

FRAUD REPORTING

A SHARED RESPONSIBILITY

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A report by the Fraud Advisory Panel

Corporate fraud is pervasive, but much still goes unreported to the regulatory and criminal justice authorities. So what are the existing legal and regulatory obligations on companies to report fraud? Who, if anyone, is responsible for reporting, and to whom? Is the present architecture for reporting fraud adequate, coherent, and fit for purpose?

The most recent fraud estimates from the National Fraud Authority have been well publicised and are stark: the cost to the UK economy as a whole in 2008 is put at £30 billion, or £621 for every adult; the private sector is thought to have lost £9.3 billion, with larger enterprises – those with which this report is primarily concerned – accounting for more than half of it.

But even such worryingly large totals are only estimates. Much fraud still goes completely undetected and plenty more is discovered but never reported.

To a degree, corporate fraud victims behave much like individuals who have been conned or scammed. Embarrassed and a little ashamed, they would rather not re-live the ignominy, even for the benefit of the authorities. Individuals dread what family and friends will think of them; corporations fear the ill-will of shareholders, financial markets, customers and competitors.

Add a widespread (and far from unfounded) feeling that the fraud-fighting parts of the criminal justice system are already under-resourced and over-stretched, and you have the foundations of BDO Stoy Hayward's claim that just 5% of detected corporate fraud is actually reported to the police.

Against this dispiriting backdrop – increased financial crime, reduced reporting – the Fraud Advisory Panel set out to examine the current obligations of UK listed companies and their advisors to prevent, detect and report corporate fraud.

A special FAP project group of industry experts looked at not only the legal and regulatory obligations, but the professional and ethical dimensions too, seeking to address an increasingly controversial but very important question: are existing UK requirements to report fraud (both within companies and to 'official' third parties) truly up to the modern challenge?

More specifically: what are the roles and responsibilities of the main business stakeholders? How do expectations and perceptions differ between them, and how do these differences translate into practical action – or inaction? What is the future of fraud reporting, and what changes might help make the UK a less attractive environment for fraudsters?

We now know that it is too simplistic to blame corporate fraud losses on any one stakeholder, as if their roles are discrete and mutually exclusive. On the contrary, it is clear that responsibility for the prevention, detection and reporting of corporate fraud is shared between a range of key stakeholders.

Our study also reveals that when it comes to the reporting of corporate fraud, whether internally or externally, the UK is now dependent on a patchwork of reporting obligations with a worrying absence of any common thread. Such obligations as do exist are disparate and difficult to discern, often flowing implicitly from broad principles of law or professional regulation, rather than being comprehensive and coherent, rooted in explicit statements of practice or prescription.

Is this really good enough?

THE STATUS QUO

Who is responsible for what?



Methodology and definitions

This project was undertaken in two phases during late 2009 and early 2010: first a literature review of the relevant legislation, regulations and guidance; then a pair of stakeholder forums in which 55 people took part. Forum participants included leading figures from the corporate sector as well as representatives from law enforcement agencies, regulators and professional service providers such as solicitors and accountants.

For our purposes we defined corporate fraud broadly; as any intentionally dishonest act, including the deliberate falsification of information, committed by or against a company by management, employees or third parties, to obtain an advantage or cause a loss.

Corporate governance and fraud risk

Any company with a premium listing of equity shares is expected to comply with the **UK Corporate Governance Code** or explain itself. Under the code and its supplementary guidance:

- governance and internal control is a shared responsibility, with the board responsible for internal control systems, management responsible for implementing board policies, and all employees to some degree responsible for 'execution';
- the board should *"maintain sound risk management and internal control systems"* to safeguard shareholders and assets, with a review of all material controls conducted at least annually;
- an audit committee should monitor the integrity of financial statements, review internal financial controls and risk management, watch over whistleblowing, monitor the conduct and independence of the statutory audit, and oversee and review internal audit;
- there is no obligation to have an internal audit function but its absence should be explained (in the annual report) and reconsidered annually.

The **regulated financial services sector** faces additional obligations under the Financial Services and Markets Act 2000. These include:

- taking *"reasonable care to establish and maintain effective systems and controls ... for countering the risk that the firm might be used to further financial crime"*;

- segregating the duties of individuals and departments to reduce criminal opportunities;
- considering the adoption of internal whistleblowing procedures;
- placing particular emphasis on money laundering risk including the appointment of a senior person with overall responsibility for *"effective anti-money laundering systems and controls"*.

Most financial services companies (and some others) are also subject to the UK's money laundering regulations. These require them to adopt policies and procedures relating to customer due diligence, record keeping, internal controls and risk management, staff training, and other mechanisms to support reporting of known or suspected money laundering, both internally and to law enforcement agencies.

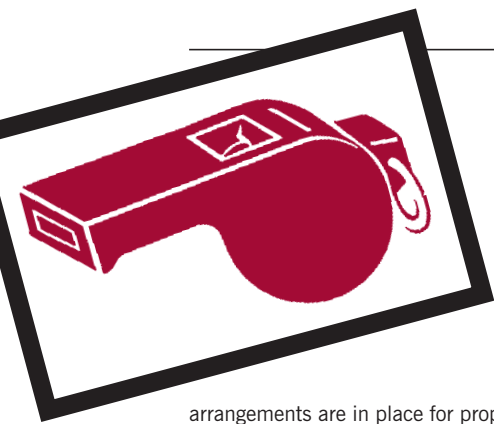
Fraud reporting within companies

The **board of directors** should ensure that internal controls enable immediate and appropriate reporting of any significant failings or weaknesses along with details of the corrective action taken.

The board may also wish to (re)consider whistleblowing arrangements as well as whether management is adequately monitoring and reporting to the board important risk and control matters, including fraud.

Companies within the regulated financial services sector are encouraged to help concerned workers blow the whistle internally about matters of relevance to the regulator. However, neither the UK Corporate Governance Code nor the FSA legally requires whistleblowing arrangements, though there is a presumption that they will exist in respect of, for example, improprieties in financial reporting.

Audit committees should act independently to protect the interests of shareholders in financial reporting and control. At least one committee member should have *"recent and relevant financial experience"*. The committee should oversee and review periodically any whistleblowing arrangements and ensure that



arrangements are in place for proportionate and independent investigation as well as appropriate follow-up.

Under the FSA's disclosure and transparency rules audit committees must monitor financial reporting, internal control and risk management (including internal audit), as well as the statutory annual audit and auditor independence.

Since **internal auditors** must evaluate both the potential for fraud and how real incidents are managed, they may also be required to review reporting mechanisms and investigate allegations. Internal auditors should provide "*independent assurance on the effectiveness of the processes put in place by management to manage the risk of fraud*". The head of internal audit must report to senior management and the board on internal audit activities including significant fraud risks and control issues.

Companies within the regulated financial services sector are expected to ensure that internal audit has clear reporting lines, either to an audit committee or an appropriate senior manager.

Employees have no general duty to report fraud internally, but certain employees have statutory obligations to external bodies regarding, for example, money laundering or professional obligations.

All personnel must cooperate with the annual statutory audit, and this might include fraud-related inquiries. Failure to do so is a criminal offence, except in exceptional circumstances.

The Public Interest Disclosure Act 1998 (PIDA) protects employees who whistleblow in the public interest and also enables them to fight any consequent victimisation. It covers all employees (including agency staff) except the genuinely self-employed, volunteers and non-executive directors.

PIDA also incentivises employers to provide whistleblowing arrangements by encouraging employees to raise concerns internally first. However, our stakeholder forums cited a number of inhibiting factors, including misunderstandings, 'hassle' and fear of retaliation.

Some organisations compel employees to report fraud under the terms of their employment contract (which the British Standards Institution cautions against) or use financial rewards to encourage them.

The role of the external auditor

The Companies Act 2006 requires that an auditor investigates the adequacy of accounting records and reports to shareholders on whether the annual accounts are true and fair. *Caparo Industries v Dickman* (1990) established that auditors owe their statutory duty not to any one shareholder but to all collectively.

The **auditor's responsibilities in respect of fraud** are set out under international auditing standards for the UK and Ireland (ISA 240). The auditor is:

- expected to maintain professional scepticism regarding the existence of fraud;
- responsible for obtaining reasonable assurance that the financial statements are free from material mis-statement caused by fraud or error;
- granted access to the books and accounts and entitled to make inquiries among directors, management and others; but is
- concerned with fraudulent financial reporting and/or the misappropriation of assets **only** where these may have led to a material financial mis-statement; and
- **is not** required to make a legal determination as to whether fraud has occurred.

Where evidence of fraud is found, the auditor has a duty to report it either to the appropriate level of management or to the board of directors. (This may be so even where no material mis-statement has resulted.)

There may also be an obligation, which over-rides client confidentiality, to report directly to a regulatory or enforcement authority, such as under the Proceeds of Crime Act 2002 for fraud-related and other money laundering activity.

Reporting corporate fraud to external parties

Companies must regularly "*present a balanced and understandable assessment of the company's position and prospects*" to **shareholders** and the market. In so doing:

- the board of directors is responsible for sending a 'true and fair' annual report and accounts to all shareholders;

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- disclosure of corporate governance arrangements must include the main features of the internal control and risk management systems in relation to financial reporting.

Although there are no explicit obligations to disclose the occurrence of fraud to shareholders and the market, listed companies must notify any inside information which would influence investor decision-making and so share price. Companies are also expected to communicate with investors in ways which avoid the creation or continuation of a false market.

Participants at the stakeholder forums indicated that a balance needs to be struck between providing shareholders with accurate information and the risk of premature reporting of a corporate fraud. As far as participants were aware there is no guidance on this matter.

Some companies *must* report fraud to a **regulatory authority**:

- A financial services company must notify the FSA immediately if it discovers or suspects 'significant' instances of: an employee fraud against a customer; that it has/may itself become a victim; irregularities in accounting and other records; serious employee misconduct connected to its operations; market abuse.
- Providers of occupational and personal pension schemes (including stakeholder schemes) must report 'significant', 'material' breaches of law (including fraud) to the Pensions Regulator.
- Gambling operators (though not spread-betting operations or the National Lottery) have a duty to report to the Gambling Commission "*any instance of criminal activity, including repeated instances of small-scale theft or fraud*".

With the exception of money laundering offences, no general obligation exists to report corporate fraud to UK **law enforcement agencies**. Companies can make voluntary reports to the police or Serious Fraud Office, but not all local forces have dedicated economic crime units. This has led to criticism of the police response. The City of London Police has been the national lead force for fraud investigation since 2008. Its expertise is intended to supplement and assist other forces.

Since October 2009 companies have also been able to report fraud to the National Fraud Intelligence Bureau usually through their trade bodies.

This government funded initiative is run by the City of London Police as a central hub to receive and analyse reports so as to better understand and tackle fraud.

Companies and individuals regulated for money laundering have a statutory obligation to report actual or suspected money laundering to the Serious Organised Crime Agency (SOCA).

Insurance policies covering crime, fidelity, and the liabilities of directors and officers often require timely disclosure of significant fraud as a condition of cover.

Various trade and industry organisations which provide anti-fraud services impose voluntary fraud reporting obligations on members or their sectors. For example:

- CIFAS – the UK's Fraud Prevention Service enables 260 participating organisations to share information about frauds.
- The payment industry's Fraud Intelligence Sharing System receives information about fraudsters and fraudulent transactions from 16 organisations including banks and credit card companies.
- Other data-sharing schemes include National HUNTER (operated by Experian) and the Insurance Fraud Bureau.

Third-party advisers and trading partners

Professional advisers, trading partners or other third parties within the scope of the regulated sector for money laundering must report known or suspected money laundering to SOCA. Failure to do so risks committing a criminal offence. Under the Proceeds of Crime Act individuals may set aside professional confidentiality obligations to make a voluntary report of money laundering when encountered in the course of a trade, profession or employment, whether or not they fall within the regulated sector.

Solicitors and barristers are bound by legal professional privilege and will not normally report suspicions of fraud-related money laundering. But where their services are being used to further a fraud, the 'fraud crime over-ride' comes into play and a report may be made to SOCA. Lawyers are also bound by money laundering regulations when carrying out regulated activities and are required to train their staff to recognise and report fraud-related money laundering.

IS THERE A CASE FOR CHANGE?

Yes there is.

Responsibility for fraud prevention and detection does not, and should not, rest with the board of directors alone. It should be a widely shared responsibility under which directors set policy and 'tone', senior management (including internal audit) implement and ensure compliance, and employees adhere and report concerns. That is the ideal.

In reality there are few obligations to have internal fraud reporting arrangements in place and very little appetite amongst stakeholders for more prescriptive arrangements. No surprise then that our forum participants expressed mixed feelings about the adequacy of anti-fraud systems and processes inside listed companies, or that the majority of frauds are still revealed by accident or by whistleblowers, with the routine application of internal controls playing only a minor role. In addition, and in spite of their great importance in the prevention and detection of fraud, the detailed operation and administration of internal fraud reporting mechanisms – reporting points, escalation processes, materiality, awareness – appear to vary considerably between companies.

Recent international research has found that internal auditors are often seen as the first line of defence against fraud, with high expectations placed on them to detect fraud, even though their primary function is simply to evaluate and assure.

A similar expectations mismatch affects external auditors, who at present play an important but limited role. Since the financial crisis broke, the role of the external auditor has come under increasing scrutiny. The FAP watches the debate with interest and notes that here too academic research has revealed that the anti-fraud obligations enshrined in auditing standards seem to fall short of the expectations of many of the profession's clients.

Turning to external reporting, compulsory obligations to report fraud to third parties are at present limited mostly to financial services companies (FSA), incidents of money laundering (SOCA), or to matters of concern to an external auditor. Shareholders and the market need to be told about a fraud only if it might threaten the company's stability or share price. The Fraud Advisory Panel questions whether this is still an appropriate threshold.

It is important that we are clear about the purpose of any external reporting requirements before consideration is given to new, or enhanced, obligations. For example, do we wish to:

- make companies take fraud prevention more seriously?
- create a more accurate picture of the nature and extent of 'known' fraud?
- encourage government to take greater action against fraud?
- create a more powerful deterrent to 'would-be' fraudsters?
- or perhaps all of these things?

That said, the idea that anti-fraud disclosures could be made either to Companies House or in the annual report as part of standard corporate governance arrangements has already found very little support. Meanwhile, suggestions for a new statutory obligation to report corporate crime to law enforcement have been so contentious that any attempt to introduce one must expect to meet with stiff opposition.



Companies remain reluctant to report fraud to external parties, particularly the police, for a host of by now well-documented reasons:

- definitional difficulties, especially regarding what is a fraud and what is 'significant' or 'material';
- fear of criticism of management and of exposing management weaknesses;
- the impact on the share price and investor sentiment;
- damage to reputation and credibility;
- reports to police are rarely acted upon;
- relinquishing control of the case;
- lost management time; and
- poor value for money versus preventative measures.

And none of these objections are likely to be withdrawn any time soon.

Reasons for under-reporting corporate fraud vary widely in quality and plausibility. But even the best among them provides no persuasive response to two pressing realities:

- Widespread corporate fraud is hugely damaging to individual businesses *and* a corrosive threat to ethical society.
- A more synergistic and consistent approach to reporting would vastly improve progress in reducing the incidence of corporate fraud in the United Kingdom.

We believe that if government and the business community are to show that they take fraud prevention, detection and reporting seriously then further consideration must be given at least to the following:

- The need to streamline existing obligations to report fraud for the purposes of compliance, consistency, transparency, clarity and cost.
- Greater weight should be given to companies' ethical and social responsibility to report fraud in the public interest.
- Initiatives to develop standard definitions for common types of corporate fraud should be progressed as quickly as possible to improve the accuracy of our understanding and to enable a better allocation of anti-fraud resource within companies and sectors, and nationally.

- Greater emphasis needs to be placed on educational initiatives designed to improve and promote the benefits of greater investment in the mechanisms of prevention and detection inside listed companies.
- The legal and regulatory frameworks for whistleblowing need to be enhanced and extended to require companies to consider formal adoption and to extend PIDA protection to volunteers and non-executive directors.
- Existing requirements and/or opportunities for companies to report known fraudsters need to be enhanced.

The full report, including all source references, can be downloaded from our website at <http://www.fraudadvisorypanel.org/>

Select the 'Publications' tab and then 'General – Research'.

Steering committee members

Jonathan Fisher QC (special project group chairman) is a barrister at 23 Essex Street Chambers, specialising in fraud and financial crime.

Felicity Banks FCA is head of business law at the Institute of Chartered Accountants in England and Wales.

Mia Campbell is the senior manager of the Fraud Advisory Panel.

Louise Delahunty is a partner in the crime and fraud investigations group at Simmons and Simmons.

Andrew Hobbs is a solicitor and director of regulatory and public policy at Ernst & Young.

Martin Robinson is the education and training consultant for the Fraud Advisory Panel and the training development adviser for the Institute of Internal Auditors – UK and Ireland.

Philip Wallace FCA is chairman of the Insolvency Service Steering Board and a non-executive director of the Financial Services Compensation Scheme.

Rosalind Wright CB QC is the chairman of the Fraud Advisory Panel and a former director of the Serious Fraud Office.



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