
Fraud reporting in listed companies: A shared responsibility

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Executive summary

Paragraphs

In late 2009 the Fraud Advisory Panel established a special project group to examine current obligations on UK listed companies to prevent, detect and report corporate fraud with particular reference to stakeholder perceptions and the future of fraud reporting.	1.1 to 1.11
Companies with a premium listing of equity shares must comply with the UK Corporate Governance Code or explain if they do otherwise. Corporate governance and internal control are shared responsibilities between directors, management and all employees, with the audit committee playing an important oversight role.	2.1 to 2.7
Additional obligations apply to companies which provide regulated financial services under the Financial Services and Markets Act 2000 or which are subject to UK money laundering legislation (the 'regulated' sector).	2.8 to 2.15
It is the responsibility of the board of directors to ensure that a company has appropriate internal fraud reporting mechanisms in place, including arrangements for management monitoring and reporting. Oversight of these arrangements resides with the audit committee, although the internal auditor may be required to review these and to investigate allegations.	3.1 to 3.12
There are some obligations on employees to report the occurrence of fraud under specific statutory or regulatory provisions, although these are not universal. The most important is to provide information on request to the external auditor as part of the annual audit of financial statements. The Public Interest Disclosure Act 1998 provides a statutory framework for the protection of employees who disclose wrongdoing in the workplace.	3.13 to 3.19
The external auditor's responsibilities to detect and report fraud are outlined in the International Standard on Auditing (UK and Ireland) 240 and are primarily concerned with fraudulent financial reporting and the misappropriation of assets which may cause a material misstatement in the financial statements. The external auditor should report actual or suspected fraud to management or the board of directors as well as to regulatory or enforcement authorities in the appropriate circumstances.	4.1 to 4.11

There are some legal and regulatory obligations on companies to report fraud to third parties. Significant and/or material frauds need to be disclosed to the external auditor, shareholders and the market, and in some cases to specified regulators and the Serious Organised Crime Agency (in the case of money laundering). As a condition of insurance, companies may also need to report significant fraud to their insurance provider.	5.1 to 5.15
Companies can also choose to make voluntary reports of fraud to the Serious Organised Crime Agency and other law enforcement agencies such as the police, National Fraud Intelligence Bureau and the Serious Fraud Office, and to industry and/or trade organisations.	5.9 to 5.19
Certain professional advisors, trading partners and other third parties have obligations to report known or suspected money laundering to the Serious Organised Crime Agency, including that which results from the possession of any proceeds of fraud committed by the company, an employee or a third party.	6.1 to 6.5
Current obligations to report corporate fraud both within a company and to external third parties are disparate and often difficult to discern. Definitional and measurement issues compound this problem.	7.1 to 7.12
Good corporate governance and internal fraud reporting mechanisms are crucial in the prevention and detection of corporate fraud. Responsibility for these is shared between directors, senior management, employees and external professional advisors (where engaged to do so), although roles and responsibilities need to be clearly defined and communicated to eliminate any ambiguity and expectation gaps.	7.13 to 7.24
Many arguments have been advanced for the introduction of enhanced external reporting requirements on companies. These have met with much resistance and suggest that the purpose of external fraud reporting needs to be better defined before any progress in this area can be made. However, the growing impetus for companies to demonstrate good corporate social responsibility may encourage greater voluntary fraud reporting in future.	7.25 to 7.36

We believe that there are a number of issues warranting further consideration by Government and business in order to address more holistically the issue of fraud prevention, detection and reporting. These include streamlining existing obligations to report fraud; ethical obligations to report fraud in the public interest; the development of standard definitions for corporate fraud; enhancing access to industry and/or national crime prevention databases; extending the legal and regulatory framework for whistleblowing; and a greater emphasis being placed on educational initiatives.

8.1 to 8.5

1 Introduction

Overview of project

- 1.1 In late 2009 the Fraud Advisory Panel established a special project group to examine the legal, regulatory, professional and ethical obligations to report corporate fraud in listed companies in the United Kingdom, with a view to determining whether existing requirements to report fraud internally within a company or to a third party such as a Government or regulatory authority are adequate.
- 1.2 In particular, the special project group set out to:
- Identify and clarify the roles and responsibilities of the main stakeholders involved in the prevention and detection of corporate fraud in listed companies, with particular regard to the use of reporting mechanisms;
 - Examine stakeholder expectations and perceptions of fraud reporting requirements and how these translate into practice; and
 - Consider the future of fraud reporting and suggest ways to make the UK a more unattractive environment for fraudsters.

Scope

- 1.3 The scope of the project was limited to fraud reporting requirements for companies with a premium listing of equity shares on the official list and regulated by the Financial Services Authority (FSA) as the UK Listing Authority (UKLA). This is because the obligations to report fraud are more stringent in the case of a company whose securities are publicly traded on a regulated financial market than those applying in the case of a privately owned company.
- 1.4 Premium listings are only available for equity shares issued by commercial companies and investment entities (closed-ended investment funds and open-ended investment companies). Equity shares are “shares that convey an unlimited right to the dividends of a company and/or unlimited rights to distribution if a company is liquidated”. Companies with a premium listing must comply with the listing requirements imposed by EU legislation as well as the FSA’s more onerous admission standards, including the Listing Rules, Prospectus Rules and Disclosure and Transparency Rules. This includes ‘comply or explain’ requirements in

respect of the UK Corporate Governance Code (formerly the Combined Code on Corporate Governance).¹

1.5 This project has not considered the more stringent obligations to prevent, detect and report corporate fraud which apply to companies which also fall under the jurisdiction of US legislation and in particular the Sarbanes-Oxley Act 2002.

Definition of corporate fraud

1.6 The Fraud Act 2006 came into effect on 15 January 2007,² creating a general offence of fraud which can be committed in three ways:

- Fraud by false representation;
- Fraud by failing to disclose information; and
- Fraud by abuse of position.³

1.7 In all three classes of fraud, the person must have acted dishonestly with the intent of making a gain for themselves or anyone else, or inflicting a loss (or a risk of loss) on another.

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

Methodology

1.9 The project was undertaken in two phases: a review of the literature pertaining to the existing legal, regulatory, professional and ethical obligations to report corporate fraud, followed by two stakeholder forums, held on 25 November 2009 and 28 January 2010, in which leading figures from the corporate sector participated alongside representatives from law enforcement agencies, regulators and professional service providers such as solicitors and accountants (see appendix 1).

¹ Financial Services Authority, 2010. *Listing regime FAQs* (March). London: FSA. Available from www.fsa.gov.uk. See pages 5 and 8.

² *The Fraud Act 2006 (Commencement) Order 2006*. SI 2006/3200. London: The Stationery Office Limited. Available from www.legislation.gov.uk.

³ *Fraud Act 2006*. London: The Stationery Office Limited. Available from www.legislation.gov.uk.

1.10 A total of 55 representatives from a self-selecting sample participated in the two forums. Over-representation by specific stakeholder groups may have resulted in some bias in the views expressed and reported herein.

1.11 Overall, we believe our examination of legal, regulatory, professional and ethical obligations in relation to corporate fraud reporting in listed companies is broadly reflective of the current position pertaining to the UK, although we recognise that it is not comprehensive.

Structure of the report

1.12 The structure of the report is outlined below:

- Chapter 2: provides an overview of the corporate governance framework for listed companies with a premium listing of equity shares in the UK, with particular reference to risk management and internal control systems and their use in the prevention and detection of fraud.
- Chapter 3: outlines the main roles and responsibilities for internal fraud reporting and whistleblowing arrangements within companies.
- Chapter 4: highlights the role of the external auditor in reporting on the information provided to shareholders in the financial statements and for bringing any fraud identified by the external auditor to the attention of the company and, where applicable and appropriate, to regulatory and law enforcement agencies.
- Chapter 5: summarises the main legal, professional, regulatory and ethical obligations on a company to report the occurrence of corporate fraud to external parties.
- Chapter 6: explores the circumstances under which third party advisors and trading partners may also have responsibilities to report fraud to the Serious Organised Crime Agency (SOCA).
- Chapter 7: highlights some of the main considerations in the introduction of enhanced internal and external corporate fraud reporting in listed companies in the UK.
- Chapter 8: proposes a number of issues requiring further consideration by Government and business in order for fraud prevention, detection and reporting to be taken seriously in the UK.

2 Corporate governance and fraud risk management

Corporate governance and the UK Code

- 2.1 During the last 15 years or so, increased attention has been paid in the United Kingdom to the importance of good governance and sound systems of internal control in safeguarding a company's assets and the interests of its shareholders.
- 2.2 A sound system of internal control should not only facilitate the effective and efficient operation of a company, but also help to ensure the quality of internal and external reporting and compliance with applicable laws and regulations,⁴ as well as contribute to the prevention and detection of corporate fraud.
- 2.3 The UK Corporate Governance Code ('the Code') and supplementary guidance provides a framework for good practice in corporate governance in the UK. All companies with a premium listing of equity shares must have regard for the Code and its 'comply or explain' disclosure requirements.⁵
- 2.4 Under the Code and its supplementary guidance, corporate governance and internal control is a shared responsibility. The board of directors has overall responsibility for the company's system of internal control, management has responsibility for implementing board policies, and all employees have some responsibility for internal control as part of their accountability for achieving objectives.⁶
- 2.5 In particular, the board of directors should "maintain sound risk management and internal control systems" to safeguard shareholders' investment and the company's assets.⁷ As part of the board's overall responsibilities, a review of all material controls should be conducted at least annually to assess the effectiveness of risk management and internal control systems covering financial, operational and compliance controls.⁸
- 2.6 The board of directors should establish an audit committee with responsibility for, inter alia, monitoring the integrity of the financial statements, reviewing the effectiveness of internal financial controls and (where applicable) risk management systems, monitoring the statutory

⁴ Financial Reporting Council, 2005. *Internal control: revised guidance for directors on the combined code*. London: FRC. Available at www.frc.org.uk/corporate/internalcontrol.cfm. See pages 3 and 7.

⁵ Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. Also see Financial Services Authority, 2010. *FSA handbook* [release 104]. Available from www.fsa.gov.uk. See LR 9.8.6 R, LR 9.8.7 R, DTR 7.2.2 R and DTR 7.2.3 R.

⁶ Financial Reporting Council, 2005. *Internal control: revised guidance for directors on the combined code*. London: FRC. Available at www.frc.org.uk/corporate/internalcontrol.cfm. See page 6.

⁷ Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. See C.2. Also see Financial Reporting Council, 2005. *Internal control: revised guidance for directors on the combined code*. London: FRC. Available at www.frc.org.uk/corporate/internalcontrol.cfm. See page 3.

⁸ *Ibid*; see C.2.1.

audit and independence of the external auditor, and the whistleblowing arrangements. It should also have oversight of the internal audit function (where one exists) and review the effectiveness of internal audit activities.⁹

2.7 Under the Code there is no obligation on a company to have an internal audit function and its role and responsibilities are undefined. However, the absence of an internal audit function should be explained in the annual report and the audit committee should consider on an annual basis whether there is a need for such a function to exist and make a recommendation to the board.¹⁰

The financial services sector

2.8 Additional corporate governance obligations apply to companies which provide regulated financial services within the meaning of the Financial Services and Markets Act 2000 (FSMA),¹¹ which are designed to encourage directors and senior managers to take responsibility for their company's arrangements.¹²

2.9 Under the rules a company must "take reasonable care to establish and maintain effective systems and controls for compliance with applicable requirements and standards under the regulatory system for countering the risk that the firm might be used to further financial crime" (including fraud or dishonesty and money laundering).¹³

2.10 Where appropriate, a company should segregate the duties of individuals and departments to reduce opportunities for financial crime and consider the adoption of internal whistleblowing procedures.¹⁴

2.11 Particular emphasis is given to money laundering risk, and companies must appoint a director or senior manager (who may also be the money laundering reporting officer) with overall responsibility for "the establishment and maintenance of effective anti-money laundering systems and controls".¹⁵

⁹ Ibid; see C.3.2, C.3.4 and C.3.5. Also see Financial Reporting Council, 2008. *Guidance on audit committees*. London: FRC. Both are available at www.frc.org.uk.

¹⁰ Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. See C.3.5.

¹¹ *Financial Services and Markets Act 2000*. London: The Stationery Office Limited. Available from www.legislation.gov.uk.

¹² Financial Services Authority, 2010. *FSA handbook* [release 104]. London: FSA. Available from www.fsa.gov.uk. See the senior management arrangements, systems and controls sourcebook, and in particular SYS 1.2.1 G.

¹³ Ibid; see SYSC 3.2.6 R, SYSC 6.1.1 R and SYSC 6.3.1 R.

¹⁴ Ibid; see SYSC 3.2.5 G and SYSC 18.2.2 G.

¹⁵ Ibid; see SYSC 3.2.6A R and SYSC 3.2.6H R.

2.12 There have been a number of cases in which the FSA has taken enforcement action against companies for failing to put in place adequate systems for the prevention, detection and reporting of fraud and financial crime.¹⁶

Anti-money laundering and the regulated sector

2.13 Most of the regulated financial services sector, as well as a number of other sectors, are also subject to obligations imposed under UK money laundering legislation which are relevant to the prevention and detection of fraud, insofar as the wide definition of money laundering includes the possession of the proceeds of fraud.¹⁷

2.14 The 'regulated sector' for money laundering purposes includes credit institutions, financial institutions, auditors, insolvency practitioners, external accountants and tax advisers, independent legal professionals (when carrying out financial or transactional work for their clients), trust or company service providers, estate agents, high value dealers and casinos.¹⁸

2.15 Under the money laundering regulations, the regulated sector must take various steps to prevent and detect money laundering and terrorist financing. These include requirements for the establishment and maintenance of appropriate policies and procedures, customer due diligence measures, record keeping in respect of customers' (or clients') identity and for transactions, internal control and risk management, staff training on the law and how to recognise and deal with money laundering, and the establishment of mechanisms to report known or suspected money laundering, both internally and to law enforcement agencies.¹⁹

¹⁶ Examples can be found on the Financial Services Authority website www.fsa.gov.uk. See press releases.

¹⁷ *Proceeds of Crime Act 2002*. London: The Stationery Office Limited. Available from www.legislation.gov.uk. See section 340.

¹⁸ *The Money Laundering Regulations 2007*. SI 2007/2157. London: The Stationery Office Limited. Available from www.legislation.gov.uk. See section 3. Also see Serious Organised Crime Agency, 2010. *The UK financial intelligence unit*. [Online]. Available at www.soca.gov.uk/about-soca/the-uk-financial-intelligence-unit.

¹⁹ *Ibid.*

3 Fraud reporting mechanisms within companies

Directors and chief executive officers

- 3.1 A company's board of directors is "collectively responsible for the long-term success of the company". The directors must act in the best interests of the company consistent with their statutory duties and ensure that the company's obligations to its shareholders and others are understood and met.²⁰
- 3.2 As part of corporate governance arrangements the board of directors should ensure that the system of internal control includes procedures which allow for the immediate reporting to the appropriate levels of management "any significant control failings or weaknesses that are identified together with details of corrective action being undertaken".²¹
- 3.3 In reviewing these arrangements, the board may wish to consider whether:
- There are established communication channels (such as whistleblowing arrangements) for individuals to report suspected breaches of law or regulations or other improprieties; and
 - There are specific arrangements in place for management monitoring and reporting to the board on risk and control matters of importance such as actual or suspected fraud and other illegal or irregular acts that could adversely affect the company's reputation or financial position.²²
- 3.4 Similarly, companies within the regulated financial services sector are also encouraged to consider the implementation of "appropriate internal procedures which will encourage workers with concerns to blow the whistle internally about matters which are relevant to the functions of the FSA".²³
- 3.5 Although neither the UK Corporate Governance Code nor the FSA requirement establishes a formal legal obligation on companies to have whistleblowing arrangements in place, there is a presumption that these exist; for example, in respect of improprieties in financial reporting or other matters (see paragraph 3.8 below).²⁴

²⁰ Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available from www.frc.org.uk. See A.1. Also see *Companies Act 2006*. London: The Stationery Office. Available from www.legislation.gov.uk. See sections 170 to 177.

²¹ Financial Reporting Council, 2005. *Internal control: revised guidance for directors on the combined code*. London: FRC. Available at www.frc.org.uk/corporate/internalcontrol.cfm. See page 7.

²² *Ibid*; see the appendix.

²³ Financial Services Authority, 2010. *FSA handbook* [release 104]. Available from www.fsa.gov.uk. See SYSC 18.2.2 G.

²⁴ Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. See C.3.4.

Audit committees

- 3.6 The role of the audit committee (or equivalent body) is to act independently from the executive “to ensure that the interests of shareholders are properly protected in relation to financial reporting and internal control”.²⁵
- 3.7 At least one member of the audit committee should have “recent and relevant financial experience”.²⁶
- 3.8 In the context of internal reporting mechanisms the audit committee should have oversight of the company’s whistleblowing arrangements (where such arrangements exist). In discharging this duty it should “review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters” and “ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action”.²⁷
- 3.9 The Disclosure and Transparency Rules set out the minimum requirements on the composition and function of the audit committee or equivalent body. Under these rules the audit committee must also monitor the financial reporting process, the effectiveness of internal control (including internal audit where applicable) and risk management systems, the statutory audit of the annual and consolidated accounts and the independence of the statutory auditor and in particular the provision of additional services.²⁸

Internal auditors

- 3.10 According to the International Standards for the Professional Practice of Internal Auditing, internal audit activity must “evaluate and contribute to the improvement of governance, risk management and control processes using a systematic and disciplined approach”.²⁹ As part of this approach, it should provide “independent assurance on the effectiveness of the processes put in place by management to manage the risk of fraud”.³⁰

²⁵ Financial Reporting Council, 2008. *Guidance on audit committees*. London: FRC. Available at www.frc.org.uk. See page 3.

²⁶ Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. See C.3.1.

²⁷ *Ibid*; see C.3.4.

²⁸ Financial Services Authority, 2010. *FSA handbook* [release 104]. London: FSA. Available at www.fsa.gov.uk. See DTR 7.1.1 R to DTR 7.1.3 R. Also see Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. See C.3.2.

²⁹ Institute of Internal Auditors Inc, 2009. *International standards for the professional practice of internal auditing*. Florida: USA. Available at www.theiia.org. See section 2100.

³⁰ Institute of Internal Auditors – UK and Ireland, 2003. *Fraud position statement*. London: IIA. Also see Institute of Internal Auditors Inc, 2009. *International standards for the professional practice of internal auditing*. Florida: USA. Available at www.theiia.org. See sections 1210.A2, 2120.A2 and 2210.A2.

- 3.11 Therefore the internal auditor must exercise due professional care by evaluating the potential for the occurrence of fraud and how it is managed.³¹ This may include the review of internal reporting mechanisms and the investigation of any allegations of fraud received through whistleblowing arrangements.³²
- 3.12 The chief audit executive (or head of internal audit) must report periodically to senior management and the board of directors on internal audit activities, including significant fraud risk exposures and control issues.³³ Companies within the regulated financial services sector should ensure that internal audit has clear reporting lines to either an audit committee or an appropriate senior manager.³⁴

Employees

- 3.13 There is no general duty on employees to report actual or suspected fraud to the board of directors, senior management, or the audit committee. However, there are some statutory obligations on certain employees to report specific concerns to external parties; for example, in the case of suspected money laundering or where professional obligations exist.³⁵
- 3.14 In particular, an employee or officer may be required to provide the external auditor with any information or explanations deemed necessary as part of the annual audit of financial statements (see chapter 4 on the role of the external auditor).³⁶ This may include inquiries about the occurrence of fraud. Failure to comply with this obligation results in a criminal offence being committed, unless it is not reasonably practical for such information or explanations to be provided.³⁷
- 3.15 The Public Interest Disclosure Act 1998 (PIDA) provides a framework of legal protection for employees who disclose corporate wrongdoings (including fraud) in the public interest and to allow employees to bring action in respect of victimisation.³⁸ It seeks to create an environment where potential whistleblowers can do so without fear of suffering detrimental consequences.³⁹

³¹ Institute of Internal Auditors Inc, 2009. *International standards for the professional practice of internal auditing*. Florida: IIA. Available at www.theiia.org. See 2120.A2.

³² Institute of Internal Auditors – UK and Ireland, 2003. *Fraud position statement*. London: IIA.

³³ Institute of Internal Auditors Inc, 2009. *International standards for the professional practice of internal auditing*. Florida: IIA. Available at www.theiia.org. See 2060.

³⁴ Financial Services Authority, 2010. *FSA handbook* [release 104]. London: FSA. Available from www.fsa.gov.uk. See SYSC 3.2.16 G.

³⁵ British Standards Institution, 2008. *PAS 1998: 2008 Whistleblowing arrangements code of practice*. London: BSI. Available from www.bsigroup.com/en/sectorsandservices/Forms/PAS-19982008-Whistleblowing/ or www.pcaw.co.uk/bsi/. See section 3.9. Also see, for example of professional obligations, ICAEW, 2010. *Members' handbook*. [Online]. Available at www.icaew.com. See section 2.7.

³⁶ *Companies Act 2006*. London: The Stationery Office. Available from www.legislation.gov.uk. See sections 499 and 500. Also see Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 240: The auditor's responsibilities relating to fraud in an audit of financial statements*. London: FRC. Available at www.frc.org.uk/apb/publications/isa/oct2009.cfm.

³⁷ *Companies Act 2006*. London: The Stationery Office. Available from www.legislation.gov.uk. See section 501. Also see Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 240: The auditor's responsibilities relating to fraud in an audit of financial statements*. London: FRC. Available at www.frc.org.uk/apb/publications/isa/oct2009.cfm.

³⁸ *Public Interest Disclosure Act 1998*. London: HMSO. Available at www.legislation.gov.uk.

³⁹ Lewis, J., & Bowers QC, J. Protecting the whistleblower. *New Law Journal*, 149, page 1377.

- 3.16 It covers all employees (including temporary agency staff) with the exception of the genuinely self-employed, volunteers and non-executive directors.⁴⁰
- 3.17 PIDA provides an incentive to employers to put in place effective whistleblowing arrangements by encouraging employees to raise concerns internally with their employer before making external disclosures to prescribed regulators (including the Serious Fraud Office and Financial Services Authority) or others.⁴¹
- 3.18 However, there are a number of factors, as identified in the stakeholder forums, which may serve to inhibit an employee from making an internal disclosure about fraud, particularly internal fraud, such as concerns about reporting fraud mistakenly, the ‘hassle’ involved in making a report and fear of retaliation.
- 3.19 The British Standards Institution (BSI) recommends that “organisations should not make it a requirement that employees blow the whistle as such a duty is unlikely to bolster staff confidence in the arrangements or help foster or embed a more open and accountable culture.”⁴² However, in practice some organisations require employees to report suspected or actual fraud under the terms of their employment contract or encourage staff to do so through financial reward or as part of good corporate culture.

⁴⁰ Public Concern at Work, 2010. *Where's whistleblowing now? 10 years of legal protection for whistleblowers*. London: PCAW. Available from www.pcaw.co.uk. See page 5.

⁴¹ *The Public Interest Disclosure (Prescribed Persons) (Amendment) Order 2003* SI 2003/1993. London: HMSO. Available at www.legislation.gov.uk. Also see Public Concern at Work, 2010. *Prescribed regulators for England, Scotland and Wales* [Online]. Available at www.pcaw.co.uk.

⁴² British Standards Institution, 2008. *PAS 1998: 2008 Whistleblowing arrangements code of practice*. London: BSI. Available from www.bsigroup.com or www.pcaw.co.uk. See section 3.9.

4 The role of the external auditor

The statutory framework

- 4.1 The external auditor plays an important role in the provision of information between the company and its shareholders in relation to the financial statements.
- 4.2 The auditor is engaged by the company to exercise professional skill and judgment for the purpose of giving shareholders an independent opinion on the truth and fairness of the company's accounts.
- 4.3 Under the Companies Act 2006 a company is required to appoint an auditor who must prepare a report to shareholders with an opinion on whether the annual accounts give a true and fair view of the company's financial position.⁴³ In discharging this duty the auditor must carry out investigations to enable an opinion to be formed as to whether the company has, inter alia, kept adequate accounting records and, if not, to state this in the report.⁴⁴
- 4.4 As the House of Lords made clear in the seminal case of *Caparo Industries v Dickman* in 1990, the auditor's statutory duty is not owed to any individual shareholder as a purchaser or potential holder of shares in the company, but to the shareholders collectively.⁴⁵

The external auditor's responsibilities for fraud

- 4.5 The International Standard on Auditing (UK and Ireland) 240 (ISA 240) outlines the auditor's responsibilities in respect of fraud in the audit of financial statements.
- 4.6 Under ISA 240 the auditor is concerned with two types of fraud – fraudulent financial reporting and the misappropriation of assets – which may cause a material misstatement in the financial statements.⁴⁶
- 4.7 The auditor is expected to maintain professional scepticism regarding the existence of fraud throughout the audit process and is responsible for "obtaining reasonable assurance that the

⁴³ *Companies Act 2006*. London: The Stationery Office Limited. Available from www.legislation.gov.uk. See section 495.

⁴⁴ *Ibid*; see section 498.

⁴⁵ *Caparo Industries Plc v Dickman* [1990] 2 AC 605.

⁴⁶ Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 240: The auditor's responsibilities relating to fraud in an audit of financial statements*. London: FRC. Available from www.frc.org.uk. See paragraph 3.

financial statements taken as a whole are free from material misstatement” caused by fraud or error.⁴⁷

4.8 In doing so the auditor has the right to access the company’s books and accounts and to make inquiries of the board of directors, management and others (including employees and subsidiary undertakings) to determine whether they have knowledge of any actual or suspected fraud affecting the company which may have a material effect on the financial statements.⁴⁸

4.9 Although the auditor may suspect or even detect fraud, the auditor does not make any legal determination as to whether fraud has actually occurred.⁴⁹

The external auditor’s duty to report fraud

4.10 Where the auditor has obtained evidence of actual or suspected fraud, the matter should be reported to either the appropriate level of management or to the board of directors on a timely basis. This may include any instances of employee fraud identified during the audit not resulting in a material misstatement.⁵⁰

4.11 The auditor may also have an obligation to report the actual or suspected fraud externally to regulatory or enforcement authorities. This can override the auditor’s professional duty to maintain the confidentiality of client information. For example, under the Proceeds of Crime Act 2002 the auditor has a duty to report suspected fraud-related and other money laundering activity to enforcement authorities.⁵¹

⁴⁷ Ibid; see paragraphs 5 and 12.

⁴⁸ *Companies Act 2006*. London: The Stationery Office Limited. Available from www.legislation.gov.uk. See paragraphs 499 and 500. Also see Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 240: The auditor’s responsibilities relating to fraud in an audit of financial statements*. London: FRC. Available from www.frc.org.uk. See paragraphs 16–21.

⁴⁹ Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 240: The auditor’s responsibilities relating to fraud in an audit of financial statements*. London: FRC. Available from www.frc.org.uk. See paragraph 3.

⁵⁰ Ibid; see paragraphs 41–43, A60 and A63.

⁵¹ Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 240: The auditor’s responsibilities relating to fraud in an audit of financial statements*. London: FRC. Available from www.frc.org.uk. See paragraph A65. Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 250: Section A – consideration of laws and regulations in an audit of financial statements*. London: FRC. Also see Financial Reporting Council, 2009. *International standard on auditing (UK and Ireland) 250: Section B – the auditor’s right and duty to report to regulators in the financial sector*. London: FRC. Both are available from www.frc.org.uk.

5 Reporting corporate fraud to external parties

Shareholders

- 5.1 Listed companies are required to disclose certain business and financial information to shareholders and the market at regular intervals under company law and regulations relating to the operation of the regulated financial markets. This information should “present a balanced and understandable assessment of the company’s position and prospects”.⁵²
- 5.2 In particular, the board of directors has a duty to prepare an annual report and accounts which must be sent to all shareholders. The accounts must give a true and fair view of the financial position of the company and be subject to audit (see chapter 4 on the role of the external auditor).
- 5.3 Companies must also disclose corporate governance arrangements (usually as part of the directors’ report), which include a description of the main features of the internal control and risk management systems in relation to financial reporting.⁵³
- 5.4 Although there are no explicit obligations resting on companies to disclose the occurrence of fraud to shareholders and the market, companies must notify a Regulatory Information Service (RIS) as soon as possible about any inside information which directly concerns it which would be used by a reasonable investor as part of the basis of their investment decision and therefore is likely to have a significant effect on the price of the company’s shares if made generally available.⁵⁴ This could include significant and/or material frauds.
- 5.5 Companies “must communicate information to holders and potential holders of its listed equity securities in such a way as to avoid the creation or continuation of a false market in such listed equity securities.”⁵⁵
- 5.6 Accordingly, publication of misleading, false or deceptive information is prohibited and a company must take all reasonable care to ensure that any notifications made to a RIS are accurate and complete.⁵⁶
- 5.7 Participants at the stakeholder forums indicated that a balance needed to be struck between ensuring shareholders receive accurate financial information about the company and the risk

⁵² Financial Reporting Council, 2010. *The UK corporate governance code*. London: FRC. Available at www.frc.org.uk. See C.1.

⁵³ Financial Services Authority, 2010. *FSA handbook* [release 104]. London: FSA. Available at www.fsa.gov.uk. See LR 9.8.6 R to LR 9.8.7A R and DTR 7.2.1 R to DTR 7.2.11 R.

⁵⁴ Financial Services Authority, 2010. *FSA handbook* [release 104]. London: FSA. Available at www.fsa.gov.uk. See DTR 2.2.

⁵⁵ *Ibid*; see LR 7.2.1 R.

⁵⁶ *Ibid*; see DTR 1.3.4 R and DTR 1A.3.2 R.

of reporting a corporate fraud too soon, before the circumstances of the fraud have been fully investigated. However, as far as stakeholders were aware there was no sector guidance on when fraud should be reported to shareholders.

Regulators

5.8 A company may have a duty to report the occurrence of fraud to a relevant regulatory authority. These requirements are often set out in the industry's codes of practice. By way of example:

- **Financial Services Authority**: Companies in the financial services sector must notify the FSA immediately if one of the following events arises and it is significant: (a) it becomes aware that an employee may have committed fraud against one of its customers; (b) it becomes aware that a person may have committed a fraud against it (or is acting with intent to commit a fraud against it); (c) it identifies irregularities in accounting or other records; or (d) it suspects one of its employees may be guilty of serious misconduct connected with its regulated or ancillary activities.⁵⁷ Suspicions of market abuse must also be reported.⁵⁸
- **The Pensions Regulator**: Companies which engage in the provision of occupational and personal pension schemes (including stakeholder schemes) have a duty to report breaches of law that are likely to be of material significance to the Regulator as soon as reasonably practical. Factors to be considered in determining whether a breach is of material significance include the cause, effect and reaction of the breach and its wider implications.⁵⁹ Breaches involving dishonesty (including fraud) are likely to be of material significance and should be reported as soon as reasonably practical.⁶⁰
- **Gambling Commission**: Companies engaged in commercial gambling operations (excluding spread betting and the National Lottery) have a duty to report matters which have a material impact on the business as soon as reasonably practicable, including "any instance of criminal activity, including repeated instances of small-scale theft or fraud".⁶¹

⁵⁷ Ibid; see SUP 15.3.17 R.

⁵⁸ Ibid; see SUP 15.10.2 R.

⁵⁹ The Pensions Regulator, 2005. *Regulatory code of practice 01: reporting breaches of the law*. Brighton: TPR. Also see The Pensions Regulator, 2005. *Regulatory code of practice 02: notifiable events*. Brighton: TPR. Both available at www.thepensionsregulator.gov.uk.

⁶⁰ Ibid; see page 13.

⁶¹ Gambling Commission, 2008. *Licence conditions and codes of practice*. Birmingham: GC. Available at www.gamblingcommission.gov.uk. See pages 53–54.

Law enforcement

- 5.9 With the exception of money laundering offences, there is no general obligation resting on a company to report corporate fraud to law enforcement agencies in the United Kingdom.
- 5.10 Companies can choose to make voluntary reports of corporate fraud to law enforcement agencies. However, not all local police forces have dedicated economic crime units, which has historically led to criticism about difficulties in reporting fraud and the lack of police response in the investigation of fraud.⁶² Since 2008, the City of London Police has been the national lead force for fraud investigation.⁶³ Its expertise is intended to supplement and assist other police forces.
- 5.11 Companies, usually through certain trade and/or industry bodies, can also report fraud to the National Fraud Intelligence Bureau (NFIB). The NFIB is a government funded initiative run by the City of London Police in partnership with other law enforcement agencies and the public and private sectors. Launched in October 2009 it acts as a central hub to receive and analyse reports of fraud from partner organisations in order to better understand and tackle fraud.⁶⁴
- 5.12 Voluntary reports of serious or complex corporate fraud can also be made to the Serious Fraud Office (SFO).⁶⁵
- 5.13 Companies and individuals in the regulated sector for money laundering purposes have a statutory obligation to report actual or suspected money laundering to the Serious Organised Crime Agency (SOCA). Individuals may report directly to SOCA or through their company's normal procedures to their company's nominated person (usually referred to as the Money Laundering Reporting Officer or MLRO) who will, where justified, make a report containing prescribed information to SOCA.⁶⁶
- 5.14 There are occasions when a company or individual makes a report to SOCA where it knows or suspects that it is in the possession of the proceeds of crime or has or is about to undertake an action which involves the proceeds of crime – including the proceeds of fraud.

⁶² Fraud Review Team, 2006. *Interim report*. London: FRT.

⁶³ City of London Police, 2010. *Economic Crime Directorate*. [Online]. Available at www.cityoflondon.police.uk. Also see National Fraud Authority, 2010. *Who we work with*. [Online]. Available at www.attorneygeneral.gov.uk/nfa.

⁶⁴ National Fraud Intelligence Bureau, 2010. *Why have an NFIB?* [Online]. Available at www.nfib.police.uk.

⁶⁵ Serious Fraud Office, 2010. *Report it in confidence/anonymously*. [Online]. Available at www.sfo.gov.uk.

⁶⁶ *Proceeds of Crime Act 2002*. London: The Stationery Office Limited. Available from www.legislation.gov.uk. See sections 330, 331 and 337, as amended by the *Serious Organised Crime and Police Act 2004* and SI 2006/308, *The Proceeds of Crime Act 2002 and Money Laundering Regulations 2003 (Amendment Order) 2006*. Also see Serious Organised Crime Agency, 2010. *The UK financial intelligence unit / frequently asked questions*. [Online]. Available at www.soca.gov.uk.

While not always compulsory, such a report provides a defence against a criminal charge of money laundering.⁶⁷

Insurance providers

5.15 In most cases insurance providers will require a company to disclose significant occurrences of fraud in a timely matter as a condition of cover under Crime, Fidelity, and Directors and Officers insurance policies. These policies cover the business against employee fraud and dishonesty (amongst other crimes) and, in some cases, third party fraud such as intermediary, supplier and computer fraud.

Others

Industry data-sharing schemes

5.16 Other voluntary fraud reporting obligations exist for companies which belong to various trade and/or industry organisations which provide anti-fraud services to their members or their sector as a whole.⁶⁸ Under these schemes participant companies routinely report the occurrence of fraud for prevention and detection purposes and to protect customers.

5.17 CIFAS – the UK’s Fraud Prevention Service is one such organisation which enables members to share information about applications for products, services or employment considered to be fraudulent. Members also exchange information about accounts and services which are being fraudulently misused or fraudulent insurance and other claims. Over 260 organisations across a variety of sectors including banking, insurance, savings and investments, telecommunications and share dealing participate in the scheme.⁶⁹

5.18 In addition, the payment industry’s Fraud Intelligence Sharing System (FISS), maintained by The UK Cards Association (formerly APACS), receives information about fraudsters and fraudulent transactions from approximately 16 voluntary member organisations, including the ‘Big Four’ banks and several major credit card companies. It allows the police and other members to extract and analyse fraud data at both high and granular level.⁷⁰

5.19 Other data-sharing schemes include National HUNTER for the financial services sector and Insurance HUNTER for the insurance industry (both operated by Experian) into which

⁶⁷ *Proceeds of Crime Act 2002*. London: The Stationery Office Limited. Available from www.legislation.gov.uk. See sections 327–329, 332, 335 and 338, as amended by the *Serious Organised Crime and Police Act 2004*.

⁶⁸ Fraud Review Team, 2006. *Interim report*. London: FRT.

⁶⁹ CIFAS – the UK’s Fraud Prevention Service, 2010. *What is CIFAS?* [Online]. Available at www.cifas.org.uk. Also see *How does CIFAS work?* (Also on CIFAS website.)

⁷⁰ The UK Cards Association, 2010. *About us / what we do*. Available at www.theukcardsassociation.org.uk.

members enter fraud data,⁷¹ and the Insurance Fraud Bureau which aims to prevent and detect organised and cross-industry insurance fraud.⁷²

⁷¹ National Hunter, 2010. *How does National HUNTER work?* [Online]. Available at www.nhunter.co.uk.

⁷² Insurance Fraud Bureau, 2010. *FAQs*. [Online]. Available at www.insurancefraudbureau.org.

6 The role of third party advisors and trading partners

Advisors and other third parties

- 6.1 Any professional advisor, trading partner or other third party who is within the scope of the regulated sector for money laundering purposes (see paragraph 2.14) has an obligation to report known or suspected money laundering to SOCA. This includes suspicions of fraud-related money laundering at a company with which the advisor or other third party has a trading relationship or is acting in an advisory capacity. Failure to make such a report risks committing a criminal offence.
- 6.2 In addition, under the Proceeds of Crime Act 2002, any individual may make a voluntary report of suspected money laundering that is encountered in the course of a trade, profession or employment, regardless of whether they fall within the regulated sector or not. This provision overrides any requirement of confidentiality in contract or law.
- 6.3 There are some circumstances in which trading partners or competitors may have a strong interest in making a voluntary report of fraud, particularly where they may be vulnerable to a criminal charge themselves.

Legal advisors

- 6.4 Solicitors and barristers are bound by legal professional privilege as well as strong requirements of professional confidentiality. Solicitors and barristers will not normally report suspicions of fraud-related money laundering encountered in privileged circumstances even where they are carrying out activities within the scope of the regulated sector. However, if lawyers' services are being used to further a criminal offence, including fraud, the "fraud crime override" to legal professional privilege comes into play and a report may be made to SOCA.
- 6.5 Lawyers are bound by the money laundering regulations when carrying out regulated activities and are required to train their staff in the recognition and reporting of fraud-related money laundering. Lawyers' requirements for integrity preclude them from continuing any actions which further any criminal activity.

7 Is there a case for change?

Introduction

- 7.1 Our examination of the existing legal, regulatory, professional and ethical obligations to prevent, detect and report corporate fraud in listed companies in the United Kingdom reveals the absence of any common thread.
- 7.2 The respective obligations are disparate and difficult to discern, often flowing implicitly from the application of broad principles of law or professional regulation rather than from explicit statements of practice or prescriptive requirements.
- 7.3 The following discussion summarises some of the key findings of our literature research and the perceptions of key stakeholders derived from our two forums in relation to some of the main arguments for enhanced corporate fraud reporting requirements in listed companies.

The scale of corporate fraud

- 7.4 Latest official statistics estimate that fraud cost the UK economy £30 billion in 2008, or £621 for every adult member of the population. The public sector was the biggest victim (£17.6 billion), followed by the private sector (£9.3 billion) and the individual and charity sector (£3.5 billion).⁷³
- 7.5 Overall, large enterprises lost £5.4 billion to fraud. The consumer goods and manufacturing industries suffered the greatest losses (£1.3 billion and £1 billion respectively), followed by construction, financial services and retail, wholesale and distribution industries.⁷⁴
- 7.6 PricewaterhouseCoopers Global Economic Crime Survey 2009 found that almost half of UK respondents (of which 39% were listed companies) reported the occurrence of fraud in the last 12 months – higher than other global respondents (almost one-third).⁷⁵
- 7.7 However, these statistics may only represent the tip of a very large iceberg; it is believed that much fraud still goes undetected and unreported.
- 7.8 One of the fundamental difficulties in the consideration of fraud is the lack of common definitions and standardised reporting and recording practices. Without a proper understanding of the nature and extent of the problem it is difficult for individual

⁷³ National Fraud Authority, 2010. *Annual fraud indicator*. London: NFA. Available at www.attorneygeneral.gov.uk/nfa.

⁷⁴ *Ibid*; estimate calculated from survey data from Kroll Global Fraud Report 2008–09. See page 26.

⁷⁵ PricewaterhouseCoopers, 2009. *Global economic crime survey: UK report*. London: PWC. Available at www.pwc.co.uk.

organisations, industry sectors and the nation as a whole to invest appropriate resources to counter fraud.

Definition and measurement of fraudulent conduct

- 7.9 One of the main issues to emerge from the stakeholder forums was that there is no standard definition of corporate fraud in common usage. Moreover, in the absence of a standard definition, there were mixed perceptions as to what conduct constituted corporate fraud, in particular the distinction between theft from a company and corporate fraud and in relation to bribery and corruption.
- 7.10 Interestingly, it was acknowledged that although risk assessments of corporate fraud should embrace both internal fraud and external fraud, in practice the emphasis was placed on internal fraud, since this was considered easier both to prevent and detect. This highlights a significant gap in a company's defences against fraud, particularly in light of recent research, which has found that fraud is as likely to be committed by an external fraudster as by an internal member of staff ('insider fraud').⁷⁶
- 7.11 Recent attempts by some government agencies to classify some of the main types of fraud and develop standardised terminology⁷⁷ and to encourage better estimation of fraud losses,⁷⁸ coupled with the introduction of the new Bribery Act 2010,⁷⁹ are likely to resolve some of these definitional and measurement issues in the longer term, assuming that organisations are incentivised to use them.
- 7.12 However, it is axiomatic that the success of government initiatives introduced in the wake of the 2006 Fraud Review, such as the National Fraud Intelligence Bureau ('NFIB'), national fraud reporting centre ('Action Fraud') and nationwide measurement exercises are dependent upon the detection of fraud in the first place. If incidents of fraud are not reported within a company, or when reported insufficient action is taken, it must follow that, with reference to corporate fraud if not other types of fraud, the ambition to learn more about the nature and extent of fraud in the UK is doomed to fail.

⁷⁶ KPMG, 2010. *Record fraud in 2009 closes out the 'naughty noughties'* [press release, 25 January]. Available at www.kpmg.co.uk. Also see

PricewaterhouseCoopers, 2009. *Global economic crime survey: UK report*. London: PWC. Available at www.pwc.co.uk.

⁷⁷ Serious Fraud Office, 2010. *Taxonomy of fraud*. [Online]. Available at www.sfo.gov.uk.

⁷⁸ National Fraud Authority, 2010. *Annual fraud indicator*. London: NFA. Available at www.attorneygeneral.gov.uk/nfa.

⁷⁹ *Bribery Act 2010*. London: The Stationery Office Limited. Available from www.legislation.gov.uk.

Corporate governance and internal fraud reporting mechanisms

- 7.13 It is a well-known precept that prevention is better than cure. However, there were mixed perceptions amongst stakeholders as to whether listed companies generally have adequate systems and processes in place to prevent and detect corporate fraud.
- 7.14 Good corporate governance and sound systems of internal control play a crucial role in safeguarding a company's assets against theft, fraud, misappropriation and other abuses.
- 7.15 Recent debate has focused on whether responsibility for the prevention, detection and reporting of corporate fraud rests solely with the board of directors or whether this responsibility is shared, and if so, to what extent.
- 7.16 Based upon our examination of best practice in corporate governance and fraud risk management, it is clear that fraud prevention and detection is a shared responsibility between directors, senior management and employees, with others also playing a role.
- 7.17 It is the responsibility of directors to set anti-fraud policies and the 'tone from the top', of senior management (including internal audit and human resources) to implement and ensure compliance with them, and of employees to adhere to them and to report any concerns or issues arising from them.
- 7.18 Professional advisers such as solicitors and forensic accountants only have a role to play in the prevention and detection of fraud where engaged to do so. External auditors also play an important role, but this is limited.
- 7.19 Although directors' expectations of the external audit process was not a subject which was addressed in the stakeholder forums, some recent academic research in this area has found, in the context of corporate fraud, a substantial audit expectations gap between business managers and external auditors, both with respect to the auditors' performance and their formal responsibilities under existing standards.⁸⁰
- 7.20 It is a reasonable assumption that similar expectation gaps are likely to exist within companies regarding the division of responsibility for the prevention, detection and reporting of corporate fraud. For example, recent international research has found that internal auditors are often seen as the first line of defence against fraud with high expectations

⁸⁰ Hassink, HFD., Bollen, LH., Meuwissen, RHG., de Vries, MJ., 2009. Corporate fraud and the audit expectations gap: a study among business managers. *Journal of International Accounting, Auditing and Taxation*, 18, pages 85–100.

placed on them to detect fraud,⁸¹ even though their primary function is one of evaluation and assurance.⁸² This highlights a demonstrable need for greater dialogue and better education amongst key stakeholders regarding the division of roles and responsibilities.

7.21 Overall, few obligations exist for companies to have internal fraud reporting arrangements in place and there appears to be very little appetite amongst stakeholders for more prescriptive requirements to be applied.

7.22 However, the value of internal fraud reporting mechanisms in the prevention and detection of fraud should not be underestimated. Participants at the stakeholder forums suggested that the majority of frauds were discovered by accident or as a result of whistleblowing, and that the routine application of internal controls played a minor role in the discovery of fraud. Therefore it is important that companies have effective whistleblowing arrangements in place, to encourage staff to report concerns without fear of reprisal.

7.23 Robust and well-defined internal fraud reporting mechanisms and policies can assist companies to ascertain the extent of the fraud problem, to learn from experience, to tighten controls and address system weaknesses. However, the operation and administration of internal fraud reporting mechanisms appears to vary considerably between companies, particularly in relation to:

- The mechanisms for making an initial report of suspected fraud and to whom it should be made;
- The process by which reports of fraud are escalated after an initial report of fraud has been received, including the person responsible for determining whether a report should be escalated or not and the criterion by which “materiality” may be assessed;
- Whether the audit committee or the board of directors or the external auditor should be informed of all allegations of fraud, or only frauds of a certain type or above a fixed financial level; and
- The methods used to raise awareness of internal fraud reporting mechanisms and to encourage employees to use them.

⁸¹ Ernst & Young, 2010. *Driving ethical growth – new markets, new challenges: 11th global fraud survey*. London: EYGM Limited. Available from www.ey.com.

⁸² Institute of Internal Auditors, 2009. *International standards for the professional practice of internal auditing*. Florida: IIA. Available from www.theiia.org. See 1210.A2. Also see Institute of Internal Auditors – UK and Ireland, 2003. *Fraud position statement*. London: IIA.

7.24 In some circumstances it appears that the audit committee and board of directors may not have a true handle on the nature and extent of the fraud problem within their companies because of the internal reporting policies and the thresholds applied.

Barriers to enhanced fraud reporting to third parties

7.25 Compulsory obligations on companies to report the occurrence of fraud to third parties are limited. Significant and/or material frauds need to be disclosed to specified regulators (most notably the FSA), SOCA (in the case of money laundering) and to the external auditor. Shareholders and the market need only be notified of frauds which may have a significant effect on the financial position of the company or its share price.

7.26 The issue of enhanced external reporting requirements for listed companies is a contentious and oft revisited one. Proposals previously promulgated have included obligations on listed companies to publicly disclose their anti-fraud policies and any incidences of significant fraud suffered by way of an annual return to Companies House, or in the annual report and accounts as part of corporate governance arrangements.⁸³

7.27 These proposals have found very little support, and there continues to be a general reticence by companies to report fraud to external parties, particularly the police, unless absolutely necessary. The reasons cited for this reluctance are manifold and remain relatively unchanged since exploratory research was commissioned by the Fraud Advisory Panel in 1998,⁸⁴ and include concerns about:

- Difficulties in the definition of corporate fraud, and in particular what constitutes 'significant' or 'material'. Invariably, the issue of materiality currently appears to govern the decision whether or not to make an external report in many cases.
- Possible criticism of management for failing to prevent fraud. Management weakness is exposed, delivering a correlative advantage to competitors and exposing the company to regulatory sanction.
- The impact on share price and potential investment. Disclosure may 'spook' the market. It may also create a false perception amongst shareholders that the

⁸³ Fraud Advisory Panel, 2006. *Additional fraud reporting requirements for companies*. [Letter] (personal communication to Fraud Review Team, 13 February 2006). Also see Fraud Advisory Panel, 2003. *5th annual review* and Fraud Advisory Panel, 2008. *10th annual review*. London: FAP. Both available from www.fraudadvisorypanel.org.

⁸⁴ Higson, A., 1999. *Why is management reticent to report fraud? An exploratory study*. London: FAP. Available from www.fraudadvisorypanel.org. Also see Fraud Advisory Panel, 2006. *Additional fraud reporting requirements for companies*. [Letter] (personal communication to Fraud Review Team, 13 February 2006) and Fraud Review, 2006. *Interim report*. London: Attorney General's Office.

occurrence of fraud is, by itself, an indicator of internal procedures not being effective, even though fraud is a fairly common occurrence in business life.

- Damage to the company's reputation and credibility, particularly in relation to management fraud, bribery or the involvement of organised crime or terrorist financing groups.
- Frauds reported to law enforcement agencies, and the police in particular, are rarely acted upon and investigated. Multi-jurisdictional issues compound this issue further.
- Loss of control once the fraud has been reported to law enforcement or regulatory authorities.
- Increased management time is required to gather evidence and construct a case.
- Additional compliance costs for very little tangible benefit. Monies could be better spent on strengthening preventative measures, rather than mechanisms to externally report the occurrence of fraud.

7.28 A much more contentious suggestion has been to impose a statutory obligation on listed companies and their boards of directors to report the occurrence of corporate fraud to SOCA or another law enforcement agency. It has been argued that this might afford more balanced responsibilities between the reporting obligations resting on the company's external auditors and other professional advisors within the regulated sector under the money laundering legislation and those with direct responsibility for the running of a company's affairs. However, to place an obligation of this kind on non-money laundering regulated companies would place a heavy burden on UK plc, which is already highly regulated.

7.29 If the objective of external reporting is to ensure that 'something is done about it' and to recover lost money or goods, then it is likely that civil proceedings will be preferable to reporting the matter to the police or other authorities in many cases.⁸⁵

7.30 The imposition of new or enhanced reporting obligations is likely to be met with strong opposition and may even have a counterproductive effect, "discouraging companies from revealing the true extent of detriment suffered by them as a result of fraud, and reporting

⁸⁵ Higson, A, 1999. *Why is management reticent to report fraud? An exploratory study*. London: FAP. Available from www.fraudadvisorypanel.org. See page 14.

substantially lower and unrealistic amounts”.⁸⁶ It may also result in the concealment of certain types of fraud which companies do not wish publicly to disclose.

7.31 Conversely, the lack of legal and regulatory reporting obligations may result in some companies becoming complacent about fraud exposure⁸⁷ and impede governmental efforts to establish a national estimate of fraud. It follows that enhanced reporting could encourage companies to have better systems, controls and behaviour.

7.32 It is important that we are clear about the purpose of external reporting requirements before consideration is given to the creation of new, or the enhancement of existing, obligations. For example, is it to:

- Make companies take fraud prevention more seriously? To highlight the fact that some organisations have poor reporting structures in place and to encourage them to do better?⁸⁸
- Enable a more accurate and comprehensive picture of the nature and extent of ‘known’ fraud in the UK to be established?⁸⁹
- Encourage Government to take greater action against fraud and to allocate better and more resources to fraud investigation and prosecution?
- To act as a deterrent to other ‘would-be’ fraudsters by demonstrating a company’s commitment to take action against fraudsters?

Corporate social responsibility and narrative reporting

7.33 Over the past few years, there has been a greater emphasis placed on corporate social responsibility by companies, which may have a positive effect on external fraud reporting, resulting in more companies making voluntary disclosures because it is in the public interest to do the ‘right’ thing.⁹⁰ Such efforts are to be welcomed and encouraged.

⁸⁶ Fraud Advisory Panel, 2006. *Additional fraud reporting requirements for companies*. [Letter] (personal communication to Fraud Review Team, 13 February 2006).

⁸⁷ Fraud Review, 2006. *Interim report*. London: Attorney General’s Office.

⁸⁸ Fraud Advisory Panel, 2006. *Additional fraud reporting requirements for companies*. [Letter] (personal communication to Fraud Review Team, 13 February 2006).

⁸⁹ Fraud Advisory Panel, 2006. *Additional fraud reporting requirements for companies*. [Letter] (personal communication to Fraud Review Team, 13 February 2006).

⁹⁰ Higson, A., 1999. *Why is management reticent to report fraud? An exploratory study*. London: Fraud Advisory Panel. Available from www.fraudadvisorypanel.org.

7.34 Good quality narrative reporting can promote greater awareness of fraud risks, provide a more explicit emphasis on fraud risk management and facilitate better quality disclosure of the related policies, systems and controls and their effectiveness.

7.35 Rentokil Initial plc's annual report and accounts for 2008 provides a useful illustration of narrative reporting:

"The introduction of a formal policy on fraud risk management aimed at reinforcing a zero tolerance culture on fraud and setting out roles and responsibilities in connection with the implementation of the policy. The [audit] committee also approved a management response plan to give guidance to managers dealing with incidents of fraud. A fraud risk management awareness review was undertaken by internal audit during the year and reported on to the committee. The group has not experienced any fraud which is material to the group as a whole although low value incidents do occur and are dealt with appropriately."⁹¹

7.36 The issue of narrative reporting raises interesting issues concerning the scope of financial reporting. Some arguments can be advanced to support the contention that in the contemporary corporate environment financial reporting could extend beyond the reporting for financial information, with a greater emphasis on narrative reporting in relation to corporate governance issues.

⁹¹ Rentokil Initial plc, 2009. *Annual report 2008*. London: Rentokil. Available from www.rentokil-initial.com. See page 33. [Rentokil won the 2009 ICSA Hermes Transparency in Governance Awards for FTSE 250 best practice disclosure on audit policy and practice.]

8 Future considerations and possible solutions

Future considerations

- 8.1 Current obligations on listed companies in the UK to prevent, detect and report corporate fraud resembles a patchwork of measures. A more synergistic and consistent approach would vastly improve progress in reducing the incidence of corporate fraud in the United Kingdom.
- 8.2 We believe that recent Government proposals to change the way fraud and financial crime is tackled in England and Wales, such as the creation of a National Crime Agency⁹² and/or Economic Crime Agency and reform of financial regulation,⁹³ presents a timely opportunity to do this.

Possible solutions

- 8.3 We believe that in order for Government and businesses to take fraud prevention, detection and reporting seriously, further consideration needs to be given to whether:
- There is a need to streamline existing legal and regulatory obligations to report fraud for the purposes of compliance, consistency, transparency, clarity and cost.
 - Companies have an ethical or social responsibility to report fraud to certain external parties (such as shareholders and/or the police). Does the public benefit derived from reporting the occurrence of fraud to external parties outweigh the private benefit of non-reporting?
 - Current initiatives to develop standard definitions for common types of corporate fraud (including the distinction between theft and fraud) should be progressed as quickly as possible and in consultation with the private sector. Such definitions could then be used by companies for internal and/or external recording and reporting purposes. This would enable a more reliable and comprehensive picture of fraud to be built up in the longer term, whilst facilitating the proportionate and appropriate allocation of anti-fraud resources – within individual companies, within and across sectors, and nationally.

⁹² Home Office, 2010. *Policing in the 21st century: reconnecting police and the people*. London: The Stationery Office Limited. Available from www.homeoffice.gov.uk.

⁹³ HM Treasury, 2010. *A new approach to financial regulation: judgement, focus and stability*. London: The Stationery Office Limited. Available from www.hm-treasury.gov.uk.

- Greater emphasis needs to be placed on educational initiatives designed to improve and promote the benefits of greater investment in mechanisms to prevent and detect corporate fraud within listed companies. A useful starting point could be to give consideration to fraud risk management as part of the forthcoming review of the UK Corporate Governance Code's supplementary guidance on internal controls (the 'Turnbull' guidance).
- The legal and regulatory frameworks for whistleblowing need to be enhanced and extended to (a) require companies under the UK Corporate Governance Code to consider the adoption of formal whistleblowing arrangements as part of good corporate governance in risk management and internal control; and (b) widen the scope of protection offered by the Public Interest Disclosure Act 1998 to volunteers and non-executive directors. Linked to this is the issue of whether employees have a general duty of care to their employer to report actual or suspected fraud.
- Existing requirements and/or opportunities for companies to report known fraudsters (particularly employees) to industry and/or national crime prevention databases need to be enhanced, to thwart dishonest individuals from committing similar crimes elsewhere.

8.4 Since the financial crisis the role of the external auditor has come under increasing scrutiny, particularly with regard to how it may better "meet the needs of regulators, investors, management and society as a whole".⁹⁴ Although this issue was beyond the scope of the current research we watch this debate with interest.

Concluding remarks

8.5 In conclusion, the Fraud Advisory Panel believes that it is too simplistic to attribute blame for corporate fraud losses to any one stakeholder – be it the board of directors or internal auditor or external auditor or other professional advisor – as if their functions were mutually exclusive of one another. On the contrary, it is clear from our examination of the legal, regulatory, professional and ethical obligations to report corporate fraud in listed companies in the UK that responsibility for the prevention, detection and reporting of corporate fraud is shared between key stakeholders.

⁹⁴ Izza, M., 2010. Auditors must learn to articulate their value. *CityAM*, 1 July, page 16. Also see Christodoulou, M., 2009. Audit reports targeted for reform. *AccountancyAge*, 29 October, page 1. Sanderson, R., 2010. Auditors expect renewed bout of scrutiny. *Financial Times*, 24 May, page 21. Haddrill, S., 2010. The shortcomings of audit. *Internal Auditing*, June, pages 10–11. Sukhraj, P., 2010. Thinking about disclosure. *Accountancy Magazine*, February, pages 22–23.

Appendix 1: Stakeholder forums

The Fraud Advisory Panel convened two stakeholder forums on 25 November 2009 and 28 January 2010, in which leading figures from the corporate sector participated alongside representatives from law enforcement agencies, regulators and professional service providers such as solicitors and accountants. The composition of each forum was as follows:

Stakeholder	Forum 1	Forum 2
Enforcement	1	1
Industry organisations	1	1
Investors	–	3
Corporate organisations	1	6
Professional advisors – accountants & auditors	7	6
Professional advisors – legal professionals	2	8
Professional advisors – fraud consultancy	1	1
Professional bodies	1	3
Regulators	2	1
Other	2	7
Total:	18	37

Please note that in some cases representatives could belong to more than one category of stakeholder.

Appendix 2: Steering committee members

Jonathan Fisher QC (special project group chairman) is a barrister at 23 Essex Street Chambers, specialising in fraud and financial crime. He is also a visiting professor at the London School of Economics and a committee member of the International Bar Association's anti-money laundering 3rd directive implementation group.

Felicity Banks FCA is head of business law at the Institute of Chartered Accountants in England and Wales. She represents the accountancy profession on HM Treasury's money laundering advisory committee and is chairman of the accountants' affinity group of the Anti-Money Laundering Supervisors Forum.

Mia Campbell (principal author) is the senior manager of the Fraud Advisory Panel, the independent fraud watchdog.

Louise Delahunty is a partner in the crime and fraud investigations group at Simmons and Simmons and is a leading lawyer in white collar crime, extradition and all types of regulatory investigations. She advises both financial institutions and corporates and has lobbying and risk management expertise, particularly in relation to anti-money laundering.

Andrew Hobbs is a solicitor and director of regulatory and public policy at Ernst & Young. He sits on a number of policy-driven committees in the CBI and the ICAEW. Before joining Ernst & Young he worked in private practice, specialising in civil litigation, professional negligence and white collar crime.

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. He is also an independent risk and audit consultant.

Philip Wallace FCA is a former partner and vice chairman of KPMG, where he specialised in restructuring and insolvency. He is the 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. She is also a member and past chairman of supervisory committee at OLAF, the European Anti-Fraud Office, and an independent member of the Insolvency Service Steering Board. She is a former director of the Serious Fraud Office.

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