. This would bring NI Water's guidance fully into line with the Department's fraud response plan.

Overall conclusion

13. NI Water's internal investigators concluded that they *"could not confirm any indicators of fraudulent activity from the work they had performed"*. However, we have concerns about the conclusions drawn, given the limited scope of the investigation and inadequacies in the methodology employed. While acknowledging that this investigation took place during a difficult period in NI Water's history, our view is that, on the whole, the guiding principles for the proper conduct of a fraud investigation were not followed.
14. The Department has assured us that, over the past two years, much effort has gone into improving fraud reporting and the management of investigations within NI Water and both are now compliant with appropriate guidance. The Department also told us that the company has made significant improvements to contract procurement and management procedures and practices throughout the organisation.

Scope and methodology of the C&AG's review

15. Our review focused primarily on the scope of the investigation; the methodology employed by the investigators; the governance arrangements for the investigation; and the extent to which the investigation complied with relevant best practice guidance.
16. We have used the guiding principles (**see Figure 1**) in public sector fraud investigation extant¹ at the time of the NI Water investigation as a benchmark in assessing the NI Water suspected fraud investigation. The guidance was updated² by DFP in December 2011 but in essence the principles have remained unchanged.

1 Internal Fraud: Management Checklist, DAO(DFP) 12/06 – October 2006

2 Managing the Risk of Fraud (NI) – A Guide for Managers – December 2011

Executive Summary

Figure 1: Guiding principles in public sector fraud investigation extant at the time of the NI Water investigation

1. The Fraud Investigation Oversight Group³ should set up an investigation team independent from the business area where the suspected fraud took place.
2. The investigation team should have appropriate financial and audit skills which are expected to include knowledge and experience of the provisions of the Police and Criminal Evidence (Northern Ireland) Order 1989.
3. Ideally the investigation should be led by an experienced counter fraud specialist.
4. Organisations that do not have counter-fraud expertise in-house should seek advice from another organisation's counter fraud specialists / PSNI at the outset and during the investigation.
5. All aspects of the suspected officer's work should be investigated, not just the area where the fraud (or suspected fraud) was discovered.
6. The investigation will obviously cover the period the officer was responsible for the processes under investigation but consideration should also be given to investigating earlier periods of employment.
7. Potential evidence, including computer files and record of amendments relevant to the case should be retained securely (in compliance with PACE requirements) and not disposed of under the normal routine procedures for disposal.

8. Control weaknesses discovered in procedures during the investigation should be strengthened immediately.
9. The extent, if any, of supervisory failures should be examined.

Source: Fraud Forum Best Practice Guidance - Internal Fraud: Management Checklist, DAO(DFP)12/06

17. Our review included an examination of documentation held by NI Water relating to both the suspected fraud investigation and the concurrent disciplinary investigation. This included a review of the transcripts of interviews conducted as part of the disciplinary investigation. We also interviewed members of both investigation teams, the Head of Corporate Governance, the Head of the Department's Shareholder Unit⁴ and the Chair of the Audit Committee. We have also consulted with third parties referred to in this report including a number of former NI Water employees.

³ The group of senior managers in an organisation identified in the Fraud Response Plan as having responsibility for the oversight of fraud investigations.

⁴ NI Water is a limited company owned solely by government, with the Department for Regional Development representing the government's shareholder interests through its Shareholder Unit.

Northern Ireland Water's response to a suspected fraud

Background

18. In early December 2009, the former CEO of NI Water asked the company's Internal Audit unit⁵ to investigate payments of £465,000 made to a company referred to as Company E (the Budget Approval Review). This expenditure, incurred between April 2009 and July 2009, did not have budgetary approval.
19. The contract between NI Water and Company E was for water meter installation and management services and it commenced in March 2007. In line with the contract terms, NI Water exercised an option to extend the contract until 31 March 2009. A breakdown of expenditure for each year of this contract is shown at **Figure 2**.
20. During the Budget Approval Review, Internal Audit found that the contract had, in 2009, been further extended until March 2010, one year outside the agreed contract period. This was considered to be a potential breach of European Union procurement regulations and the Regulatory Licence requirements⁶. Internal Audit also noticed an unusual invoice pattern; a large number of invoices presented for payment had a financial value of just under £20,000. The weekly and, at times, the daily expenditure levels under the contract were often substantially in excess of this level. For example, on 11 April 2008, seven separate invoices (with a total value of £108,000) were submitted by Company E and subsequently seven separate payments were made by NI Water.
21. Internal Audit established that the instruction to Company E to limit invoices to under £20,000 had been given, in January 2008, by the NI Water manager who was at that time responsible for the contract (the Contract Manager). This was confirmed

Figure 2: NI Water payments to Company E

| Year | 2006-07 | 2007-08 | 2008-09 | 2009-10 | Total |
|-------------|---------|---------|---------|---------|-------|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| Expenditure | 77 | 608 | 2,505 | 898 | 4,088 |

Source: Answer to a Northern Ireland Assembly Written Question – AQW 981/11

20. During the Budget Approval Review, Internal Audit found that the contract had, in 2009, been further extended until March 2010, one year outside the agreed contract period. This was considered to be a potential breach of European Union procurement regulations and the Regulatory Licence requirements⁶. Internal Audit also noticed an unusual invoice pattern; a large number of invoices presented for payment had a financial value of just under £20,000. The weekly and, at times, the daily expenditure levels under the contract were often substantially in excess of this level. For example, on 11 April 2008, seven separate invoices (with a total value of £108,000) were submitted by Company E and subsequently seven separate payments were made by NI Water.
21. Internal Audit established that the instruction to Company E to limit invoices to under £20,000 had been given, in January 2008, by the NI Water manager who was at that time responsible for the contract (the Contract Manager). This was confirmed by the Contract Manager, but he initially claimed to have acted under instruction from his line manager (the Line Manager). The Contract Manager subsequently alleged that this instruction had come from the then Director with responsibility for this business area (the Director).

5 Until 31 March 2010 the internal audit of NI Water was contracted to a private sector firm. In January 2010 a designate Head of Internal Audit was appointed by NI Water to head an in-house internal audit unit, taking up the substantive post on 1 April 2010. All references in this report to the Head of Internal Audit are to the individual who was designate Head of Internal Audit in the period January to March 2010. It was the in-house unit, and not the contracted-in internal audit function, that was instructed to undertake the invoice slicing investigation.

6 The procurement breach resulted in irregular expenditure totalling £867,490. The C&AG reported previously on procurement breaches in NI Water in his memorandum to the Public Accounts Committee – Examination of Procurement Breaches in NI Water, 9 December 2010.

22. The motivation for limiting the size of individual invoices can be to circumvent delegated limits for authorisation, that is, to avoid the requirement for payments above a certain value to be authorised by a senior member of staff. This action is often referred to as 'invoice slicing'. Invoice slicing can be an indicator of fraud. The applicable delegated limits for NI Water are set out at **Figure 3** below.
- invoice slicing as a potential indicator of fraud and collusion was not identified and highlighted to the Executive Committee.
- There were exceptional circumstances in Northern Ireland Water at this time**
24. In late 2009, following concerns over the value for money of a consultancy

Figure 3: Delegated invoice approval levels of NI Water officials

| Grade ¹ | 1/4/07 to 31/3/08 | 1/4/08 to 31/10/09 | 1/11/09 to 31/03/10 | 1/4/10 to 06/06/10 |
|----------------------------|----------------------|-----------------------|------------------------|-----------------------|
| Level 2 (Director) | Any Amount | Any Amount | Any Amount | Any Amount |
| Level 3 (Line Manager) | Up to £100,000 | Any Amount | Any Amount | Up to £150,000 |
| Level 4 (Contract Manager) | Up to £50,000 | Up to £100,000 | Up to £100,000 | Up to £75,000 |
| Level 5 | Up to £30,000 | Up to £50,000 | Up to £50,000 | Up to £40,000 |

Source: NI Water

Note 1: All transactions must be approved by two persons of appropriate delegated grade

23. The findings of Internal Audit's Budget Approval Review were presented to NI Water's Executive Committee on 11 January 2010. The invoice slicing issue was referred to in a list of recommended next steps. The Committee was advised to, "Consider approach to dealing with the clear breaches in respect of the instruction given to break down supplier invoices and poor financial management by budget holders". However, the significance of
- contract, the former CEO commissioned Internal Audit to conduct an organisation-wide 'Contracts Approval' review, covering procurement expenditure over the preceding twelve months. The review identified significant instances, at all levels of the organisation, of non compliance with the company's financial delegation policy and the Department's Shareholder Governance letter⁷, and potential breaches of the Regulatory Licence.

⁷ The March 2007 Governance Letter sets out the terms of the relationship between the Department, as shareholder, and NI Water

Northern Ireland Water's response to a suspected fraud

25. The 'Contracts Approval' review was made available to the Executive Management Team on 15 January 2010. The findings were passed to the Chairman and Non Executive Directors of the Board of NI Water on 18 January. The former CEO tendered his resignation on 18 January, citing the significant governance issues he faced. On 20 January the former CEO withdrew his resignation, and, with the Department's Accounting Officer jointly commissioned an Independent Review Team⁸. In addition, further in depth reviews covering expenditure going back to 2007 were carried out by a joint Departmental and NI Water Internal Audit team, led by NI Water's Head of Internal Audit. Following consideration of the Independent Review Team's report of 25 February 2010, the then Minister for Regional Development dismissed four non-executive NI Water board members on 11 March 2010. A number of senior executives were also subject to disciplinary procedures as a result of the issues arising from the contract reviews.
26. This was a difficult period in the life of the company and all involved (senior executives, board members and internal auditors) were under considerable pressure. It was in these unusually difficult circumstances that the invoice slicing investigation was conducted.

Separate suspected fraud and disciplinary investigations were initiated on instruction from the Chief Executive

27. The former Director of Customer Services was instructed by the former CEO on 20 January 2010 to "conduct interviews under the disciplinary process to:
- understand the reasons for suppressing the invoices to below £20,000;
 - clarify who gave instructions to who; and
 - consider, in conjunction with me, any immediate steps we need to take to protect the company and to comply with the delegations".
- The former CEO suggested that a Human Resources official and the Head of Internal Audit should be present at any interviews.
28. On 23 January 2010, the former CEO emailed the Head of Internal Audit suggesting that "we need to go deeper". He wondered if the help of a forensic accountant to scrutinise invoices was needed and thought that it may be useful to interview Company E.
29. A timeline showing key events surrounding the invoice slicing issue is at **Figure 4**.

⁸ An Independent Review Team (IRT) was jointly commissioned by the Accounting Officers of the Department and NI Water to undertake a review of procurement governance issues within NI Water. The IRT reported on the 21 June 2010.

Figure 4: The 'invoice slicing' key events timeline

| Date | Key Event |
|--------------|---|
| 3 Dec 2009 | Internal Audit asked by former CEO to investigate expenditure of £465,000 incurred with Company E between April 2009 and July 2009, which did not have budgetary approval. |
| 11 Jan 2010 | Internal Audit present conclusions of the Budget Approval Review to NI Water Executive Committee. |
| 18 Jan 2010 | The Director of the Department's Shareholder Unit informed of invoice slicing by former CEO of NI Water. |
| 20 Jan 2010 | Email from former CEO to the former Director of Customer Services instructing him to conduct interviews under the disciplinary process to establish the facts. |
| 20 Jan 2010 | Key staff interviewed by the disciplinary investigation team. |
| 23 Jan 2010 | Email from former CEO to the Head of Internal Audit instructing her to commence a suspected fraud investigation. |
| 26 Jan 2010 | The disciplinary investigation team contacts Company E and discusses the invoice slicing situation. |
| 28 Jan 2010 | The Head of Corporate Governance informed of the suspected fraud on 27 January 2010 and in line with NI Water's Fraud Policy initiated an Initial Confidential Enquiry (ICE) report. |
| 2 Feb 2010 | Terms of reference for the suspected fraud investigation team agreed with Chair of Audit Committee, the Department, former CEO and Director of Finance. |
| 11 Feb 2010 | Interim progress report on the suspected fraud investigation shared with the Chief Executive, the Department and the Independent Review Team. |
| 15 Mar 2010 | NI Water Executive Committee is presented with draft suspected fraud investigation report. |
| 29 Mar 2010 | Audit Committee ⁹ briefed on findings of suspected fraud investigation. |
| 1 April 2010 | Suspected fraud investigation final report finds no evidence of fraud but identifies serious control weaknesses in contract management procedures which are to be addressed urgently. |
| 7 April 2010 | Disciplinary investigation final report finds the Contracts Manager and the Line Manager have a case to answer in respect of breaches of procedures relating to invoice slicing. |
| 20 May 2010 | Audit Committee briefed on the findings of the suspected fraud investigation final report. The investigation team concluded <i>"that there was no evidence of wrongdoing"</i> . Human Resources were now taking forward disciplinary actions, <i>"regarding incidental poor contract management issues found"</i> . |
| 26 July 2010 | Disciplinary hearings held with two responsible officials. |
| 6 Aug 2010 | Officials informed by the Director hearing the disciplinary case that no further action would be taken. |

9 The Audit Committee was inquorate as there was only one Non-Executive Director of the company. It was agreed that pressing audit issues should be dealt with by the Board.

Northern Ireland Water's response to a suspected fraud

The disciplinary investigation commenced in advance of the suspected fraud investigation

30. The disciplinary investigation led by the former Director of Customer Services started with interviews of key staff. These began within two hours of receiving the former CEO's instruction on 20 January 2010 to "conduct interviews under the disciplinary process" to establish the facts. The Contract Manager was interviewed by telephone (he was on leave at the time) and the Line Manager was interviewed in person on 20 January 2010. The manager who had subsequently taken responsibility for the contract was interviewed the following day and the invoice slicing issue was discussed with Company E representatives on 26 January. The Director (who had left NI Water in June 2009, taking early retirement under a compromise agreement) was interviewed by phone on 1 February 2010. The Contract Manager and the Line Manager were interviewed for a second time on 1 February 2010.

31. In the initial phone interview, the Contract Manager confirmed that he had instructed Company E to limit invoices to under £20,000, on verbal instruction from the Line Manager. In the second face-to-face interview he alleged that it was the Director who had given a verbal instruction. The Contract Manager maintained that lower value invoicing gave more control over the validation process and was unaware of the implication of the instruction. He told us that any decisions he had made were "to ensure maximum efficiency and project control". He added that the instruction for his team to process invoices came from the Director "passing that responsibility".

32. The Line Manager, in both interviews, denied all knowledge of the instruction to limit invoice values. The Director also denied giving the instruction to limit invoice values. Company E confirmed that an instruction had been delivered to them by the Contract Manager at a contract meeting in January 2008.

33. In our opinion NI Water should not have started a disciplinary process in advance of completion of the suspected fraud investigation as evidence had not been secured and there was a real risk of suspects being alerted. The disciplinary investigation began on 20 January 2010, three days before the former CEO instructed the Head of Internal Audit to undertake a suspected fraud investigation.

Communication of the suspected fraud to internal and external stakeholders was not in line with guidance

34. The suspected fraud was reported by NI Water to the Department's Shareholder Unit by mid-January. The Department failed to inform the C&AG of the suspected fraud in accordance with DFP guidance¹⁰. This is a serious breach of a long established and important accountability control and this lapse is worrying given the significant procurement failures being highlighted at that time.

35. In normal circumstances, when fraud was uncovered or suspected, the Head of Corporate Governance would have been informed immediately, but the former CEO told us that, in light of his confidence in

¹⁰ Managing Public Money Northern Ireland (paragraph A.4.7.8) requires that NICS Departments should report immediately, to DFP and the C&AG, all frauds (proven or suspected), including attempted fraud, which affect their Departments or Agencies and NDPBs sponsored by them.

the Head of Internal Audit's handling of the emerging procurement issues, his best judgement was to allow her to proceed with her investigation. This approach was, however, contrary to NI Water's Fraud Policy and Fraud Response Plan.

36. The Head of Corporate Governance was informed of the suspected fraud on 27 January 2010 and, in line with the Fraud Policy, initiated an Initial Confidential Enquiry report on 28 January 2010. The Chair of the Audit Committee and the Director of Finance were formally informed at this point. The ICE report included details of the preliminary investigations that had already been conducted by the Head of Internal Audit, together with brief details of the potential fraud and recommendations for future action.

Recommendation

37. **In any investigation of fraud or suspected fraud, it is important that communications with internal and external stakeholders are handled effectively. The process for achieving this should be clearly documented: who needs to know, when, why and how. This requirement should never be set aside.**

A significant period of time elapsed between discovery of the potential fraud and the start of the suspected fraud investigation

38. A significant period of time elapsed between discovery of the potential fraud by Internal Audit during December 2009 and the start of the suspected fraud investigation in February 2010. Despite the exceptional business circumstances at the time, in our opinion NI Water was slow to react. Best practice indicates that management's response to suspected fraud must be prompt, ensuring that suspects are not alerted, evidence is secured early and assets are protected.

The composition of the investigation team was problematic

39. The investigation team for the suspected fraud was selected by the former CEO and included the Head of Internal Audit and the Deputy Internal Audit Manager. In line with the Fraud Policy, the Director of Asset Management was subsequently appointed as the independent Case Manager at the request of the Director of Finance. Consultants were engaged to provide specialist forensic support relating to capturing and analysing electronic records.

Northern Ireland Water's response to a suspected fraud

40. The independent Case Manager would normally have had full responsibility for progressing, overseeing and controlling the investigation. However, in this case, with the support of the former CEO, the Head of Internal Audit took this role. The Head of Internal Audit met with the Case Manager on only two occasions and the Case Manager assumed a quality assurance type role for the suspected fraud investigation report.
41. The forensic consultants were appointed on 1 February 2010 to download and review the computer records of the two officers under investigation. The consultants were qualified in the use of the forensic industry standard software. The in-house fraud investigation team were qualified accountants who had limited experience of previous fraud investigations but no specialist fraud investigation training.

Recommendation

42. **As a rule, management should not expect that internal auditors have the expertise to investigate fraud or suspected fraud. We recommend that fraud investigations should be carried out by fully trained and experienced investigators with a working knowledge of interviewing suspects and collecting evidence in accordance with the provisions of the Police and Criminal Evidence (Northern Ireland) Order 1989. Ideally, a fraud investigation should be led by an experienced counter-fraud specialist.**

NI Water did not engage either formally or informally with the PSNI

43. NI Water's Fraud Response Plan stated that "*consultation with the PSNI at an early stage is beneficial in enabling them to examine the evidence available at the time*". NI Water did not seek advice from PSNI. It confirmed that no advice was sought from other public sector counter fraud specialists. We were told that advice on the wider investigation was received from the forensic consultants but have been provided with no documentary evidence to support this. The work of the forensic consultants appears to us to have been limited to the review of computer records they were contracted to undertake. Since 2011, NI Water can make use of the central investigation service of the Department of Agriculture and Rural Development (DARD), if required. This is enabled through the Department's service level agreement with DARD.

Recommendation

44. **We recommend that organisations that do not have counter fraud expertise in-house should seek early advice from PSNI and, if required, public sector counter fraud specialists. Informal contact at the outset with the PSNI can help to inform the investigation approach and evidence requirements.**

Recommendation

45. **We consider that there would be considerable merit in establishing a Northern Ireland public sector fraud investigation service. We understand that DFP is considering this idea as part of its ongoing review of Internal Audit services in the NICS.**

The suspected fraud investigation was limited in scope and extent because of inadequacies in NI Water's records

46. The suspected fraud investigation was to have encompassed three separate exercises:

- the forensic consultant's review of two NI Water employees' computer records;
- an Internal Audit review of a sample of Company E invoices; and
- a reconciliation of payments made to Company E to NI Water's records of work completed.

47. The forensic consultants were provided with copies of the Contract Manager's and Line Manager's hard drives. A key word search was run against the data held on the hard drives and any files highlighted as a result were reviewed by both the forensic consultants and Internal Audit. No evidence was found to support either the Contract Manager's claim that he had been instructed to limit invoice values or the potential for collusion between the contractor and officials.

48. Payments to Company E in the period under investigation (April 2007 to January 2009) were in excess of £3.9 million across 386 invoices. The bulk of the charges from Company E related to meter installations for around 18,000 new build domestic properties and 50,000 property surveys¹¹. Internal Audit reviewed a sample of 32 invoices (eight per cent of the total), confirming that payment rates for both meter installations and survey work claimed by Company E were correct. A sample of 140 meter installations was selected for verification testing. The investigation team sought to confirm that the work had been completed (against relevant customer billing records; meters were not physically inspected). NIAO notes that:

- the sample of 140 meter installations valued at £18,000 represents three per cent in value of the invoices reviewed by Internal Audit and 0.7 per cent in value of the total payments to Company E;
- the sample of 140 meter installations represents 0.8 per cent of the total number (18,000) of meters installed; and
- for 8 out of the 140 meter installations reviewed, there was insufficient information for Internal Audit to confirm whether or not a meter had been installed. NI Water has told NIAO that the missing meters were subsequently confirmed as having been installed.

¹¹ The Department informed us that meter installations could be either internal (£128 - £190.45) or an install on an existing boundary box (£25). Some also required fitting of a new boundary box and, dependant on type of boundary box, the cost would range from £148 to £202. The majority of surveys (some 50,000 surveys were conducted) were on domestic properties and cost £28.84 each; there was also a small number (approximately 120) of non-domestic surveys costing £38.10 each.

Northern Ireland Water's response to a suspected fraud

49. Significant control weaknesses made it impossible for Internal Audit to complete the intended overall reconciliation between the charges invoiced by Company E and the work done, according to NI Water source information. Internal Audit concluded that:
- the format and extent of information provided by Company E in support of its invoices was inconsistent, making it difficult in some cases to identify the exact nature of individual charges. However, Company E told us that the information for every charge (meters and surveys) was provided on an electronic datasheet for each address and that the datasheet format had been provided by NI Water. NI Water had to either reject or pass for payment each datasheet and Company E then raised invoices only for the "passed for payment" details;
 - it was not possible to reconcile invoices to instructions issued from NI Water because centralised records of these were not maintained;
 - there was a lack of management information and reports generated from the customer billing system to enable effective monitoring and management of the contract;
 - it was not possible to reconcile surveying activity due to lack of comprehensive collated records of survey requests and insufficient detail on Company E's invoices. The total value of this work was around £1.4 million (36 per cent of the total paid). Company E told us that every survey completed was sent electronically to NI Water;
 - Company E had charged NI Water £111,000 (approximately 12,000 charges at £9.27) for unsuccessful attempts to install meters at new properties as a result of inaccurate instructions forwarded by NI Water; and
 - there was a generic contract in place with Company E, which had not been tailored to specific services required. NIAO notes that survey work (worth £1.4 million) had not formed part of the original contract with Company E and thus represented a significant extension to that contract.
50. NIAO has several observations to make on the scope and extent of the fieldwork undertaken by the investigation team:
- although eight of the sample of 140 meters could not be located by the end of the investigation, no site visits were undertaken;
 - the hard drives of the Director and the Contract Manager's immediate subordinate (who had a role in authorising invoices but no role in the instruction to limit the value of invoices) were not made available to the forensic consultants;
 - the team did not interview any suspects or witnesses as part of its investigations but placed reliance on the interviews conducted as part of the disciplinary investigation, which commenced ahead of the suspected fraud investigation;

- the investigation did not cover all aspects of the suspected officer's work, including earlier periods of employment, despite this being a specific requirement of NI Water's fraud policy;
 - the investigation did not look more widely at invoicing practices across NI Water; and
 - the process for tendering, selection and award of the Company E contract was not scrutinised.
51. The investigation team reported on the 1 April 2010 that *"it could not confirm any indicators of fraudulent activity from the work it had performed"*. The report did however identify *"a number of serious control issues"* and made recommendations for improvements. NIAO's opinion is that, given the limited investigative work undertaken, the team was not in a position to draw meaningful conclusions on the presence or absence of fraud. In our view, NI Water's Executive Team and the Audit Committee should have given serious consideration to extending the verification sampling and widening the investigation. This may have required additional resources being contracted from an external provider or other public sector counter fraud unit. Indeed, the over stretched Internal Audit Unit may not have been best placed to conduct even the initial investigation.
52. During the course of our review we asked NI Water if the serious control weaknesses identified, and recommendations made by Internal Audit (see paragraph 49), had been addressed as a matter of urgency by NI Water's management, as no follow-up audit had been carried out. We would have expected in the normal course of events that, if Internal Audit had had any particular concerns, then these would have been escalated to the Audit Committee. This did not happen in this case. The Chair of the Audit Committee told us that responsibility for implementing specific actions arising from audits lies with management and that the Audit Committee is only required to be made aware of Category 1 and 2¹² audit recommendations as a matter of course. The Department told us that the investigation's recommendations were not categorised in this way as this was not a normal Internal Audit assignment. The investigation work was carried out by Internal Audit on management's behalf in accordance with the NI Water Fraud Policy. However, updates on the progress of the investigation were provided to the Audit Committee¹³ which was told that, *"there was no evidence of any wrongdoing"*.
53. In response to our concerns, NI Water in January 2012, collated a Completed Actions Report which summarised management's response to, and implementation of, the investigation's recommendations. In addition, the

12 Category 1 issues are defined as those where there is a risk of significant impact on the business that must be addressed immediately. Category 2 issues are defined as those where there is a risk of moderate impact on the business, for example a control failure or absence of an effective control in an area of moderate risk. Category 3 issues are defined as those relating to minor control improvements or enhancements in control efficiency.

13 Board Minutes, 20 May 2010

Northern Ireland Water's response to a suspected fraud

Department has told us that an update report was provided to the Chair of the NI Water Audit Committee.

Recommendation

54. **We recommend that, in future, the Audit Committee's monitoring of audit recommendations should include consideration of recommendations arising from fraud and suspected fraud investigations. It is particularly important in fraud cases that control weaknesses are strengthened immediately and that management provides a timely, formal assurance to the Audit Committee that this has happened.**

Departmental and NI Water officials charged with governance did not identify weaknesses in the investigative approach

55. The investigation team's terms of reference (see Figure 5) were drawn up by the Head of Internal Audit. They were agreed on 2 February 2010 by the Department, the Chair of the Audit Committee, the former Chief Executive and other senior NI Water officials. The terms of reference were what we would expect of an internal audit review but, in our opinion, they provided inadequate direction to a forensic fraud investigation:
- the objectives were too narrowly defined, the methodology proposed was deficient and the timetable was unrealistic;

- there is no reference to the relevant legislation and therefore no indication of the case to be proven and the evidence required to prove it;
- the persons who were to be the focus of the investigation were limited to the Contract Manager and the Line Manager without any apparent consideration of others, such as the Director, who also had a role in the contract; and
- no detail was provided of the sample size to be selected and why it was considered appropriate.

Figure 5 - Terms of reference for the suspected fraud investigation

Objectives

- To determine whether the internal Level 3 or former contract manager have personally fraudulently benefited as a result of collusion with the contractor (Company E);
- To determine whether it seems likely that the contractor has fraudulently issued fictitious invoices or over-charged on invoices issued.

Approach

- Copy of NI Water Level 3 and former Contract Manager's PC hard drives to be taken by a forensic technology team contracted from [name of consultant]. Scanning of copy hard drives to be completed to identify whether there is any evidence of email or

other communication with the contractor to indicate any personal benefit to personnel involved;

- Sample of individual metering charges to be taken from contractor invoices and validated against meter records to confirm whether work completed;
- An overall reconciliation of total costs charged by contractor to the volumes of meter installations, meter disconnects and meter surveys per the Rapid customer billing system to be performed (based on agreed contractual charging rates); and
- Based on findings of the investigation work, a report of recommendations and actions to be issued to Chief Executive, Board, Audit Committee Chair, Director of Finance and Regulation, Head of Corporate Governance and DRD.

Target Timescales

- Work to commence 29/01/10
- Report of findings by 5/02/10

Source: NI Water

56. The Department was not involved in the conduct of the investigation but was kept advised of its progress. We consider that the Department could have done more to ensure the guiding principles for fraud investigations, as set out at **Figure 1**, were followed. In particular, we are surprised that the inadequate terms of reference for the investigation were not questioned by Departmental officials.

57. In addition, the NI Water officials charged with governance and oversight of the investigation did not identify or address the clear weaknesses in the scope of the investigation and the methodology adopted. We were told that this may be attributed, to some extent, to the difficult circumstances in the period during which the investigation took place.

Recommendation

58. **Fraud and suspected fraud investigations should be wide-ranging from the outset and should exploit a range of investigative methods. In our opinion, it is a serious mistake to decide that a limited fraud investigation will be conducted initially and the scope will only be widened if new evidence is found.**

There were major shortcomings in the disciplinary process

59. The disciplinary investigation team reported on 7 April 2010 that:

- the instruction by the Contract Manager to Company E that invoices be kept below the £20,000 level contravened the principles behind the financial delegations;
- in its opinion there had not been any deliberate malicious intent but the contract management procedures applied to Company E fell well below best practice;

Northern Ireland Water's response to a suspected fraud

- a breach of duty on the part of those responsible had occurred, with culpability in relation to proper oversight and management of the contract and the adherence to the relevant policies and procedures; and
- Human Resources should pursue appropriate disciplinary action in line with the Company Disciplinary Policy.

60. The Director of Human Resources at this time considered that she had a potential conflict of interest because contracts she had authorised formed part of the ongoing contract approvals review. She therefore took no part in the disciplinary case. The Company Secretary of NI Water decided, in the absence of in-house HR advice, to contract-in the services of an external legal firm to provide advice on the disciplinary proceedings. The legal adviser concluded that there was a case to answer in relation to the Contract Manager and the Line Manager. It was agreed that the newly appointed Customer Services Delivery Director should conduct the disciplinary hearing, with any appeal to the former CEO, who therefore played no part in the disciplinary proceedings. Draft letters, inviting the two officials to a disciplinary hearing and setting out the charges to answer, were provided by the adviser. The letters were sent out on the 19 July and the hearing was set for 26 July 2010.

61. The Public Accounts Committee of the Northern Ireland Assembly was, at that time, undertaking an investigation¹⁴ into contract approvals in NI Water. The Committee was informed by NI Water that, in relation to the invoice slicing

investigation, the disciplinary panel had found that, *"the invoices were handled in accordance with the policy laid out in the financial delegations and that the instruction to limit the value of invoices was driven by a desire to ensure that expenditure against this contract was closely monitored. On this basis, no disciplinary action is to be taken forward with the individuals concerned"*.

62. During our review we noted a number of shortcomings in the disciplinary process:

- the case against the Contract Manager and Line Manager, set out in the formal disciplinary letters issued to them, contained an error of fact: an error which may not have been identified until the disciplinary hearing. The letters wrongly stated that their delegated limit for approving invoices was £20,000. In fact it was 'up to £50,000' for the Contract Manager and 'up to £100,000' for the Line Manager in 2007-08 and 'up to £100,000' and 'any amount' respectively for the period 1 April 2008 to 31 October 2009. The allegation put to the two employees was that, when the Contract Manager instructed Company E to invoice slice at £20,000, financial delegations had been breached. The panel concluded that there had been no breach of financial delegations as the same approval mechanism remained and the employees therefore had no case to answer. However, NIAO's view is that if invoices had been submitted without an artificial slice, then in many instances Director level approval would have been required. Splitting invoices at £20,000 ensured authorisation was restricted to the Contract Manager and his immediate subordinate. We agree

14 The Committee's investigation led to the publication of its report 'Measuring the Performance of NI Water and Procurement and Governance in NI Water' on 3 February 2011

with the earlier disciplinary investigation team's report that this clearly *"contravened the principles behind the financial delegations"*;

- the error in the disciplinary letters, stemmed from the fact that NI Water staff checked the letters against the investigation reports, rather than the correct financial delegations at the time;
- both the suspected fraud and disciplinary investigations concluded that the Line Manager was culpable, in relation to proper oversight and management of the Company E contract. However, the disciplinary panel found that, due to lack of evidence, it could not conclude that the Line Manager had failed to exercise proper oversight and management of the contract;
- failings in relation to the proper oversight and management of this contract were not included in the disciplinary charge against the Contract Manager. NI Water told us that these charges were framed taking account of expert legal advice from an external adviser. The external legal advisers told NIAO that *"we determined it was appropriate to convene formal disciplinary hearings against the Contract Manager and the Line Manager based on the instructions provided to us. In doing so, and in producing the draft disciplinary invite letters, we relied upon: (a) the terms of the investigation reports including the suspected fraud investigation report; and (b) our subsequent discussions with NI Water"*; and

- the limited scope of the investigations conducted impacted on the quality and quantity of evidence available to the disciplinary hearing panel.

NI Water should consider further refinements to the Fraud Response Plan

63. In line with best practice, when the invoice slicing investigation had been completed, NI Water revisited its Fraud Response Plan. A number of refinements were made to the action flowchart, but NIAO considers that a number of further improvements could be made. The Department informed us that it will review the Fraud Response Plan in conjunction with NI Water, to ensure that the two sets of guidance are aligned where possible.

Recommendation

64. **We recommend that two further amendments are made to the NI Water Fraud Response Plan. The action flowchart should require that:**
- **Internal Audit is informed of a suspected fraud, by the Head of Corporate Governance, at the same time as the Director of Finance and the Chair of the Audit Committee are informed; and**
 - **the written Initial Confidential Enquiry report should be produced by the Head of Corporate Governance within 24 hrs (48 hours at present) of the initial verbal report. This would bring NI Water's guidance fully into line with the Department's fraud response plan.**

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CDS Belfast
4c Heron Wharf
Sydenham Business Park
Belfast
BT3 9LE

Telephone: 028 9045 7772
Email: cds-ni@cds.co.uk

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