



WORKING PARTY PAPERS

Response to the Auditing Practices Board on the Consultation Paper

Fraud & Audit: Choices for Society

Information Gathering Working Party

Introduction

The Fraud Advisory Panel is a multi-disciplinary body, set up initially with funding from the Institute of Chartered Accountants in England and Wales, with the following objectives:

- to establish the essential facts about the extent and nature of fraud;
- to advise businesses and others on measures to fight fraud, including prevention, detection and reporting; and
- to improve the approach to investigation and prosecution of fraud.

The Panel welcomes any serious initiative aimed at tackling the problem of fraud affecting the private or public sectors and is pleased to comment on the APB's thoughtful and well-written paper. This response, put together by a group of Panel members from a range of business and professional backgrounds, mainly addresses the questions raised by the paper.

1 Do you think this paper summarises the main issues related to fraud and the audit? If not, what other facts should APB take into account?

The paper analyses many of the issues well. The Panel considers that when considering the actions needed emphasis should be put on the following areas.

Management fraud in public interest entities is the most serious private sector problem, not just because of losses incurred by all the victims but because of the damage to confidence. We support the APB's general approach of putting forward a package of measures to address the issue. This is very much in line with the Panel's aims of seeking better coordination of the actions of those interested in combating fraud.

The relationship of the external auditor with the entity being audited, and in particular its shareholders and governing body (normally the directors) is key. External auditors need to have close contact with company directors and management in order to understand the business properly and hence to audit effectively. Communications between the auditor and the Board are in many ways more important than the typically short form communications with the shareholders. For listed companies the relationship between the Audit Committee and the external auditors is increasingly important. We welcome any constructive measures to improve the effectiveness of Boards of Directors, Audit Committees and communications with the External Auditors. We note that the recent US 'Blue ribbon' Report has made recommendations to strengthen Audit Committees – we commend in particular those referring to the 'financial literacy' of Audit Committee members and would add that 'risk and control literacy' would also improve the situation.

The second area is the attitude of business to fraud. It is clear from our own work that fraud is not seen as a significant problem in the majority of industries, and is not therefore high on the list of priorities - many businessmen believe it cannot happen to them and do

not see the need to take preventive steps. This laissez faire attitude could be attributed to a number of factors:

- the lack of hard information on the level of commercial fraud. Estimates of fraud vary widely and are therefore generally regarded as unreliable;
- the lack of training at all levels within the business and professional communities. This is beginning to change in those sectors more affected by high levels of fraud or external regulation, such as the retail, financial services and banking sectors;
- a fear of revealing fraud problems, which may be seen by investors, financiers, competitors, suppliers, customers and employees as indicative of weak management.

Any constructive steps taken to improve and increase awareness, knowledge of the risks and preventive measures will be welcome. We also support increased emphasis being given to the role of internal audit.

2 Is the current balance between avoiding unnecessary constraints on business and preventing/detecting fraud appropriate?

The Panel believes that directors and management in business, and owners of businesses, have to accept more responsibility for the level of commercial fraud. All businesses can be the victims of fraud whether directly or indirectly. For many companies minor fraud is just a cost of doing business, to be managed. But major fraud, which will normally involve executive management (which can include directors), can hit without apparent warning and be devastating in its effect. It is clearly unreasonable to expect external auditors to be the main or only group with a responsibility for detecting and reporting fraud, for the simple reason that their remit is for the most part to report on annual financial statements. The Panel is therefore supportive of the proposals to change corporate law and governance. In particular, we would suggest that attention is directed to directors' ongoing duties and the responsibilities as part of governance arrangements of executives and non-executives.

However, the Panel feels that auditors can also improve their procedures and performance and welcomes some of the proposals in the paper on clarifying current auditing standards. Comments on specific proposals are included in the answer to question 4.

3 If yes (to question 2), is there a need to rebalance public expectations in the light of the comments in this paper regarding the likelihood of auditors detecting management fraud?

Not applicable. We have already commented on the importance of concentrating on management fraud.

4 If no, what actions set out in sections 3, 4 and 5 of this Paper would you support?

Changing corporate law and governance

The Panel feels that the existing roles and responsibilities of directors are not well understood. This is, in part, due to the fact there is no statutory statement of the responsibilities of directors. Instead, these have been established by case law. This is particularly true in relation to fraud, where there is a gap between reality and perception over who is responsible for preventing fraud. Despite frequent statements emphasising that the primary responsibility for preventing and detecting fraud rests with the directors, the public perception is that the auditors are responsible for detecting fraud, and that the audit acts as the main deterrent.

The Panel therefore welcomes any action to increase awareness amongst directors of their responsibilities and to heighten the corporate governance obligations of directors. As discussed below, the Panel feels that it should be the express obligation of directors to analyse risks from fraud and to develop systems to combat fraud, and this should be clearly stated in the financial statements. We hope that the ICAEW Committee developing guidance on reviewing and reporting on internal control will identify fraud as an area of particular responsibility and we recommend that if this is not covered by the draft guidance the APB should make strong representations to the Committee to address it. This Panel certainly shall.

Clarifying companies' responsibilities for fraudulent acts by directors and employees

The Panel supports the proposals in paragraphs 5.6 to 5.8 to make companies more responsible (to a greater or lesser extent) for the frauds of its employees and directors. We feel that the knowledge of fraudulent directors and employees should be imputed to the company except where the director and/or the employee has acted solely for his own benefit. In judging the benefit of a fraudulent act, the court should have regard to both the long and short term benefits to the company and the director and/or employee concerned.

Tighten directors' duties to provide information to auditors (section 389A)

The Panel strongly supports the proposals in paragraphs 5.13 and 5.14. If the onus of proof as to whether there is a fraud is switched from the auditors to the directors this could provide a much stronger basis for the auditor reporting concerns as to the quality of information and explanations received (see below). We believe that the duty to provide information and explanations should be extended to include a duty on directors to provide all information which they knew, or ought to have known, would be material to the financial statements of the company. Furthermore, the section should apply where any reports are prepared by accountants for public use (e.g. prospectuses), and not just to the audit. The section should also apply to employees of the company where the auditors seek information from them.

We suggest that the provisions for assessing damages could include an assessment of whether the directors or employees misled the auditors or accountants (either by omission

or commission). This would help to ensure that a company could not avoid responsibility for the acts or omissions of its directors or employees on the grounds that they were not acting in the course of their employment or actual authority. This could be done by amending section 727, which is rarely used successfully.

5 Can you suggest any additional action that could be taken to prevent or detect management fraud?

Directors statement on fraud prevention measures

In recent years, more importance has been placed on the role of directors in the effective management of a company, with increasing disclosure on corporate governance in listed companies. In addition, the duties of directors of companies operating within the financial sector includes the prevention and detection of fraud. The Fraud Advisory Panel therefore welcomes the suggestions in paragraph 5.4 for a Code of Conduct for listed company directors and legislation to clarify the responsibilities of directors.

The Fraud Advisory Panel also suggests that listed company directors should give disclosures on the company's fraud prevention measures in the financial statements. This would impose a positive obligation on the Board to satisfy the auditors on a number of specific criteria.

In addition, the existence of specific assertions would allow the internal audit function and the non-executive directors to measure performance and challenge the executive directors where appropriate. Finally, any statement would increase transparency in company reporting, which must be welcomed.

Fraudulent statements by directors

In order for the above statement to be effective, legislation should include stiff penalties for directors giving knowingly incorrect or misleading statements or information to the auditors (linking with the suggestions in paragraph 5.13).

The role of non-executives

Non-executive directors are taking an ever-increasing role in corporate governance and more emphasis should be placed on the role of the Audit Committee in the paper. Whilst there is the perennial problem that non-executive directors are not necessarily going to be able to control the Board, they do have the power to ask searching questions. The Panel believes that the powers of the non-executive directors, through the operation of the Audit Committee, should be increased. There are a number of possibilities that should be explored.

Firstly, the majority of listed and public interest companies should be required to have an Audit Committee, with an internal audit function acting as an executive arm. The internal audit function would therefore be responsible to the Audit Committee, rather than the executive directors. The lines of reporting to the Audit Committee would be direct and

confidential. The Audit Committee would also receive reports from the risk management function where appropriate.

Secondly, the Audit Committee should be mainly responsible for the relationship with the external auditor, being responsible for the engagement terms, the scope of the audit and the respective responsibilities of internal and external auditors.

Thirdly, with increased responsibilities Audit Committees have to be more effective at discharging them. This means making them more professional, with at least one or more members being 'financially' and 'risk and control' literate.

The Panel do not believe that these measures should necessarily apply to all listed companies as there are many small plcs where it may be unrealistic to expect the formation of an audit committee or an internal audit function. However, the distinction between 'large' and 'small' should not be based solely on quantitative grounds, but should take account of likely public interest.

Auditing standards

SAS 110 and other relevant standards should be reviewed to see how effective they are in addressing management fraud. Given that this is the most difficult fraud for auditors to detect any standards have to be measured against this, so as not to set standards that are unreasonable.

The phrase in the SAS 'reasonable assurance' is particularly difficult to interpret. We are aware of the APB's own research that shows there are widely different interpretations of what it is reasonable to expect the auditor to detect – clearly it is more reasonable to expect the auditors to detect a fraud involving a theft and consequential material overstatement of stock than it is to expect auditors to detect a more wide-ranging collusive procurement fraud involving over-charging by suppliers and kickbacks; there is also research being undertaken at the University of Hull that shows that certain phrases are more likely to be misinterpreted than others. Although this research is not complete the phrase 'reasonable assurance' does not come out well. As part of this the auditor's fraud risk assessment might usefully address specifically the different types of fraud, including management fraud.

There is wide recognition that corporate governance, particularly of listed companies, is well served by improved transparency and communication. Therefore, how auditors communicate concerns about the quality of their audit evidence should be reconsidered. Often auditors will have concerns but feel that the evidence of a suspected fraud available to them is insufficient to warrant an audit qualification. Is this right? What alternative courses of action might be open? Could auditors discharge their responsibility by reporting to the audit committee (believing that they are untainted) rather than reporting to the shareholders? We strongly recommend that the APB reviews the existing standards on management representations, audit evidence, related parties and auditor reporting with this in mind.

The Panel is not in favour of auditing standards prescribing in detail the procedures the auditor should perform in relation to identifying fraud. The auditor has to be encouraged to

use professional judgement and apply due professional scepticism. But auditing standards on quality assurance might usefully address what steps are taken within firms to educate audit partners and staff about fraud and professional scepticism and how the auditor should identify where there may be a fraud risk and how to act when there is one.

6 Do you believe investors and the business community are prepared to bear the costs, financial and otherwise, that would be involved in implementing and recommendations?

As already discussed, wide sections of business are currently unlikely to accept that the problem of commercial fraud requires serious actions by directors and management. So there will be a reaction to bearing extra costs, if these are believed to be significant. However, this should not be a reason for backing off pursuing reforms. Many of the proposed reforms and matters addressed in this letter can be implemented without significant cost and there will be compensating benefits. The existence of the ICAEW Committee on internal control and the Government's Company Law review also mean that the time is right to be questioning company law, governance arrangements and directors' and auditors' responsibilities. We therefore strongly support the APB pursuing a broadly-based package of reforms and the Fraud Advisory Panel is prepared to help achieve them.

Any reforms should be accompanied by an aggressive education programme for both business and the professions affected, to emphasise the true cost of commercial fraud to UK business and the need for a coordinated approach to combating it.