

The Fraud Advisory Panel

Fourth Annual Report 2001/2002

# Sounding the alert on fraud: The role of the Fraud Advisory Panel

The Panel's role is to alert the nation to the immense social and economic damage caused by fraud and help both public and private sectors to fight back. It is dedicated to a holistic approach and the long view.

The Panel works to:

Originate proposals to reform the law and public policy on fraud

Develop proposals to enhance the investigation and prosecution of fraud

Advise business as a whole on fraud prevention, detection and reporting

Assist in improving fraud related education and training in business and the professions

Establish a more accurate picture of the extent, causes and nature of fraud

The Panel is an independent body of volunteers drawn from the law and accountancy, banking, insurance, commerce, regulators, the police, government departments and public agencies. It is not restricted by seeing the problem from any single point of view but works to encourage a truly multi-disciplinary perspective.

“This is an organisation that deserves the active support of British business. A stronger Panel means a stronger voice on fraud policy and prevention in places that matter.” **Digby Jones,**  
Director-General, CBI

“It is essential that fraud is kept at the forefront of the political agenda. The Panel plays a vital role in ensuring that the key decision makers are kept in the picture. It can call on the most knowledgeable and experienced people now engaged in the fight against fraud.” **Rosalind Wright,**  
Director of the Serious Fraud Office

“..a unique forum of private and public sector experts. I am pleased to commend the Panel’s important work..and its continuing achievements in the fight against fraud.” **Sir John Bourn, Comptroller and Auditor General, Head of the National Audit Office**

“British business needs the Panel as a voice in high places, as a powerhouse of new ideas and as a kind of conscience pressing it to take fraud seriously. If we didn’t have the FAP, I guarantee we would have to invent it.” **The Lord Sharman of Redlynch OBE, Chairman of the Government’s “Foresight” Panel on Crime Prevention**

“the thoughtful submissions of... the Fraud Advisory Panel.” **Lord Justice Auld, “Review of the Criminal Courts of England and Wales”**

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Foreword by  
The Lord Mayor  
of London



Financial fraud is one of the great ills of modern society. Technological advance, growing market sophistication and an ever increasing complexity of instruments and products has opened up the potential for fraud just as it has transformed business practices. We in the UK continue to have one of the most effective financial systems in the world, but despite our success, the problem of fraud is never far away.

The Fraud Advisory Panel is one of a key network of bodies and watchdogs who are helping to tighten up the UK financial services systems, making them ever more water-tight. Over past years, global awareness of the impact of fraudulent transactions has risen as a commercial and a political priority, especially in the wake of 11th September which underlined the link between terrorism and fraud. That tragedy more forcefully than ever underlined the essential need to combat fraud before it can not just corrupt the financial markets but also help destroy human lives.

As representative and envoy of the UK-based international financial services community, I am aware of the need to fight against fraud in every sector and all of the time. Vigilance of individuals, as well as policing and advisory bodies such as the Panel are essential if the problem is to be overcome. By uniting lawyers, accountants, investigators and the police the Panel acts as a dynamic body, looking at the markets and providing guidance and support for those who operate within them.

It is our collective duty to try to ensure that the markets function properly and honourably, refusing to allow fraud to grow or to spread. The Fraud Advisory Panel plays a key role in this task, advising and galvanising action to make the markets a safer place to do business.

I congratulate the Panel upon a very successful year, and hope that these achievements will be reflected in the months and years to come.

A handwritten signature in black ink that reads "Michael Oliver". The signature is written in a cursive, slightly slanted style. Below the signature is a long, thin horizontal line.

The Right Honourable  
The Lord Mayor,  
Alderman Michael Oliver

## Chairman's Overview by George Staple. Learning From Shock?

Observers of the scale and growth of fraud often noted that only a major shock was likely to stimulate drastic counter-action. The last year has provided not one, but three such shocks. The first, and by far the worst in its effects, were the attacks on New York and Washington last September. The collapse of Enron, and now the events at WorldCom, though not comparable in human terms, have nonetheless dramatically underlined the damage that even the suspicion of fraud in major companies may do to share values and therefore to the economy itself. There are signs that we are learning from the first but the jury is still out on whether we will do so from the two corporate disasters.

September 11th has led to an intense focus, in Britain, America and throughout the EU, on the intimate link between terrorism, fraud, which funds many of its operations, and money laundering, which makes those funds useable. It is worth noting that no less than £70 million was actually seized by our own government in the two months after the attacks. The Government deserves praise for the speed and scale of its response. In the Anti-Terrorism, Crime and Security Act and the soon to be enacted Proceeds of Crime Bill the UK now possesses some of the world's best legislation against terrorist funding, fraud and money laundering.

## Fraud as a Cause of Systemic Shock

The need now is to monitor its implementation (particularly in the so far unsatisfactory area of prosecutions for money laundering) and to turn the minds of policy makers towards those other aspects of economic crime which, in the long run, may do as much damage as terrorist outrages to the prosperity and stability of our lives. Both the Bank of England and HM Treasury have rightly warned that more Enrons and WorldComs may have serious consequences. We have yet to see how business will respond but the signs are that, though attention is rightly being paid to physical security, fraud is receiving little more attention than a year ago. Britain does indeed possess more well-developed rules for corporate governance and financial reporting than the United States. But we should never forget that those standards were implemented in response to serious problems that had arisen from a period of complacency. Continuing vigilance is the best defence we have against a future major fraud. As it is fraud continues to rise year by year, its cost estimated at £13.8 billion two years ago. We have been warned.

We may be on the verge of uncovering more serious cases as a result of the current experience of slow growth and near recession. Those scandals with which the authorities had to deal a decade or so ago, such as Guinness, Barlow Clowes, Blue Arrow, Maxwell and BCCI were very much the result of the boom years of the late '80s coming to an end. This inevitably led to more insolvencies, which always reveal a level of financial malpractice covered up in more favourable times. It is a disturbing fact that, now as then, most major cases involve senior management, their purpose often being to disguise losses or to manipulate share prices. There are very clear attitudinal and procedural lessons here for both companies and their auditors.

### Fraud and Business Culture

The climate of indifference to fraud in so much of British business suggests the need for a change in cultural attitudes. The 1998 Public Interest Disclosure Act, alias 'the whistleblower's charter', may prove a landmark in this respect. Properly integrated into corporate practice, and supported by well-considered training, it will promote the vigilance and the honesty without which even the best anti-fraud systems may be rendered impotent. But a strong ethical climate is also essential if ordinary employees are to feel safe to speak out within a business. The focus on culture change in one chapter of this report (at the suggestion of one of our Board members, Martin Robinson) reminds us that the individual conscience is our real line of defence against fraud. As Dr Johnson put it "Where courage is not, no other virtue will survive save by accident".

### Recognition for the Panel

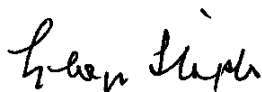
The ordinary employee needs also to be convinced that fraud harms us all, not just a wealthy few. Fraud impoverishes those least able to afford it, all too often leading to lay-offs, the loss of pensions and savings and lower pay rises. Tax fraud results in extra tax for everyone. Every time someone puts in an inflated insurance claim, premiums rise for the rest of us. Every time someone defrauds a bank with a forged cheque or misuses a credit card, charges rise. The Director of the Serious Fraud Office has remarked that "fraud is commonly said to cost the public annually seventeen times the amount lost through burglaries."

The Fraud Advisory Panel exists to raise the alert on fraud and serve as a catalyst for action by developing practical proposals. Amongst others we have outlined plans for a National Economic Crime Commission; submitted proposals on company law to the Company Law Review; suggested detailed changes to serious fraud trial procedures to the Lord Chancellor's Department; submitted a blueprint for strengthening the relationship between the police and the SFO; identified potential deficiencies in the anti-fraud and fraud awareness content of business and professional education and training; published an anti-fraud checklist and guides for SMEs; conducted a major joint survey of business cybercrime and issued advice on beating it.

Founded in 1998 due to a public spirited initiative by the Institute of Chartered Accountants in England and Wales the Panel's work is now attracting high level recognition. In his "Review of the Criminal Courts of England and Wales" Lord Justice Auld endorsed our proposals on pre-trial procedures in serious fraud cases. The Panel has been invited to supply representatives to studies being conducted by several public bodies. Ministers are considering our recommendations to direct greater resources to the police effort against fraud.

The wonder is that we have achieved as much given our small resources and the essentially voluntary basis on which we operate (though I am pleased to acknowledge the great commitment of our Executive Helen Fay, and thank Simon Pearce who has helped prepare this report). Both I and my colleagues on the Board are indebted to all those who have supported the Panel's endeavours, whether by their donations of time or money (chief amongst whom is the ICAEW). Nor could I close without recording the role played by those members of the Board, and its predecessor the Steering Group, who have stood down during the last year. Howard Page QC, Bill Cleghorn and Peter Yapp have all done sterling service; indeed, Howard served four years as Chairman of the Investigation, Prosecution and Law Reform Working Group.

The Panel became a Company limited by guarantee in November 2001. Our Annual Report 2002-03 will therefore be the first to carry detailed information on our finances. This document simply maintains our custom of reporting on our own work and surveying major developments in the fight against fraud.



July 2002

## An Agenda for Government

Fraud should come high on the public policy agenda. The Panel has developed a programme of action for the Government on the most urgent issues in the campaign against fraud.

1. Make combating fraud a major police objective by placing economic crime on the national list of police priorities and mandating individual forces to produce anti-fraud strategies. The Panel welcomes proposals for a National Fraud Squad to ease the pressure on local forces. Useful immediate steps would be to increase manpower and skills by offering short-term contracts to recently retired fraud squad officers and introducing a more flexible approach to the rotation of senior investigators out of their squads.
2. Bring a joined-up anti-fraud strategy to Whitehall. As the Panel pointed out last year the Government's initiatives cannot function effectively when 16 departments and agencies have one kind of responsibility or another for the problem. There is a fragmentation of perspective, policy and institutions which allows fraud to grow.
3. Create an official National Economic Crime Commission dedicated to the holistic, long-term view of the problem that is so badly required. Comprised of senior representatives of business, the professions, the police and Whitehall the Commission would serve as a high profile forum for debate and a permanent source of authoritative recommendations to government and public agencies.
4. Expand the Serious Fraud Office's remit specifically to embrace major corruption and money laundering cases even when no direct element of fraud is involved. It makes no sense to exclude an expert organisation from crimes so closely linked to fraud.
5. Increase the number of prosecutions for money laundering. There were only 357 (and 136 convictions) between 1987 and 1999. A more vigorous approach is required if money laundering is to be deterred.
6. Review the law against cybercrime. A full review of the Computer Misuse Act 1990 is required to assess whether current legal concepts are, or are likely to prove, adequate to cope with cybercrime.

7. Convene a national fraud education and training conference of professional bodies and providers of business qualifications. Minimal progress in this area strongly suggests that an external stimulus is needed. Close attention should be paid to improving awareness of ethical issues.

8. Establish a National Fraud Loss Study which would conduct an authoritative annual survey of the actual extent and cost of economic crime. It is impossible to motivate serious reform without adequate statistics. Their absence allows fraud to be politically marginalized. An interim arrangement would be to require police forces to begin estimating the cost of fraud in their areas and to do so on a mutually consistent basis.

## The Panel's Year 2001-2002

The Panel is run by a Board of Directors, chaired by George Staple, a consultant to Clifford Chance and a former Director of the Serious Fraud Office. It is comprised of senior figures from law, accountancy and risk management. The Panel became a company limited by guarantee on 22nd November 2001. This allows the Board more flexibility to contract with outside parties for research or any other aspect of the Panel's work. No dividends are paid and all monies over those needed to pay properly incurred costs are retained to further the Panel's purposes. The Board is grateful to Bill Cleghorn for handling this major change in legal status.

The Panel's detailed work is conducted by four multi-disciplinary working groups addressing different aspects of fraud. Their activities in 2001-2 - and other work conducted by the Panel - was as follows.

### Investigation, Prosecution and Law Reform

Chaired by Neil Griffiths. To review the legal process and statute law as it relates to fraud and recommend changes where desirable.

Neil Griffiths, a partner of Denton Wilde Sapte, succeeded to the Chairmanship from Howard Page QC in November 2001. The Working Group had submitted a response to Lord Justice Auld's Review of the Criminal Courts in January of that year. The Auld Report substantially adopted the Working Group's views on pre-trial procedures submitted to the Lord Chancellor in 1998. Members have also monitored closely the Proceeds of Crime Bill during its progress through Parliament. The previous year's series of seminars continued with a joint event with Transparency International (UK) in April on asset tracing.

The Working Group is representing the Panel in a joint project on company law reform with the Institute of Chartered Secretaries and Administrators (ICSA). In the coming year it will be conducting two new studies: into the effectiveness of the new money laundering regime; and on legislative and regulatory obstacles to the detection and prevention of fraud, with particular reference to the impact of the Data Protection Act.

## Research, Information and Intelligence

Chaired by Mike Hoare MBE. To investigate the nature, extent and consequences of fraud; to identify, develop and publish new sources of information and intelligence.

The Working Group (in conjunction with the Education, Events and Training Working Group) turned the spotlight on a usually neglected area of fraud, the threat to small and medium-sized enterprises (SMEs). "Indications of Fraud in SMEs" by Andrew Higson, of Loughborough University Business School was published in April 2002 to widespread media attention. A linked paper was published by Martin Robinson and colleagues in February. Mike Hoare also served as a member of a National Audit Office (NAO) fraud study as a representative of the Panel.

Two major research projects are underway. One is on the problem of bribery and corruption, with particular reference to procurement fraud. Paul Barnes, from Nottingham Trent University, is also drawing on his work in producing the Panel's "Cybercrime Survey 2001", to undertake a piece of research for the Working Group on the scale and nature of cybercrime. Other scheduled projects include: a look at signs of cyber fraud (again by Paul Barnes); a study of anti-fraud education examining content, gaps and take-up; and a joint conference with the Institute of Internal Auditors on procurement fraud.

## Education, Events and Training

Chaired by Martin Robinson FCIS, FIIA. To identify and disseminate best practice in training and guidance in fraud prevention, detection and investigation.

"Fighting Fraud-a Guide for SMEs" was published to widespread interest from SME groups and the press in February. This was the first comprehensive checklist of warning signs of fraud in this sector. The paper was paired with that on indications of fraud in smaller firms. This heralded a new approach whereby groups have worked more closely together to produce paired documents on a common theme, one providing a fraud checklist, the other discussing preventive measures. Published in a common format the documents are practical, concise and web-based. Information from both are given in this Report's chapter "Focus on SMEs". Martin Robinson also served on an NAO study into fraud on behalf of the Panel.

The Working Group plans to undertake more work on SMEs during the coming year.

## Cybercrime

Chaired by Steven Philippsohn. To promote greater understanding of cybercrime and the safeguards against it.

Steven Philippsohn succeeded to the Chairmanship in January from Peter Yapp who stood down due to other commitments. "Cybercrime – What Every SME Should Know" was published in June and aroused strong interest. This not only focussed on the problems arising from IT and e-commerce but also discussed the systems, attitudes and training needed to protect firms from cybercrime. Members are also active in forging working partnerships with a range of business and public sector organisations.

The Working Group also plans to publish a paper on how firms can protect themselves from cybercrime.

"The Cybercrime Survey 2001" was published in August last year, once again to considerable media reportage. The survey was the result of a collaboration with the CBI and others with Board member Tony Bingham leading for the Panel. The survey's key findings are set out in this Report's chapter on "The Challenge of Cybercrime".

## Spreading the Message

Panel members are in increasing demand as speakers. Amongst other events the Chairman has addressed the International Fraud Convention, conferences held by the National Audit Office, Leicester University, the Chartered Institute of Management Accountants (CIMA) and the Institute of Directors. Working group chairmen have spoken to the Institute of Internal Auditors, the Institute of Accounting Technicians, South Bank University and other bodies. Working Group members are liaising with a number of organisations, including the Department of Health.

# The Board



**George Staple CB QC.** Chairman of the Panel; Consultant to, and former partner of, Clifford Chance; Director of the Serious Fraud Office 1992-97; a Chairman of the disciplinary tribunals of the Securities Association and the Securities and Futures Authority 1987-91; former DTI Companies Act Inspector; Member, Senior Salaries Review Body; Chairman of the Review Board for Government Contracts.



**Gerry Acher CBE FCA.** Deputy Chairman of the Panel; member of the Board of KPMG and the Senior Partner of its London office until 31st December 2001. Founder Chairman of the Audit Faculty of the Institute of Chartered Accountants in England and Wales 1996-2001 and a Council Member for that period. Chairman, DTI Foresight Panel working party on crime and business; Head of the Partnership in Policing Agenda as Vice-Chairman of London First with the Metropolitan Police Service.



**Tony Bingham FCA.** Partner at PricewaterhouseCoopers; originator of the “Taking Fraud Seriously” initiative which resulted in the foundation of the Panel; Chairman of the Technical Auditing Committee of the Institute of Chartered Accountants of England and Wales; a UK Board member of anti-corruption group Transparency International; member of working parties of the Auditing Practises Board and the Federation Europeens Experts Comptables.



**Ruth Eisenberg FCA.** Director, Special Projects at the Institute of Chartered Accountants in England and Wales.



**Neil Griffiths.** Chairman, Investigations, Prosecutions and Law Reform Working Group; solicitor; a partner in the Insolvency Group at Denton Wilde Sapte; a sub-committee chairman with the Creditors Rights Committee of the International Bar Association.



**Mike Hoare MBE.** Chairman, Research, Information and Intelligence Working Group; Chairman of the Risk and Security Management Forum since 1990; formerly a Metropolitan Police Commander and Director of the Investigation Department of the Post Office.



**Martin Robinson FCIS, FIIA.** Chairman, Education, Events and Training Working Group; Senior Manager, Lloyds TSB Bank Plc; Training and Development Adviser, the Institute of Internal Auditors; Audit Adviser to the Institute of Chartered Secretaries and Administrators.



**Steven Philippsohn.** Chairman of the Cybercrime Working Group; solicitor; founder and Senior Partner, Philippsohn Crawfords Berwald; Co-Editor of the UK Manual of the Association of Certified Fraud Examiners; member of the editorial Boards of “E-Commerce Law & Policy” and “Inside Fraud Bulletin”.

## Supporting the Panel

Funding is always of crucial concern to the Panel. Despite support from a number of organisations it has not had the resources needed to pay for the level of research, publications and conferences that it could otherwise provide. Yet such support is in the interests of both business and the professions which can only benefit from a respected body raising the alert on fraud and making the case for improved fraud prevention. Financial assistance, preferably on a long term basis, is urgently required.

For further details please contact the Panel's Executive, Helen Fay at [fap@icaew.co.uk](mailto:fap@icaew.co.uk) or telephone 020 7920 8721.

The Panel is pleased to record its gratitude to those organisations which have supported its work during 2001-2002.

The Institute of Chartered Accountants in England and Wales

Barclays Bank Plc

Boots Plc

Canary Wharf Group Plc

The Corporation of London

HSBC Holdings Plc

Lloyds TSB Plc

Nationwide Building Society

Royal & Sun Alliance Plc

Singer & Friedlander Ltd

UK200 Group

Zurich Financial Services Ltd

## The State of Fraud Statistics

There is a marked discrepancy between reported fraud and the levels uncovered by both official and commercial surveys. 317,399 offences of fraud and forgery were reported to the police in England and Wales in 2001-02, a 1% fall from the previous year. The Home Office has admitted that "a great many offences of fraud continue to go unreported" and are included in business overheads. Indeed, it is difficult to take official figures seriously as a guide to the true extent of fraud, particularly since no regular attempts are made to gauge the economic value of even recorded offences. The British Crime Survey does not report fraud of any kind. The Home Office has conducted but one Commercial Victimization Survey, covering only the retail and manufacturing sectors, and that as long ago as 1994.

The most comprehensive estimate to date is "The Economic Cost of Fraud", a report for the Home Office by National Economic Research Associates (NERA), published in late 2000. This not only sought to calculate direct losses; it also allocated costs to investigations, court proceedings and preventive measures and calculated the extra tax revenue required to offset the cost of welfare and other frauds on public funds. The resulting estimated total economic cost of fraud per annum was up to £13.8 billion. No less than £10.3 billion was the result of actual fraud.

NERA believes these figures are likely to be underestimates and has remarked that the Association of British Insurers 1999 estimate of fraud costing £16 billion a year (£650 for every household in the country) was "not outside the bounds of plausibility, especially when the potential scale of undiscovered fraud is taken into account". APACS (the Association of Payment Clearing Services) estimated losses from credit and debit card fraud alone at £411 million in 2001, a rise of 30% in a single year. A recent PricewaterhouseCoopers survey found that 70% of major companies in the UK had been victims of economic crime. Only 15% had successfully recovered more than half their losses. 39% had not reported the fraud to the authorities.

## Policing Fraud: Light on the Horizon?

The Attorney-General, Lord Goldsmith has recently acknowledged a serious decline in the number of police fraud investigators. He expressed concern that fraudsters operating within the 'middle ground' of small benefit frauds and SFO type-cases valued at £1 million or more may be operating with impunity. There are currently only 600 police fraud investigators in England and Wales ("each of whom" said Lord Goldsmith "is liable to be called away to other duties") compared to 869 in 1995. Another result of this situation is a highly damaging loss of experienced officers which further undermines police efforts.

The Serious Fraud Office (SFO) is a highly effective body but can only handle 80-90 serious and complex cases a year. The Metropolitan Police Fraud Squad usually handles only cases worth more than £750,000. A huge raft of other fraud is dealt with at local level or, increasingly, not dealt with at all. This is due in part to lack of funds and partly to fraud failing to figure in either the Government's Crime Reduction Strategy or its priorities for the police. The Director of the Serious Fraud Office has rightly said that "there is a disincentive to report fraud when police forces are under-resourced and harassed officers are bound to explore with a complainant whether there are civil avenues of redress that can be pursued, or to redirect a complaint from one police office to another, sometimes over several counties, until the complainant feels it is not worth the candle and gives up the unequal struggle."

Such a state of affairs (highlighted in the Panel's last Annual Report) is a public scandal, particularly as organised crime is now so closely involved in fraud. The National Criminal Intelligence Service (NCIS) has warned that such gangs now derive as much money from fraud as from drug trafficking - indeed drug imports are often financed by fraud. The NCIS estimates that over 50 organised criminal groups were involved in VAT, excise and tax fraud.

The prospect of some improvement has now appeared on the horizon. Ministers accepted a series of recommendations made by an official working group in the autumn of 2001, the terms of reference of which were to "establish ways of improving the response to fraud, to make proposals for ensuring that suitable resources are made and kept available for fraud investigations." Chaired by the Director of the SFO and including government departments, the police and the FSA, it recommended examination of the feasibility and cost of a national police fraud squad; enhancing the SFO's civilian investigative and casework resources; better training for police fraud officers and financial investigators; new guidelines on which type of fraud cases will be accepted by the police, what criteria will be applied and which force will be responsible; new arrangements to estimate the cost of fraud consistently; and a 'thematic inspection' throughout England and Wales by HM Inspectorate of Constabulary into the way fraud investigations are carried out.

There have been reports that the Home Secretary is preparing to endorse plans for a national squad. The Panel would welcome such an initiative but it should not be taken as an excuse to ignore immediate needs. Useful immediate steps would be to increase manpower and skills by offering short-term contracts to recently retired fraud squad officers; and to introduce a more flexible approach to the rotation of senior investigators out of fraud squads.

Policing cannot be easily separated from the wider workings of the criminal justice system. Lord Justice Auld's "Review of the Criminal Courts of England and Wales" underlines the current ineffectiveness of "joined-up government" made by the Panel in its last Annual Report. Lord Justice Auld wrote that "The expression 'criminal justice system' is misleading. There is no system worthy of the name, only a criminal justice process to which a number of different government departments and agencies and others make separate and sometimes conflicting contributions". Joint management has been developing since 1998 and Crown Prosecution Service areas have now been aligned with their police counterparts. "But sadly this 'working together', or 'joined-up government' as this is called, is not achieving results commensurate with all the enthusiasm and effort put into it. There is little over-all planning or direction, as distinct from pooling ideas, plans and schemes for co-operation".

## Money Laundering and the Link with Terrorism and Organised Crime

Terrorists need money. Much of it is obtained via other crimes - armed robbery, drug trafficking and fraud – which often overlaps with more ‘conventional’ organised crime. No less than £70 million was actually seized by our own government because of suspected links to terrorist groups in the two months after September 11th. Money laundering is used to deceitfully ‘legitimise’ the proceeds and is itself fraudulent in nature.

## Gunmen, Gangs and Corruption

Recent reports on Northern Ireland have highlighted the overall impact of terrorist fundraising. “The Northern Ireland Organised Crime Task Force Threat Assessment 2001” identified the key role of business and social security fraud and intellectual property theft (counterfeiting) for paramilitary groups. A recent report from the Northern Ireland Select Committee has pointed out that “These probably net the terrorist groups millions of pounds of income each year. Some of the revenue goes to fund individual criminal lifestyles. The remainder buys propaganda and weapons which help terrorists maintain their dominance - often violent - of local communities...Nor is there any room for complacency that the problem is confined to Northern Ireland: these criminals are now turning their attention to the larger and potentially more profitable markets of Great Britain”.

The Select Committee also pointed out that “Organised crime, whether or not it is directly linked to terrorism, has the potential to corrupt and undermine the economy by distorting markets and making normal business practice impossible.” This is not only because fraudulently obtained funds free such groups from the cost of legitimate borrowing, so furnishing them a major advantage over honest businessmen. Money laundering also infiltrates a criminal presence as well as criminally obtained funds into commercial circles, laying advisers and unwitting business partners open to extreme pressure, including blackmail, to break the law themselves, usually via money laundering.

Late 2001 saw the creation of a new Terrorist Finance Team (TFT) within NCIS’s Economic Crime Unit. This will allow the link between organised crime and terrorism to be analysed for the first time. Team members are drawn from several agencies and provide anti-terrorist as well as financial intelligence analysis expertise. The TFT’s position within the Economic Crime Unit will enable it to identify linkages between terrorism and financing from crime, and to generate information about other serious financial offences.

## The New Legislative Armoury

The attacks on New York have spurred a new surge of legislative activity aimed at money laundering and terrorist funding. As a result Britain now has one of the most formidable armouries of legislative remedies in the world.

The **Second European Money Laundering Directive** will become part of British law by the end of this year. Amendments to the 1993 Regulations will extend their scope to auditors, lawyers, bureaux de change, estate agents and casinos. The Directive also calls for a common definition of money laundering and a harmonised legal framework. EU Member States will be required to adopt common definitions of fraud, corruption and common rules of liability and penalties applicable to such offences.

The **Anti-Terrorism, Crime and Security Act 2001** makes it an offence to launder terrorist monies and contains powers to compel the disclosure of information to the police. Cash can be seized and detained for up to three months while investigations are taking place, and can be forfeited upon conviction.

The **Financial Services and Markets Act 2000** became effective on 30th November last year. One of the Financial Services Authority's regulatory objectives is the reduction of financial crime which includes the handling of the proceeds of crime. The Authority can prosecute for breaches of the money laundering regulations by financial institutions and enforce its own rules – which are stronger than the Regulations themselves. It can also fine and ‘name and shame’ banks that do not comply. The FSA is treating money laundering as a priority, not least via support for training of staff and management in sectors most vulnerable to criminal targeting.

The **Proceeds of Crime Bill** will shortly receive the Royal Assent. The legislation is intended to deprive beneficiaries of criminal activities of their ill-gotten gains. The Bill specifically targets the relationship between organised crime and legitimate businesses, especially those in the financial services industry. The Assets Recovery Agency will have powers to investigate and tax an individual, company or partnership where income, profit or gain is suspected of being derived from crime. The Bill will also consolidate and simplify the existing laws against money laundering. Financial institutions will have to revise their anti-money laundering procedures and manuals, and provide staff with training prior to the Act's coming into force.

The Bill also creates a new form of action to recover the proceeds of crime by way of civil proceedings in the High Court. Liability will be determined on a balance of probabilities. The Agency will be able to freeze assets by way of an interim receiving order. Then, following a full hearing the property may be subject to a recovery order. This is aimed at depriving the beneficiaries of crime of their assets in circumstances where their involvement in criminal activity cannot be proved to the criminal standard. Questions will arise, and doubtless challenges mounted, on the basis of Article 6 of the European Convention on Human Rights which provides the right to a fair trial and the presumption of innocence.

#### Reporting and Prosecution

NCIS received 18,408 Suspicious Transaction Reports (STRs) in 2000, a 27% increase on the previous year and the most significant increase in five years. Reports received in October 2001 alone numbered 4,387, almost four times as many as during the same period the year before. NCIS has noted "a greater enthusiasm for the task" of reporting suspicious transactions since September 11th but expresses surprise that the majority of financial institutions have made few or no STRs.

A recent survey by the University of Leicester's Scarman Centre probed the attitudes of key staff in financial institutions. It found that:

Only 6.2% of financial institutions were equipped with dedicated anti-money laundering software programs. Most respondents were very negative about the capability of software to monitor transactions effectively, including firms using such systems.

A few organisations believed that suspicions may sometimes not be passed on through lack of both means and time. Some fear that disclosure could undermine client confidentiality, (an attitude more common amongst smaller institutions).

There was concern over a lack of feedback from NCIS. Many institutions require a response in order to understand what constitutes a good report.

Could low reporting levels by financial institutions also be linked in part to the low prosecution and conviction rate for money laundering? In June 2000 the Cabinet Office Performance and Innovation Unit reported a total of 357 money-laundering prosecutions and 136 convictions between 1987 and 1999. The conviction rate stood at only 44% for money-laundering prosecutions compared to the overall Crown Prosecution Service (CPS) conviction rate of 76%.

The CPS may be reluctant to pursue prosecutions that often require significant expenditure on forensic accounting evidence. Judges and counsel can be less comfortable dealing with detailed financial evidence. Whatever the reasons the situation is clearly unsatisfactory. The new legislative armoury will be of little use if it is not effectively used by the prosecuting authorities.

## The Auld Report and Serious Fraud Trials

Lord Justice Auld's "Review of the Criminal Courts of England Wales", published in October 2001, has major implications for the prosecution of serious fraud. It calls for judges to be allowed the option of hearing such cases with two expert assessors rather than a jury. Defendants would have an automatic right of appeal on such a ruling to the Criminal Division of the Court of Appeal. The Government will respond to Auld this summer.

Auld has also recommended the introduction, via a judicial sentencing guideline, of sentencing discounts, so graduated that the earlier a plea of guilty the higher the discount that would apply. A judge would be entitled to indicate formally the maximum sentence in the event of a plea of guilty at a particular stage, together with the possible sentence on conviction.

More effective use of defence statements would be facilitated through professional conduct rules and training. Lord Justice Auld commented that "I share the view of the Fraud Advisory Panel that there is an urgent need for more extensive, structured and continuing training of judges for this task".

The Panel warmly welcomes the extensive procedural changes recommended by Lord Justice Auld in his report and foreshadowed by its own earlier paper on procedural reform in serious fraud cases of October 1998. He noted that he had adopted "almost all" of the Panel's proposals in his recommendations for the conduct of jury trials.

The Panel does not, however, wish to see the Government follow the Review's findings in respect of its recommendation that consideration should be given to transferring financial and market infringements from the criminal courts to regulatory and disciplinary mechanisms. Such conduct has been treated as criminal since Tudor times and the Panel would not welcome a return to the characterisation of some financial offences as "victimless crimes".

Greater emphasis should be placed on the more extensive use of admissions, agreed schedules and flow charts in serious fraud cases with large numbers of documents. Failure by any party to co-operate should be met by a wasted costs order. Rules of Court should be introduced to provide a comprehensive statutory framework to this effect. More attention should be also paid to the resolution of differences between expert witnesses at preparatory hearings.

## After Enron: Auditing and Corporate Governance

Fraud or the fear of fraud strikes directly at business confidence. Many large American businesses have suffered serious falls in share values as concerns have multiplied in the wake of Enron and WorldCom. On this side of the Atlantic the Bank of England has warned that uncertainty about the integrity of reported earnings has raised the equity risk premium for capital. There are clear implications for auditors though the prime responsibility for fraud prevention, in both law and fact, lies with company directors.

The DTI has recognised that two related issues are at stake by instigating both a review of financial reporting and auditing, and the role and effectiveness of non-executive directors. The Secretary of State, Patricia Hewitt has said the Government is considering a number of measures designed to restore confidence to the corporate and accounting sectors. These include stripping executive directors of the power to appoint company auditors and barring large accountancy firms from providing other services to the companies they audit. She also criticised the practice of offering large share option packages to senior executives as creating "perverse incentives" and has asked regulators to examine the practice.

## The Dangers of Aggressive Earnings Management

The Auditing Practises Board (APB) drew attention earlier this year to how increasing commercial and economic pressures can cause "aggressive earnings management" (AEM) whereby companies seek artificially to enhance earnings in order to boost share prices. "Despite the progress made during the last decade in corporate governance, accounting standards and auditing standards, the quality and reliability of financial reporting may be undermined by increasing commercial pressures on those responsible for preparing financial statements".

A recent paper by Professor Michael Levi, James Morgan and John Burrows for the DTI's Foresight Business and Crime Task Force has discussed the extreme effects of this phenomenon. "One of the main ways in which fraud affects businesses is through "false accounting". Executives will falsely report results in order to conceal their own poor performance – and perhaps to protect bonus payments based on reported company performance."

The APB is considering the issue of further guidance to auditors via revising "Statement of Auditing Standards 110, Fraud and Error" on matters that should alert auditors to the risk of aggressive earnings management. It added, however, that "Many commentators observed that aggressive earnings management is not something that can be countered by auditors alone; good corporate governance and appropriate accounting standards are essential".

The APB wishes to see consideration of root causes - motivations, opportunities, and means, rather than just detection techniques. This will require examination of remuneration and rewards for directors and senior management, corporate governance arrangements, accounting practices and financial reporting regulations. It could also extend to reviewing the pressures on companies from City analysts and commentators.

### Auditors: The Need for Professional Scepticism

The APB has emphasised that "an attitude of professional scepticism is vital" for auditors. Whilst acknowledging the role of auditing standards, it regards auditor training and the cultures and attitudes that exist within audit firms as far more important factors. The accountancy bodies should review how their education and training programmes promote sceptical thinking. Audit firms should consider how to strengthen working environments to ensure that audit teams exhibit "an appropriate level of professional scepticism".

The Panel believes that auditors must possess a heightened ability to assess people, the pressures they face and the responses they may employ. These are traditional, indeed basic, skills but some serious fraud cases suggest they may not be as highly valued as once they were. It is right to point out that auditors are not fraud-hunters and that there are strict limits to what even the most diligent auditors can achieve in the face of sustained deception by corrupt senior managers. But "an attitude of professional scepticism" can still play a vital role in deterring and unearthing fraud and must not be neglected on the grounds that it is not an all-embracing remedy. The accountancy profession must also take a rigorous look at the multiplicity of roles its members sometimes fulfil for individual companies, and ask itself whether it is entirely free of any conflict of interest that would undermine auditing judgements.

The ICAEW recently announced that it would develop new guidance on the application of "Statement on Auditing Standards 240, Quality Control for Audit Work", focussing on practical measures rather than a 'box-ticking' attitude to compliance.

### The Duties of Company Directors

The forthcoming Companies Bill offers a timely opportunity to restate the responsibilities of company directors. These are not well understood and current publications on the subject are largely silent on the problem of fraud. The proposed formulation in law of a modern statement of directors' responsibilities could make a major contribution here, and should be reflected in the public sector too.

Corporate governance rests ultimately upon the Companies Acts, but its detailed content derives from the Combined Code of the Committee on Corporate Governance, the code of conduct for Britain's listed businesses. Yet only 35% of FTSE 100 companies disclosed that they had fully complied with the Combined Code in 2001. Many of these deficiencies lie in the area of risk controls (of which fraud prevention should be a particularly important element), and was the principal focus of the 1999 Turnbull Report, the recommendations of which form part of the Code.

Corporate governance obligations should oblige directors to develop systems designed to combat fraud at all levels of the organisation, including the Board. These should include review of risks at board level; the designation of a lead director for risk issues; a policy statement backed by work practices; employee training and rules of conduct; the monitoring and regular review of controls; simple procedures to report whistleblowing; proper recruit vetting; and prosecution of offenders. Non-executive directors must be enabled to judge the adequacy of fraud prevention controls, and there should be regular reporting of such controls to shareholders.

Recent events provide a clear warning for audit committees; there is a widespread recognition that many of their chairmen and members are poorly qualified for their roles, are paid little for them and accordingly spend little time discharging their responsibilities.

As with auditing, a long-term focus on business education is also required. The Levi, Morgan and Burrows study found "almost no evidence that the subject of crime is addressed in business schools as a business risk or in the case studies on which the business school teaching is based. External issues such as the environment, and some aspects of public protest threats, may appear in social audit and corporate social responsibility courses: but crime externalities do not appear either as a formal category or in substance."

## The Challenge of Cybercrime

Cybercrime is a growing problem for all organisations. It takes many forms including fraud, hacking and theft of confidential information (or 'Netspionage').

A report published in April by the Department of Trade and Industry found that cybercrime is costing the nation up to £10 billion a year. 50% of all businesses were victims of such attacks compared with 25% in 2000. Four out of five of the largest companies have fallen victim to fraud, hackers or viruses in 2001. The average cost of each security lapse is £30,000; several companies reported that fraud and hacking had cost them well over £500,000.

The FAP-sponsored "Cybercrime Survey 2001" discovered that the growth of e-business in SMEs and business to consumer transactions is being inhibited by fears over cybercrime. Over dependence on technical controls and lack of involvement by many boards is at the heart of the problem. Nearly 40% of respondents did not have a board member responsible for cybercrime risk management. A board level risk assessment of e-business threats had not been performed by 40% of respondents. Yet 66% had reported a serious incident in the last 12 months.

The Government has responded by the formation of the National Hi-Tech Crime Unit, staffed by experts from the National Crime Squad, NCIS, HM Customs and Excise and various police forces. The United Kingdom has also signed the Council of Europe Cybercrime Convention which is aimed at facilitating more effective cross-border investigation and prosecution. The Convention covers harmonisation of national laws defining offences, the definition of investigation and prosecution procedures and the establishment of enhanced co-operation between the signatory states.

Further action is needed, notably in further training of officials in cybercrime methods and specialist investigation techniques. A full review of the Computer Misuse Act 1990 is also required to assess whether current legal concepts are, or are likely to be, adequate to cope with cybercrime.

## Focus on SMEs

The Panel's recent publications "Indications of Fraud in SMEs", "Fighting Fraud – a Guide for SMEs" and "Cybercrime – What Every SME Should Know" have broken fresh ground by highlighting the risks facing the most common type of business in Britain. SMEs (defined as firms employing less than 500 people) generate the bulk of the nation's employment and much of its wealth.

SME owners and managers may tend to be more worried about the bank manager, the tax inspector and the auditor than the threat of fraud. But recent years have seen a tendency for fewer external checks on this type of business. For example, in the past an SME would have been obliged to have an external audit and many functions, such as IT, have been outsourced. As a consequence managers may be becoming more isolated from the totality of their businesses' financial details. Yet the increase in via e-communication means that more people have access to confidential material than ever before.

The SME sector is far from homogenous. Some firms lack the need, as well as the resources, for well-developed control systems. But all require an awareness of fraud risks and close consideration of the prevention methods appropriate to their individual circumstances.

The greatest need is to raise awareness and educate managers in cheap but effective fraud prevention and detection techniques. The Panel will continue to work in this area but hopes to see closer involvement by the DTI with the far greater resources at its command.

## Changing the Culture of British Business

Could it be that the culture of British business inhibits proper fraud prevention? Of course there can be little uniformity in so large a field and many instances of good and bad practice exist. But a large number of companies may be unconsciously smoothing the way for fraudsters.

### Every Man for Himself?

The casting and avoiding of blame are common features of business life. Not for nothing has 'shooting the messenger' become a standard phrase. It should not be surprising that many employees, often at high levels, prefer to protect themselves, even at the expense of the companies for which they work.

Seeking power through the control of information is also all too common. Cases have come to light of knowledge of specific frauds being concealed from colleagues. Sharing problems, the better to solve them, is alien to many offices. Here too the 'blame culture' exerts its baleful influence.

These factors contribute to the failure of so many organisations to aggregate fraud losses. Senior managers define these as an 'operational loss', a method that might have been designed to promote crime rather than suppress it. It can amount to systematic concealment from colleagues, shareholders and the authorities.

The public record illustrates the price paid for this kind of business culture. The Bingham Inquiry into the corruption at the Bank of Credit and Commerce International (BCCI) found that there was an autocratic environment where neither workers nor firms were willing to voice concerns. The European Commission failed to deal with the warnings of one of its own officials who was forced to go public. In these and other cases the results were far worse than if the organisations concerned had faced up to their obligations.

A number of initiatives are attempting to create cultures of transparency with better flows of information and open discussion, aimed at promoting more widespread understanding and better ideas. They go a step beyond Turnbull's valuable but largely systems-oriented approach to risk.

The onus lies with boards to accept that a problem exists, demand information and create policies, structures and procedures. But there is also a need for a different kind of business culture. Staff must feel confident that they will not be penalised for coming forward with their concerns or reporting bad news. Some businesses operate a 'no blame' policy whereby anyone who has made a mistake (as opposed to having deliberately committed a serious offence) can come forward without fear of punishment. The idea is that by cutting out the 'fear factor', reporting of incidents will be improved, thus ensuring the minimum of unforeseen difficulties.

**A Culture of Openness** The Public Interest Disclosure Act 1998 may prove a landmark in the long battle to change attitudes within business. But law alone is not enough. Public Concern At Work's recent paper "Whistleblowing: the New Perspective" by Gordon Borrie & Guy Dehn, points out that someone who informs on corruption in which he or she has participated will receive more protection and help from the authorities than an innocent colleague who reports wrongdoing. Such a situation encourages the unscrupulous to use information for their own advantage and at times of their own choosing.

One solution is to create safe channels of communication to senior management. Such initiatives have developed most successfully in businesses in highly competitive markets where the early reporting of suspected wrongdoing is clearly in an organisation's interest. This involves the provision of alternatives to the reporting of problems via line managers in order to avoid monopolistic control over information flowing up to senior executives. But Borrie and Dehn believe that "the approach many organisations now take to information from workers is similar to the attitude taken toward consumers thirty years ago (that they were troublesome, untrustworthy complainants)".

### **Nurturing Moral Behaviour**

A radical approach is to instil a more highly developed code of moral standards in an organisation by internalising it in individual employees from the lowest to the highest levels, so making everyone responsible for upholding them. An 'internal monitor' setting moral boundaries for acceptable behaviour is the best defence against fraud and failure and ultimately more reliable than rules and structures, essential though these undoubtedly are. This approach is finding favour in America and a large Association of Ethics Officers has been created. The World Bank inaugurated such a programme in 1998, using a British company to do so. One of the consultants, Tom Oxley, has said that "ethics are more powerful than rules which cannot cover every eventuality, let alone police them."

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