

the fraud third
advisory annual
panel report

2000 2001

Sounding the alert on fraud:

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:

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.

the role of the Panel

Originate proposals to reform the law and public policy on fraud

Develop proposals to enhance the investigation and prosecution of fraud

Advise business 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

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Fraud is virulent and pervasive. It cheats and harms businesses and employers, shareholders and employees, taxpayers and citizens. It spans the public and private sectors and has national and international dimensions.

Fraudsters seek to match each development in the way business is conducted. The techniques they employ become ever more sophisticated and the growth of e-business and electronic commerce provide fresh opportunities for those who seek to gain dishonestly at the expense of others. But the good news is that the fight against fraud is gaining momentum too.

Awareness of the threat has risen in the last year or so. More action is being taken to tackle, pursue and prosecute fraudsters.

Improved financial regulation, moves towards greater transparency in financial reporting and developments in corporate governance all contribute towards building a business culture in which fraud and malpractice are addressed and regarded as corporately and socially unacceptable. There is nevertheless much to be done to tackle the menace that fraud represents.

As the external auditor to the central public sector, I am acutely conscious of the need to keep up the pressure. The good work being done in the private sector as well as by government departments and others responsible for the delivery of public services is very welcome. Such developments are complemented by the work of the Fraud Advisory Panel, a unique forum of private and public sector experts. The Panel brings together the legal and accountancy professions, law enforcement, investigators and many others, to provide a catalyst - and an authoritative source of advice and education - in combating and raising awareness of fraud and financial dishonesty.

I am pleased therefore to commend the Panel's important work during the past year and its continuing achievements in the fight against fraud.

A handwritten signature in black ink that reads "John Bourn." The signature is written in a cursive, slightly stylized font.

John Bourn
Comptroller and Auditor General,
Head of the National Audit Office

Society may be in a race against time to arrest the growth of fraud. Standards in both commercial life and public service, certain high-profile cases notwithstanding, are relatively high.

Yet such probity is not the natural order of things but the result of long labour and vigilance. Sadly, our traditional systems of checks and balances, in both public and private sectors, are becoming inadequate. The problem is aggravated by our reluctance to acknowledge the changes that are underway.

We tend to think of fraud as either small scale and seedy (“fiddling the books”) or as an occasional work of evil genius. We need to understand that fraud’s face has changed and that neither of its traditional manifestations are now typical. It is a crime increasingly linked to corruption and money laundering and conducted by organised criminals. When combined with the growth of e-business, which is difficult to monitor and regulate, fraud seems set for a rapid rise. The National Criminal Intelligence Service now places it on a par with drug trafficking as a major crime threat.

The Government is to be praised for taking economic crime seriously and has achieved much over the last year. But its valuable individual initiatives still lack sufficient central direction and co-ordination. 16 departments and agencies have one kind of responsibility or another for the problem. There is a fragmentation of perspective and policy which allows fraud to grow. We at the Fraud Advisory Panel hope that the emerging emphasis on a more holistic approach will be translated rapidly into action. It is worth remembering that society’s response to rising crime before the 1990’s showed too little imagination and involved too little multi-agency thinking. We must not make the same mistake twice. Organised crime, once established, is immensely difficult to eradicate.

Last year’s survey by NERA for the Home Office revealed the cost of fraud, including detection and prosecution, as up to £13.8 billion per annum –a figure thought likely to be an underestimate by those who calculated it. Fraud is a hidden tax on everyone. It increases the cost of goods and services, diverts public funds from those they are intended to help, impoverishes small as well as corporate shareholders, strikes at the future of private pension holders, jeopardises jobs and saps faith in the City’s unique standing at home and abroad.

About the Fraud Advisory Panel

Established in 1998 through a public spirited initiative by the Institute of Chartered Accountants in England & Wales, the Panel exists to challenge complacency and supply remedies. Our role is to develop policy, make submissions to government and public bodies, conduct educational initiatives, commission research and serve as an information exchange. We have a broad range of members from different disciplines, businesses and public bodies and work to encourage a truly multi-disciplinary perspective. The Panel is given a serious hearing as a consequence and has contributed to the new, more vigorous attitude in government towards fraud.

Major developments 2000-2001

It may be helpful to summarise some of the most important fraud related developments of the last year (most are addressed in detail in the main text).

The Government has set out a number of major proposals which have the potential to make a significant impact on fraud. The Proceeds of Crime Bill, will make it easier to confiscate the proceeds of economic crime. The White Paper *Criminal Justice – The Way Ahead*, published in February 2001, emphasizes the need for greater co-operation between law enforcement agencies and Whitehall and, indeed, between government departments themselves.

Growing European co-operation against serious crime, notably via the agreement on mutual legal assistance and the creation of Eurojust, a new forum of EU member state judicial authorities.

A significant increase in funding for the Serious Fraud Office and a subsequent increase in its case load. The Police & Criminal Justice Bill also promises to extend the SFO's powers of seizure by allowing papers and other evidence to be examined off-site.

The important example set by the NHS' anti-fraud programme which demonstrates how much can be achieved by a truly committed and holistic approach.

The establishment of the National Hi-Tech Crime Unit, (NHTCU), Britain's first national law enforcement organisation tasked with combating computer-based crime.

The first successful "whistle blower" claims for unfair dismissal under Section 5 of the Public Interest Disclosure Act 1998, some resulting in substantial damages.

The enquiry, by the House of Commons Select Committee on International Development, into British involvement in overseas corruption and the implications for joined-up government. This has led to the Government's pledge to incorporate the OECD Convention on the Bribery of Foreign Public Officials in International Business Transactions into domestic law.

A number of unwelcome developments can also be identified.

The inadequacy of resources available to police fraud squads leaves many serious offences uninvestigated. A study for the National Fraud Working Group has revealed that each officer has a live caseload of 3.7 cases with an average value of nearly £900,000. Squads are losing experienced officers and those that remain are often rotated elsewhere.

Potential confusion between the Financial Services Authority's soon to be extended anti-money laundering remit and that of the police, itself illustrative of a lack of "joined-up government".

Underreporting of suspicious financial transactions by lawyers, accountants and banks which may be hampering the fight against money laundering.

Concerns over the impact of the incorporation of the European Convention on Human Rights on the effective prosecution of serious frauds.

The Company Law Review's failure to address the implications of fraud for corporate governance, a response out of step with the wider governance debate.

Much of business still lacks a serious response to fraud, as illustrated by a widespread lack of reporting of economic crime, training and adequate risk controls.

An agenda for government

The following proposals outline the Panel's view as to the most urgent issues for government in the campaign against fraud.

1. Improve the overall police response to fraud. Place economic crime on the national list of police priorities and mandate individual police forces to produce anti-fraud strategies. The Home Office should initiate a review of whether additional resources should be directed to chief constables or to other bodies, including a National Fraud Squad. 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 fraud squads.
2. Devise a blueprint for a joined-up anti-fraud strategy drawing on the proposals set out in the Cabinet Office Policy & Innovation Unit's report on confiscation of criminal assets and the successful ongoing campaign in the National Health Service.
3. Create a 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 source of authoritative recommendations to government and public agencies. It would facilitate closer co-operation and report to a lead government department.
4. Expand the Serious Fraud Office's remit to embrace major corruption and money laundering cases. It makes no sense to exclude an expert organisation from crimes so closely linked to fraud.
5. 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. 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.
6. Reform Company Law to take account of fraud. New requirements for the Operating and Financial Review (OFR) should include specific reference to fraud prevention and detection. Directors should be obliged to develop systems designed to combat fraud at all levels of the organisation, including the board.
7. Convene a national conference of professional bodies and providers of professional qualifications aimed at enhancing standards in anti-fraud education and training. Minimal progress in this area strongly suggests that an external stimulus is needed.

Supporting the Panel

The Panel is still a small scale, essentially voluntary initiative (though I wish to pay tribute to Sue Diggens, who has conducted our administration, and to Simon Pearce who has played a key role in the preparation of this report). Both I and my colleagues on the Steering Group are greatly indebted to all those who have supported the Panel's endeavours, whether by their donations of time or of money. Chief amongst these is the Institute of Chartered Accountants in England & Wales (ICAEW) which not only established the Panel but has continued to provide generous support. The Corporation of London has also provided valuable assistance during the last year.

Yet we require significant additional funding if the Panel is to properly exploit the expertise of its membership. A number of projects have been seriously delayed or shelved due to lack of funds for research and publication. Support from the financial community, the professions, business and the public sector, preferably on a long term basis, is urgently required.

Details of how to contact the Panel are set out on the back cover.

Corporate supporters 2000-2001

The Institute of Chartered Accountants in England and Wales
The Corporation of London
The Accountants Joint Disciplinary Scheme
Argos Ltd
Barclays Bank Plc
BKR Haines Watts
Boots Plc
HBL Kidsons
Herbert Smith
HSBC Holdings Plc
Lloyds TSB Bank Plc
Mazars Neville Russell
Nationwide Building Society
Prudential Ltd
Royal & Sun Alliance Plc
SmithKline Beecham Plc
Wren Syndicates Management Ltd

The Panel's achievements to date

Public policy & legal reform

Developing proposals for a National Economic Crime Commission

Submitting proposals on company law to the Company Law Review, the Law Commission and the DTI

Making proposals to HM Treasury and the FSA on dealing with financial fraud

Submitting proposals to the Law Commission on reforming the law of fraud and deception

Presenting proposals to the Lord Chancellor's Department on the reform of serious fraud trial procedures

Presenting detailed proposals for strengthening the relationship between the police and the SFO

Education & training

Identifying and publicising potential deficiencies in the anti-fraud and fraud awareness content of business and professional education and training

Preparing an anti-fraud checklist and Code of Practice for small and medium sized enterprises (SMEs)

Working with universities on enhancing anti-fraud education and training

Presenting on fraud issues at major business conferences

Research

New research into the extent and nature of fraud which has revealed the inadequacy of existing statistical sources

A study of business cybercrime for use by executives, government and business and professional organisations

A study of fraud in the SME sector with advice for owner-managers

Guidance for retailers on avoiding Internet fraud

Specialist seminars on the Data Protection Act, the law of corruption and confiscation of criminal assets

Members of the Steering Group



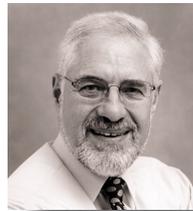
George Staple CB QC

Chairman of the Panel; Consultant to Clifford Chance and former Partner; Director of the Serious Fraud Office 1992-97; Member of the Council of the Law Society; Treasurer of the Society 1989-92; Chairman of the Disciplinary Committee of the Securities Association and the Securities and Futures Authority 1987-91; former DTI Companies Act Inspector; Member, Senior Salaries Review Body.



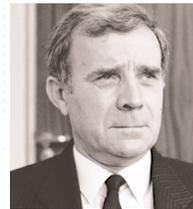
Howard Page QC

Chairman, Investigation, Prosecution and Law Reform Working Party; Serle Court, Lincoln's Inn; Deputy President of the Lloyd's Appeal Tribunal; Bencher of Lincoln's Inn.



Gerry Acher CBE FCA

Deputy Chairman of the Panel; Senior Partner, KPMG London and founding Chairman of its Client Service Board; former UK Head of Audit and Accounting; former Chairman of KPMG's world-wide Audit and Accounting Committee; Chairman of the Audit Faculty of the ICAEW; Chairman, DTI Foresight Panel working party on crime and business; Deputy Chairman of London First.



Mike Hoare MBE

Chairman, Research, Information and Intelligence Working Party; Chairman of the Risk and Security Management Forum (RSMF) since 1990; former Metropolitan Police Commander; former Director of the Investigation Department of the Post Office.



Peter Yapp

Chairman, e-commerce Working Party; Manager, IS Security Consultancy Services; formerly a Senior Investigations Officer with the National Investigation Service of HM Customs & Excise.



Tony Bingham FCA

Steering Group Member; Partner, PricewaterhouseCoopers; originator of the *Taking Fraud Seriously* initiative which resulted in the foundation of the Panel; Chairman of the Technical Auditing Committee of the ICAEW; a UK Board member of anti-corruption group Transparency International.



Martin Robinson FCIS, FIIA

Chairman, Education and Training Working Party; Head of Risk Training Lloyds TSB Bank Plc; Chair of the Training Development Committee of the Institute of Internal Auditors; audit adviser to the Institute of Chartered Secretaries and Administrators.

The Panel at work

Structure and specialist functions

The Panel is directed by a Steering Group 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, risk management and information technology. The Panel wishes to express its thanks to Frank Heinrich-Jones FCII and David Perry FCA who have left the Steering Group during the last year.

The Panel's detailed work is conducted by four multi-disciplinary working parties addressing different aspects of fraud. The current working parties are:

Investigation, Prosecution and Law Reform (chaired by Howard Page QC). To review the legal process and statute law as it relates to fraud and recommend changes where desirable.

Education and Training (chaired by Martin Robinson FCIS, FIIA). To identify and disseminate best practice in training and guidance in fraud prevention, detection and investigation.

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.

e-commerce (chaired by Peter Yapp). To promote understanding of Internet fraud and safeguards against it. The Working Party has also developed the Panel's Website which is currently being tested prior to launch.

Principal activities 2000-2001

1. Research and discussion on the role of a National Economic Crime Commission. A round table has been held with the participation of senior officers from both the City of London and Metropolitan police forces and a paper prepared by Michael Levi, Professor of Criminology at Cardiff University.
2. An Anti-Fraud Code of Practice and Checklist for medium sized businesses. Most fraud prevention advice is written with large firms in mind. This forthcoming publication from the Education & Training Working Party explores the needs of SMEs, covering such issues as risk training, fraud policy development and promotion, prevention, detection and prosecution, whistle blowing, implications for recruitment and personnel, and reviews of policy and compliance.

3. A major survey of cybercrime in conjunction with CBI, PricewaterhouseCoopers, security consultants Armor Group and Professor Paul Barnes of Nottingham Business School (see chapter on "The corporate realm").

4. A programme of discussions between a number of universities and the Education & Training Working Party has begun to consider how the treatment of fraud in business, legal and accountancy courses might be enhanced.

5. A major research paper by Dr Andrew Higson of Loughborough Business School on fraud and fraud prevention in SMEs is about to be published by the Research Working Party. Smaller firms are generally not equipped to make the most of the complicated handbooks prepared for larger organisations with their more elaborate control mechanisms. The study aims to encourage SME managers to consider the vulnerability of their organisations to fraud and illustrates dangers with real-life examples.

6. A forthcoming report on e-fraud by Professor Paul Barnes of Nottingham Business School, commissioned by the Research Working Party, which reviews the extensive literature on the subject and provides practical advice on both dangers and preventive measures.

7. Extensive guidance on avoiding Internet fraud has been published by the e-commerce Working Party covering the Distance Selling Regulations, credit card fraud, delivery to accommodation addresses, use of security badging in website protection and methods of protecting customer databases from internal fraud and abuse.

8. A critique of the Company Law Review proposals has been submitted by the Law Reform Working Party. This expresses concern at the Review's persistent failure to address the problem of fraud and makes recommendations for action (see "The corporate realm").

9. A seminar on "Co-ordinating the Response to Corruption" by the Law Reform Working Party in conjunction with Transparency International (UK) at Lincoln's Inn in February 2001.

10. A seminar on confiscation of criminal assets, chaired by Neil Griffiths of Denton Wilde Sapte under the aegis of the Law Reform Working Party in April 2001. Both this seminar and its predecessor heard distinguished speakers from the legal profession and Whitehall.

11. A seminar on the impact of the Data Protection Act on investigators and researchers, held by the Education & Training Working Party in March 2001.

The threat

How great a problem?

Why is a major national problem not a national priority? In part due to a lack of authoritative statistics which enables the problem to be politically marginalized. This also has profound implications for managing the response to fraud, as we know too little of its extent and distribution to be sure of targeting resources in the most effective way. Moreover, government departments, professional bodies, business organisations and the police all have their own working definitions. This lack of standardisation makes proper comparisons almost impossible. There are doubts about quantification too. It is not clear whether available figures reflect suspected, proven, reported or potential values. Yet such information as is available suggests fraud is great in extent and growing apace.

Perhaps the most significant new research in this field is *The Economic Cost of Fraud*, a report for the Home Office and the Serious Fraud Office by National Economic Research Associates (NERA) published in late 2000. This not only seeks to calculate direct losses; it also allocates costs to investigations, court proceedings and preventive measures and has 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 is up to £13.8 billion. £10.3 billion of this is the result of actual fraud. NERA believes these figures are likely to be underestimates.

NERA considered the Association of British Insurers' 1999 estimate of fraud costing the country £16 billion a year (£650 for every household) to be "not outside the bounds of plausibility, especially when the potential scale of undiscovered fraud is taken into account".

319,324 fraud and forgery offences were recorded by the police in England & Wales in the year ending March 2001, a fall of 4.6% on the previous year. However, the Home Office warned that "a great many offences of fraud continue to go unreported, for example where losses are absorbed by businesses as overheads or individuals believe that crimes are unlikely to be detected".

70% of major companies in the UK reported that they had been subject to economic crime in the previous two years, according to a survey published this summer by PricewaterhouseCoopers. Other findings are that 89% of all frauds are committed by employees; 83% of organisations believe that the risk from fraud will be the same, or greater, in the future; 39% admitted they had not reported frauds to the authorities; only 15% of UK organisations have successfully recovered more than half of their losses. This broadly confirms a 1998 Ernst & Young survey where two-thirds of British respondents reported being defrauded in the preceding 12 months and 84% in the previous five years.

KPMG's Fraud Barometer measures instances of reported fraud over £100,000 that reach Crown courts and result in convictions. It records 665 cases in the decade to December 2000 with charges valued at a staggering £4.2 billion (an average of £6.3 million per case). Some spectacular cases have not met the criteria and have therefore not been taken into account.

The social impact

Statistics often fail to dent the common perception that fraud harms only rich institutions or individuals. Yet 16 investors took their own lives in the aftermath of the Barlow Clowes fraud and hundreds lost their homes and savings. There are other serious impacts:

Fraud entails the corruption of critical procurement processes such as the development of specifications and the qualification of suppliers and can therefore lead to vital system failures, accidents and environmental problems.

Fraud creates a misallocation of public resources so that more tax has to be raised than would otherwise be required. Department of Social Security figures published in July 1998 estimated confirmed aggregate benefit fraud at £2 billion a year with an additional "high suspicion of fraud" figure of £3 billion.

Fraud distorts markets. Manufacturers build in provision for fraud losses thus raising prices. Insurance fraud, estimated at £750 million a year by the Association of British Insurers, adds to premiums. Certain markets, such as Internet banking, grow more slowly because of the fear of fraud.

Fraud by organised crime now has national security implications. Modern economies are becoming ever more information based. Public and private sectors now share parts of the same information transfer systems and rely on the same or linked computer networks. National Information Infrastructure (NIIS) concerns arose as part of the Government's 1998 Strategic Defence Review which emphasised the need to protect the integrity of such systems against fraud and money laundering manifesting themselves as cybercrime.

Dynamics of growth

Two factors make the growth of fraud certain unless government and business adopt a more vigorous and holistic response.

- (i) The Internet. e-business brings many advantages but is undeniably a paradise for fraudsters. Monitoring and regulation become more difficult; barriers to market entry are lowered, making it harder to distinguish legal and illegal players; an expectation of speed increases intolerance of delays caused by thorough checking; the enhanced internationalisation of business creates jurisdictional difficulties in fraud investigation and prosecution. And the connection of most computers to the Internet facilitates crimes that were previously difficult to commit.
- (ii) Organised Crime. Last December's 10 Downing Street summit confirms that Whitehall now sees organised crime as a dangerous British problem. The NCIS warns that gangs now derive as much money from financial crime as from drug trafficking. Indeed, drug imports are often financed by fraud. Its strategic assessment *The Threat to the United Kingdom of Serious and Organised Crime*, published last year, estimated that over 50 organised criminal groups are involved in VAT, Excise and tax fraud. The FSA believes that infiltration of City institutions is high on the criminal agenda and recent exposures of criminal manipulation on Wall Street have illustrated the dangers facing London.

Money laundering

Huge sums continue to be 'earned' from drug trafficking, smuggling, fraud, tax evasion, prostitution, illegal immigration and arms trading. Such transactions create a pressing need for criminals to disguise the source of their wealth. "Laundering" is by definition a fraudulent activity and has three stages: placement in the financial system; "layering", moving funds from one company or jurisdiction to another; and "integration" whereby the owner enjoys the benefits without risk. The International Monetary Fund has estimated (using 1996 figures) that global money laundering is worth between US\$590 billion and US \$1.5 trillion a year – a remarkable 2 to 5% of global GDP. There are no reliable British estimates but there is a great deal of official concern about the actual and potential impact on our own country.

Though the international Financial Action Task Force (FATF) has praised British money laundering legislation London's very position as a respected major financial centre increases its vulnerability since passing laundered money via the City enhances its apparent legitimacy. The Treasury believe that Britain is used largely to layer and integrate funds.

Defending the City demands a high degree of vigilance from the financial, legal and accountancy sectors. Yet a House of Commons Select Committee report of March this year stated that it was "concerned at the under reporting of suspicious transactions by certain professional groups, in particular lawyers and accountants." There were only 57 reports by solicitors in 1999 and 84 by accountants. The response from the financial sector is patchy. In 1999 a mere 10 out of 554 banking institutions reported 78% of suspicious transactions; only 4% of insurance companies and 6% of London Stock Exchange member firms made reports compared to 78.6% of building societies. The Financial Services Authority's recent investigation of money laundering control at 23 banks found significant weakness in 15 of them. Latest figures reveal that, although overall disclosures rose by nearly 27%, only 170 out of 575 registered banks made reports in 2000. Solicitors and accountants also continued to have low reporting levels.

The incentive to report is reduced by the inability of many police forces to cope with the demands already placed upon them. Financial institutions complain of little feedback and late responses, a considerable problem when money movements are swift. The NCIS receives some 15,000 money laundering reports a year with 30 staff and a budget of well under a million pounds. Its Australian counterpart has 82 staff and a budget of almost £4 million to monitor a much smaller financial sector.

Better use could also be made of existing resources by expanding the Serious Fraud Office's remit to embrace corruption and money laundering cases. It makes no sense to exclude so expert an organisation from crimes so closely linked to fraud though additional funding would naturally be required.

Current money laundering legislation is unduly complex and the NCIS states that this has inhibited money laundering prosecutions which are at a lower level than in many Continental nations. The Government has said that it intends to consolidate and simplify the law via the forthcoming Proceeds of Crime Bill.

Joined-up government?

A multiplicity of actors

The Government has announced or implemented a number of welcome measures during the last year. A new ministerial group on the Criminal Justice System should improve departmental co-operation on serious crime. Closer police-SFO liaison is planned and the Draft Proceeds of Crime Bill promises a more coherent approach to money laundering. But “joined up government” does not yet embrace the fight against fraud. No fewer than 16 bodies have responsibility for policy, investigation or prosecution.

HM Treasury
Cabinet Office
Home Office
Lord Chancellor’s Department
Attorney General
Department of Trade & Industry
Department of Social Security
Department for International Development
NCIS
The Police
National Audit Office
SFO
Crown Prosecution Service
HM Customs & Excise
Inland Revenue
Financial Services Authority

One practical problem illustrates the consequences of this remarkable fragmentation. The FSA’s remit will soon include money laundering. Yet how will this new responsibility mesh with those of the police, and particularly that of the recently established and successful Metropolitan Police money laundering investigation team?

The Cabinet Office Performance & Innovation Unit (PIU) was commissioned by the Prime Minister to study and make proposals for an improved strategy for the recovery of criminal assets. Its findings, published last year, urged a “more strategic approach, with joined-up government from all relevant parts of the criminal justice system and better trained and supported law enforcement officers able to pursue complex financial investigations.” It argued that “A major weakness in the confiscation regime is the absence of streamlined and mutually supportive organisational objectives...each service is held accountable only for achieving its own targets...cooperation does take place, but it does so despite the incentive mechanisms, not because of them”. The Panel believes that the report points the way to both a strategy, and a sustaining structure, for combating fraud.

The PIU Report: a blueprint for joined-up crime fighting
The key points of the PIU proposals are as follows.

A national, multi-agency strategy driven by a dedicated lead body, the National Confiscation Agency.

Set demanding published targets benchmarked against tangible statistics (the volume of suspicious financial disclosures).

Align incentives and promote co-operation between law enforcement bodies. This should be bolstered by a cross-cutting Public Service Agreement for the criminal justice system in order to promote accountability.

The NCA to become a centre of excellence keeping pace with changing criminal methods and lending assistance on complex cases.

A new National Specialist Law Enforcement Centre to provide training in investigative techniques for NCIS, the National Crime Squad, the police and customs.

Increase secondments to promote cross-agency understanding, particularly between investigators and prosecutors.

A supervisory board drawn from law enforcement, prosecution and relevant agencies. The Board would also tender advice to ministers.

A department, the Cabinet Office, to ensure close co-ordination between departments of state.

Overarching ministerial accountability via a lead member of the Cabinet, the Home Secretary

The Government should now review this structure in order to assess its precise suitability for dealing with fraud. Much can also be learnt from recent experience in the NHS (see below).

The case for an Economic Crime Commission

The Panel has long argued that a coherent national anti-fraud strategy requires a dedicated body, a National Fraud or Economic Crime Commission, an idea originally promulgated by Lord Roskill in his report on serious fraud trials in 1985. The range of bodies – police and prosecutors, regulators and Next Step agencies – to whom fraud functions have been devolved has increased significantly since the mid-1980's, and there are few connections between them. In a paper for the Panel Professor Michael Levi has pointed out that the historical record provokes "Scepticism about the sustained energy of government...in zealously keeping watch over the centripetal forces of institutionalisation and department-centeredness that is a characteristic of all bureaucracies."

A Fraud or Economic Crime Commission would have the advantage of promoting a more measured, comprehensive and consistent response to fraud. Its role would be a non-executive one, concerned with monitoring, advice and education. Sitting outside Whitehall, but as a public body reporting to a lead department of state (possibly the Cabinet Office), it would bring together senior figures from business, the professions, the police and Whitehall in order to:

Raise awareness and keep fraud high on political, commercial and policing agendas.

Report on the activities of departments and agencies, and the degree and quality of co-operation between them.

Review best practice at home and abroad and disseminate the knowledge obtained through targeted educational campaigns.

Recommend changes in law and administrative practice.

Research fraud and methods of combating it.

Above all, the Commission would be dedicated to the holistic, long-term view of the problem that is so badly required and which departments of state, for all their strong specialist talents, are not best equipped to provide.

Beating NHS fraud:

a holistic strategy in practice

The benefits of a holistic approach to fraud are vividly illustrated by recent developments in the National Health Service. NERA estimates that fraud costs the NHS up to £150 million a year.

The formation of the Directorate of Counter Fraud Services in 1998 has proved a major step forward. £7m of illegally-gained money was recovered last year alone and there has been a 41% fall in recorded pharmaceutical services fraud, freeing £48 million for patient care. Over 500 people were under investigation in February 2001.

These achievements have rested on the essential foundations of:

- political commitment
- a clear and comprehensive strategy
- a lead organisation
- careful loss and risk measurement
- realistic targets
- adequate funding
- trained staff
- local and specialist action plans
- staff educational programmes to develop a genuine anti-fraud culture
- cooperation with professional bodies
- clear local accountability

The law and fraud

The draft Proceeds of Crime Bill

This major initiative draws inspiration from similar regimes in the USA, Australia, South Africa and Ireland and marks a significant extension of the State's powers to deprive individuals of the proceeds of crime. Of particular significance is the extension of the confiscation regime from criminal convictions (though these powers are to be enhanced) to civil recovery of the proceeds of criminal conduct, even in the absence of criminal conviction. Indeed, the Bill envisages that the proceeds of crime will be subject to taxation.

The proposals would establish a Criminal Assets Recovery Agency under the control of a Director who will have substantial powers and responsibilities directed towards the reduction of crime. There are additional provisions for creating wider powers of investigation and a tighter anti-money laundering regime.

The Panel welcomes the Government's proposals but has expressed concern that the new regime would not help victims of crime, not least in cases of financial fraud, to recover any part of their losses. There is also recognition that the Bill erodes traditional legal protections for those unconvicted of criminal offences. The Panel will monitor the development of the legislation and comment accordingly.

The Human Rights Act

It is too early to judge the consequences of the incorporation of the European Convention of Human Rights (ECHR) into English law (Scotland incorporated in 1999) but concern has arisen over the implications for fraud prevention, investigations and trials.

The Convention imposes an obligation to bring a case to trial within a reasonable time. ECHR jurisprudence gauges this from when a defendant can be said to be "substantially affected" by criminal proceedings, to the determination of any appeal. The SFO is potentially vulnerable on this count since major fraud cases require lengthy investigation and because the length of a trial, and any appeal process, may be dictated by a number of factors outside its control. There may be room for argument as to exactly when a defendant became "substantially affected." SFO investigations often follow on the heels of action taken by the DTI, liquidators, or disciplinary authorities. Will action by other authorities be taken into account? Will the onset of an SFO investigation itself 'start the clock'? The post-trial period may see confiscation proceedings, or an appeal against conviction or sentence. In the recent case of Howarth the Strasbourg Court ruled that the interval between sentence and determination of appeal had been unreasonable. Yet, in many cases, there is very little that the SFO can do to speed proceedings.

The Data Protection Act 1998

The Data Protection Act 1998 has caused considerable concern amongst fraud investigators. Section 29 (3) of the Act allows a data controller to disclose personal data for purposes of crime prevention and detection where satisfied that a refusal to disclose would be likely to prejudice the prevention and detection of crime. This allows, but does not compel disclosure. It is likely to be the case that many data controllers will feel more comfortable making disclosures where criminal proceedings have already been initiated, or are imminent, rather than at an early stage in the investigation. This, quite clearly, could inhibit fraud inquiries.

Fraud squads: a crisis of resources

The Panel's last Annual Report highlighted the problems facing police fraud squads. Evidence has mounted during the last year of a crisis in resources. SFO Director Rosalind Wright said that "it is no secret that there is a body of fraud being committed...which is not being investigated or prosecuted by any agency". A study published this year by Alan Doig and Sarah Johnson from Liverpool John Moores University and Professor Michael Levi of Cardiff University has exposed some of these problems in detail.

The problem is structural in nature and flows as much from Whitehall priorities and targets as from funding levels. Fraud is simply not recognised as a sufficiently serious policing issue. The Public Service Agreement between HM Treasury and the Home Office emphasises vehicle crime, domestic burglary and robbery but not economic crime. Other government targets encourage chief constables to ignore fraud in order to devote resources to offences of greater public concern.

Policy and structural weaknesses

The Doig-Johnson-Levi (DLS) study found that half of UK forces made no mention of fraud in written policy, though the matter was sometimes covered in the course of more general statements on crime prevention and detection. Only the City of London force listed fraud as a core objective.

Squads are led by officers of lower rank or of less fraud experience than formerly. DLS found that over 60% of staff (including civilians) are Detective Constables and a further 20% are Detective Sergeants. The pool of expertise has evaporated, not least due to the debilitating impact of the tenure system whereby officers are rotated out of posts. Most fraud squads are headed by Detective Inspectors and there are only 8 officers of the rank of Superintendent or above, almost all of whom are also heads of other squads.

Most squads have reduced in size; some forces are abolishing theirs or merging them with larger serious crime units. There is a clear mismatch between the total resources available to investigate fraud and the value of the cases under investigation. DLS found that each officer has a "live" caseload of 3.7 cases, each with an average value of nearly £900,000. Many squads will not deal with frauds valued at less than £250,000 – a blatant rejection of the justified expectations of both business and the general public, albeit unwillingly adopted by the officers concerned.

Short and long term solutions

It is difficult to avoid the conclusion that significant new funding is required to bring police fraud work up to the required level. Three lower cost policies could meanwhile be supported by the Home Office.

Lost expertise could be recovered by offering short-term contracts for fraud work to officers who retire at 50.

A much more flexible approach to rotation of senior investigators should be required.

A new emphasis on training fraud squad officers is clearly essential.

A working party, chaired by the Director of the SFO and consisting of representatives from the police and Whitehall submitted a report on the resourcing of fraud investigations to the Attorney General last autumn. This argued that providing additional resources to chief constables specifically to investigate fraud was, in itself, unlikely to prove an effective long-term strategy. Some forces may enjoy periods when few major frauds come to light in their areas and it would be wasteful if ring-fenced resources could not be used for other pressing work.

The suggestion of a national fraud squad was raised but a warning given that such a response would have to be sufficiently comprehensive to deal with all fraud cases or chief constables would still need additional resources to handle smaller cases lest these remain uninvestigated.

The working party's proposed solution was that the SFO should build up its own civilian investigative resource in order to reduce the need for the police to staff investigations. The Director would thus have control over the investigative resources available to her and could use them more flexibly than present arrangements allow. This would reduce the pressure on chief police officers to staff SFO cases. The costs of this option were likely to be relatively small.

Ministers have accepted the group's recommendation to increase SFO funds and number of cases (to 110 by 2004). The working group is also examining the feasibility and cost of establishing a national police fraud squad. Its report to Ministers is expected in September. The Panel is sympathetic to the concept of a national squad and look forward to a serious public debate on the subject.

The corporate realm

Failure to report fraud

The principal difficulty in obtaining a clear view of the extent of corporate fraud is management's reluctance to report it. The recent PricewaterhouseCoopers study found that even 39% of major companies had not reported frauds to the authorities. KPMG believes "there is an increasing reluctance for banks, financial institutions and other firms to prosecute as they have become conscious of the potential damage to their reputation that may result from taking their cases to court". Management is particularly reluctant to report fraud where large amounts of senior staff time and effort may be required to show beyond all reasonable doubt that a crime has occurred. Yet proper reporting is essential to threat assessment and to ensure effective allocation of resources.

There is considerable value in reporting fraud even when there is insufficient evidence to secure a conviction. Questionable documents or instruments can be taken out of circulation and loss thereby imposed on the criminals that have created them. Pursuit of fraudsters can also pay dividends. Citibank's policy is to do so in all cases. Its record of success is a good one and has sometimes involved securing a profit on the 'transaction' as recovered assets have appreciated in value due to sound investment of stolen assets by the criminals concerned!

Internet fraud

The DTI-sponsored Information Breaches Survey 2000 found that 60% of organisations had suffered an Internet security breach in the previous year. Other DTI sponsored research has estimated that 89% of businesses using electronic links do not have firewall systems to repel electronic intruders. 59% have unprotected websites; only 37% have conducted a risk assessment on information security.

The Fraud Advisory Panel in conjunction with CBI, PricewaterhouseCoopers, Armor Group and Professor Paul Barnes of Nottingham Business School has conducted a survey to gauge the impact of cybercrime on the e-business activities of CBI members which will be published shortly. The responses represent a cross section of companies in terms of both organisational size and type of business activity. Key findings indicate that cybercrime is widespread and inhibiting business growth.

The law needs to be revised to address both new offences and the way in which old offences may be conducted using this new medium. The recent agreement by EU member states to implement the principles of the 'Cyber Treaty' is only the beginning. A review of the adequacy of existing legal concepts for fighting cybercrime and cyber fraud also needs to be carried out.

The Government should also initiate a substantial programme of training for law enforcement officials on the nature of cybercrime and the specialist techniques of investigation required. Successful examples exist in the United States where the Federal Government has adopted an activist approach to the problem.

Education and training

The development of a corporate anti-fraud culture requires serious and sustained training. Yet little progress in the marketplace can be reported since the Panel's 1999 survey which revealed serious deficiencies in the programmes run by business, educational institutions and the professions. The gaps in corporate defences may widen as changing economic conditions lead to heightened pressure on costs. The loss of staff with experience of control systems, particularly in middle and senior management, creates greater opportunities for fraud. Pressure on corporate life also means that more must be done in shorter periods, leaving less time for supervision and a broad view of organisational needs. Edicts from the board are insufficient unless supported by adequate time and other resources to enable line managers to understand the problem and take responsibility for finding solutions.

Company law reform

The Company Law Review's consultation paper *Developing the Framework* made welcome proposals for a statutory statement of director's duties together with a mandatory Operating and Financial Review (OFR), and discussed ways of increasing incentives for shareholders to take a more active interest in corporate governance issues. It was disturbing, however, to see fraud given so little prominence either in this paper, or indeed at earlier stages of the Review. There is a proposal that a company should be liable for loss suffered by others as a result of fraud by a director. But for the most part the consultation paper makes only passing references that fall well short of substantive consideration of the subject. Yet fraud has a material bearing on any discussion of corporate governance in general and directors' duties in particular. The Review to date is oddly out of step with government pronouncements and initiatives as a whole.

The Panel has argued that the following measures be incorporated in future companies legislation.

The proposed statutory statement of director's duties must give greater emphasis to stewardship of, and active accountability for, the company's assets and interests.

The new Operating and Financial Review should include specific reference to fraud prevention and detection systems.

Directors should be obliged to develop systems designed to combat fraud at all levels of the organisation, including the board. Corporate policies should be laid down to enable non-executive directors to judge the adequacy of fraud prevention control, and there should be regular reporting of such controls to shareholders.

An authoritative guidance booklet on directors' duties, with fraud as a separate topic, would be an important tool of business education. Legal responsibilities are often poorly understood, not least because too many current publications are largely silent on the problem of fraud.

Specific discussion is also required on whether management and employees should be obliged to report evidence of suspected fraud to the board or audit committee.

Developments in auditing

The debate amongst auditors on the exact extent of their responsibility to detect fraud continues. The International Auditing Practices Committee (IAPC) has issued a new Statement *The Auditor's Responsibility to Consider Fraud and Error in a Financial Statements Audit* (ISA 240). This will be effective for audits of financial statements for periods ending on or after 30th June 2002, although earlier application is permissible.

Highlights of the new basic principles and essential procedures, a number of which are already reflected in UK standards and practice, are:

Expanded inquiries of management and discussions with those charged with governance.

New planning discussions amongst the audit team to discuss the susceptibility of an organisation to material misstatements in the financial statements resulting from fraud or error.

A requirement, as part of the auditor's assessment of risk, to consider whether "fraud risk factors" are present, indicating the possibility of either fraudulent financial reporting or misappropriation of assets.

A requirement to address any fraud risk factors identified in designing substantive procedures.

Expanded management representations, including obtaining written confirmation that the effect of uncorrected financial misstatements aggregated by the auditor are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Specific requirements to document fraud risk factors and the auditor's response to them.

IAPC has already agreed to work towards further revisions in collaboration with the US Auditing Standards Board (ASB), taking account of the recommendations of the US Panel on Audit Effectiveness. The latter recommends that there should be a "forensic phase" in all audits, during which auditors should perform a minimum level of examination focused on identifying fraud; this would involve a higher than usual level of professional scepticism. Many commentators have criticised this recommendation as impractical and liable to transfer too much responsibility away from company directors. New working parties will now consider the extent to which auditors could reasonably be expected to identify fraud. There are, of course, clear cost implications for companies audited by more demanding procedures.

The UK Auditing Practices Board (APB) is likely to leave to the new standard-setting organisation by which it is soon to be succeeded the task of considering whether to update SAS 110 in line with ISA 240, or whether to wait for the outcome of the joint US/IAPC 'phase 2' work. These developments could result in more specific auditing procedures though any changes are unlikely to take effect in the near future.

The APB has recently issued a consultation paper on aggressive earnings management. This practice involves companies selecting inappropriate accounting policies (and/or stretching financial judgements) that create misleading impressions of performance and profitability. These can constitute a criminal offence if they involve false accounting or wilful misrepresentation

Experience shows that such practices become more common as economic conditions deteriorate. While the APB recognises that the primary responsibility for preparing financial statements rests with directors and management, it also believes it would be helpful for auditors to identify and respond to cases of aggressive earnings management. The paper explains how legitimate business practices can develop into unacceptable financial reporting and explores some of the steps auditors might take to identify and respond to them.

The international dimension

Fraud has a strong international dimension. Successful investigation and prosecution are reliant on a network of treaties, conventions and bilateral agreements imposing an additional legal regime not usually encountered in the prosecution of other crimes. The majority of SFO cases, for instance, involve overseas transactions. The activities of those committing financial crime usually cross several borders. Witnesses such as bankers and professional advisers, together with documentary evidence, are often to be found in a number of different jurisdictions. Suspects are frequently not in the state in which they should be brought to trial. The proceeds of crime can be in one jurisdiction and the victims in another.

It is unrealistic to expect that a supranational system of investigation and prosecution will replace the existing framework of international agreements by which states co-operate in the fight against financial crime. But the last year or so has seen a number of developments in co-operation within Europe.

The European Judicial Co-operation Unit (Eurojust) has been established. Its main feature will be to facilitate contacts between national judicial authorities and to submit proposals to the European Council and Commission for improvements in judicial co-operation.

The police co-operation body, Europol, is being strengthened by empowering national representatives to commit resources and order operations in their respective countries.

The signing, in May 2000, of a new Convention to improve judicial co-operation in criminal matters between Member States. Once incorporated into national laws the Convention will enable requests for assistance to be made and returned directly between judicial authorities rather than through the Home Office or its Continental counterparts. The Convention also provides for the transfer of persons in custody to another Member State where they are required for the purpose of an investigation, and it will be possible to hear, and where necessary compel, evidence by trans-national video conferences. Joint investigative teams drawn from two or more Member States will also be permitted.

Anti-cybercrime initiatives are underway at the international level in the OECD, UN, Council of Europe and the G8, organised crime and money laundering being particularly high on the latter's agenda. The eEurope Action Plan adopted by the Feira European Council in June this year included actions to enhance network security and the establishment of a coherent approach to cybercrime by the end of 2002.

The Panel's publications

Copies of all publications are available from the Fraud Advisory Panel
Tel: 020 7920 8721: email fap@icaew.co.uk

Study of Published Literature on the Nature & Extent of Fraud
By the Information Gathering Working Party Sub-Group assisted by Professor A Doig,
Liverpool John Moores University; Professor Michael Levi, Cardiff University

Why is Management Reluctant to Report Fraud? An Exploratory Study
By Andrew Higson, Loughborough University Business School

The Legal Relationship between the Serious Fraud Office and the Police
By Chris Dickson, Accountant's Joint Disciplinary Scheme; Peter Hyatt, Mazars Neville
Russell; John Knox, Criminal Cases Review Commission; Stephen Low, Levy Gee;
David Roberts, Roberts Croston Associates

Proposals for Procedural Reform in cases of Serious Fraud
By Jonathan Fisher, 18 Red Lion Court; Monty Raphael,
Peters & Peters; Gervase McGregor, BDO Stoy Hayward

Response to the Law Commission's consultation paper No. 155,
Fraud and Deception
By a sub-working group chaired by Kuldip Singh QC, 5 Paper Buildings

Comments by the Investigations and Prosecutions Working Party on
The Financial Service Authority's Consultation Paper 17 –
Financial Services Regulation: Enforcing the New Regime.
By a sub-working group chaired by Kuldip Singh QC, 5 Paper Buildings and
Michael Stein, Denton Wilde Sapte

Response of the Investigations and Prosecution Working Party to the Department of
Trade and Industry's consultation paper on Company Law Reform
By Richard Fleck, Herbert Smith; Christopher Gibson, Lowells; Michael Steiner,
Denton Wilde Sapte; John Knox and John Huntingdon

Provisional Response of the Investigations and Prosecution Working Party to
the Joint Law Commissions' Consultation Paper on Company Directors:
Regulating Conflicts of Interest and formulating a Statement of Duties
By Howard Page QC, Serle Court, Lincoln's Inn

Response to the Financial Services
and Markets Bill and consultation documentation
By Michael Steiner, Denton Wilde Sapte; Howard Page QC, Serle Court,
Lincoln's Inn; Richard Lewis, Kidsons Impey; Sarah Evans, Ernst & Young;
and Peter Burrell, Herbert Smith

Response to the Auditing Practices Board on *Fraud and Audit: Choices for Society*
By Tony Bingham, PricewaterhouseCoopers: Howard Page QC, Serle Court,
Lincoln's Inn; Michael Valner, Frere Cholmeley Bischoff: John Webb, Cazenove

Outline Response to the Home Office Working Group on Confiscation of Criminal Assets
By Neil Griffiths, Denton Wilde Sapte; Sarah Dayman, BDO Stoy Hayward; and Andrew
Mitchell QC, Furnival Chambers

Response to the Company Law Review Consultation Paper *Developing the Framework*
By Howard Page QC, Serle Court, Lincoln's Inn

How Safe is Your Data?
By Peter Yapp, IS Security Consultancy Services

Business to Business Fraud
By Steven Philippsohn, Philippsohn Crawfords Berwald

Credit Card Fraud
By Steven Philippsohn, Philippsohn Crawfords Berwald

The Distance Selling Regulations: Commercial Friend or Foe?
By David Rowe Francis

Guidance on Protecting Your Organisation's Business When Using the Internet
By John MacGowan, Advisory Forum for Retail Credit Card Transactions

The Information Superhighway: is it Safe for Business?
By CBI, The Fraud Advisory Panel, Armor Group, PricewaterhouseCoopers, Nottingham
Business School. Working Group chaired by Tony Bingham, PricewaterhouseCoopers
and comprising Clive Edrupt, CBI; Andrew Beard, PricewaterhouseCoopers; Nigel Woof,
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