



**WORKING PARTY PAPER**

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**Why is Management Reticent to Report Fraud?  
An Exploratory Study**

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Dr Andrew Higson  
Loughborough University Business School  
Ashby Road, Loughborough  
Leicestershire, LE11 3TU

## Executive Summary

This study reports the results of thirteen interviews with senior auditors / forensic accountants on whether their clients report suspected fraud to an external authority. Though some companies do report it, quite a number seem reticent about reporting. Three factors appear to contribute to this reticence:

- the impression of the word “fraud”
- the vagueness of directors’ responsibilities
- confusion over the reason for reporting suspected fraud (is it to gain the magnitude of fraud, or to deter potential perpetrators, or to punish fraudsters?).

If directors wish to recover lost money or goods, civil proceedings may be preferred to reporting the matter to the police. A “memorandum of understanding” setting out the nature of the offences the police will prosecute, the time scale anticipated and the quality of evidence required, may help clarify any dilemmas directors have about reporting them.

Generally, the treatment of a suspected fraud is at the discretion of the directors (although external auditors do have a “public interest” duty. As part of their Corporate Governance responsibilities, consideration could be given to requiring directors to ensure that suspected “frauds” are thoroughly investigated internally. A policy document on the treatment of a suspected fraud may help to clarify the directors’ responsibilities. Much greater consideration appears to be needed regarding the vetting of potential employees. Companies should also give consideration to the establishment of the post of “anti-fraud compliance officer” within their management structure.

As the complexity of business seems set to increase, one can only assume that the problem of fraud is here to stay. Providing that companies recognise the ever present threat of fraud, it is hoped that the above actions may help to reduce their exposure to it.

## Introduction

Following the creation of the Fraud Advisory Panel in February 1998, “establishing reasons why there is poor reporting of fraud” was identified as a high priority activity (ICEAW news release 2/2/98). A commonly held view has been that directors are reluctant to report cases of alleged fraud. If this is so then the danger is that the full extent of fraud will remain unknown and the law as a deterrent to the perpetrators of fraud will be lost. Therefore, this was an exploratory study with the following objectives:

1. to ascertain whether there really was a reluctance by directors to report and prosecute cases of alleged fraud
2. to identify the main reasons why directors may or may not want to take further action
3. to see if there were any factors that appeared to influence the likelihood of an incident being reported.

The initial starting point for this study was that the reporting of fraud is beneficial, hence the concern about non-reporting. However, the first problem encountered was the specification of the word “fraud”. Huntington & Davies (1994, p3, point out that “English law does not define fraud”, but based on Buckley J’s comments in *Re London and Globe Finance Ltd*, they consider that any fraud would have two essential elements, namely:

- deception or concealment
- deprivation or loss to the victim.

This is in line with the French’s (1985, p128) definition of “fraud as: “Deception, either by stating what is false or by suppressing what is true, in order to induce a person to give up something of

value.” However, Comer (1985, p439) used the definition: “Any behaviour by which one person intends to gain a dishonest advantage over another. A fraud may not be a crime.” This would seem to be a somewhat wider interpretation of the meaning of the word “fraud”. In terms of external auditing, the Auditing Standards Board’s Statement of Auditing Standards (SAS) 110 (para.4) states: “...”fraud” comprises both the use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentations affecting the financial statements by one or more individuals among management, employees, or third parties. Fraud may involve:

- falsification or alteration of accounting records or other documents
- misappropriation of assets or theft
- suppression or omission of the effects of transactions from records or documents
- recording of transactions without substance
- intentional misapplication of accounting policies
- wilful misrepresentation of transactions or of an entity’s state of affairs.”

This SAS (para.3) also points out that: “It is for the court to determine in a particular instance whether fraud has occurred.” This emphasises the importance of remembering that until a case has been proven, one is dealing with suspicions and allegations of fraud (see Table 1). It must be noted, in English law there is not a criminal offence of “fraud”. Any prosecutions have to be brought against a specific offence, “the most common being theft under s1 of the Theft Act 1968, obtaining property by deception under s15 of the Theft Act 1968, and false accounting under s17 of the Theft Act 1968; carrying on business with the intent to defraud under s458 of the Companies Act 1985 and the common law offence of conspiracy to defraud” (Huntington & Davies, 1994, p.3).

**Table 1**

**The Anatomy of a “Fraud”**

1. A deception / misappropriation occurs
2. An anomaly is discovered
3. The suspected perpetrators/s is/are identified
4. Evidence is gathered
5. The matter is reported externally
6. The evidence is strong enough to support a prosecution
7. The perpetrator/s is/are found guilty of committing a crime

It can therefore be seen that the word “fraud” is commonly used as an umbrella term to cover a multitude of offences which may differ markedly in size, e.g. they can be very small (e.g. a false expense claim) or a very large (e.g. a fictitious overseas subsidiary). Whether all of these should be classified in the same way is problematic.

Another problem encountered related to the actual identification of something as “fraud”. Levi (1987, p.27) makes the point that:

“With the possible exception of car theft, no crimes are fully reported and recorded. However, fraud does present some special problems, because it offers the possibility of inducing into the victim an erroneous interpretation of what has happened. The victim may believe that he or she has been unfortunate or has made a commercial misjudgement: capitalism, after all, is taking risks and profiting or losing by one’s risk-taking. Victims may even remain unaware that they had lost money at all.”

The classification of an action as being fraudulent may depend on the motivation behind it (e.g. was it deliberate or accidental?). Burns (1998, p.38) asked: “At what point does sharp practice become fraud?” This does seem to imply that the dividing line between the two, in certain circumstances, may at the very least be fine. Oakes & Standish (1996, p.2) considered that:

“As fraud is the product of deception, it follows that estimation of its incidence is subject to significant error, with the true but unknown extent of

fraud greater than detected fraud. In turn, detected fraud is greater than the extent of successful criminal prosecutions and civil damages for fraud, where the difference comprises fraud events on which companies take no action toward prosecution or recovery, and of unsuccessful actions. Detected fraud events within companies not followed by prosecution or recovery actions may nevertheless provoke dismissal or diminished career prospects.”

The issue of reporting fraud is very much linked to corporate governance. Corporate governance came to the fore in the 1990s and this way partly due to a number of spectacular corporate collapses brought about by fraudulent activities. The Cadbury Report (1992, p.27) points out:

“Directors are responsible under s221 of the Companies Act 1985 for maintaining adequate accounting records. To meet these responsibilities directors need in practice to maintain a system of internal control over the financial management of the company, including procedures designed to minimise the risk of fraud.”

The concern about the non-reporting of fraud appeared as follows in the Report (p.44)

“One proposal made to the Committee was that auditors should have a duty to report fraud to the appropriate authorities. The auditor’s duty is normally to report fraud to senior management.... The Committee does not recommend that a statutory duty to report fraud should be extended beyond the regulated sector to the generality of companies. The Committee does however see scope for extending to the auditors of all companies the statutory provisions applying to auditors in the regulated sector which enable them to report reasonable suspicion of fraud freely to the appropriate investigatory authorities.”

SAS 110 sets out the external auditors’ current responsibilities regarding the reporting of fraud. If they discover a fraud “auditors should as soon as practicable communicate their findings to the appropriate level of management, the board of directors or the audit committee” (para 41), but “when a suspected or actual instance of fraud casts doubt on the integrity of the directors, auditors should make a report direct to a proper authority in the public interest without delay and without informing the directors in advance” (para 52). The SAS continues (para 53):

“In certain exceptional circumstance auditors are not bound by the duty of confidentiality and have the right or duty to report matters to a proper authority in the public interest. Auditors need to weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to a proper authority.”

These “exceptional circumstances” include where the auditors “suspect or have evidence that the directors are aware of such fraud and, contrary to regulatory requirements or the public interest, have not reported it to a proper authority within a reasonable period” (para 54). However, one weakness is: “Public interest is a concept that is not capable of general definition.” So, in non-regulated sectors, apart from in the public interest, there would appear to be no onus on directors to report suspected fraud.

Levi (1987, pp.131-136) reported the views of senior corporate executives about “the practice of fraud reporting”. It appeared that “companies with an American connection had a much tougher line on the reporting of fraud than did the British companies” (p.131). A reluctance to report fraud “often reflected the uncertainty as to the consequences of reporting it – they [the senior executives] did not want to be sued for defamation – as well as a lack of confidence in the police and the Department of Trade and Industry” (p.132). One executive in Levi’s study “referred to calling in the police as ‘opening Pandora’s box’ because once they are in an organisation, ‘there is no telling

where they will end up and what they will uncover” (p.132). Though “to discourage re-offending and for both retributive and general deterrent purposes was an important part of the reasons given by some executives for reporting frauds” (p.134).

A more recent survey conducted by Neville Russell (1998, p.5) found that:

“Only a fifth of finance directors... would report an incidence of suspected fraud to the police or other authority as a matter of policy. Other respondents said they would report the matter for the sake of having it investigated, because they had suffered significant loss as a deterrent to potential fraudsters.”

The survey also found that “the main identifiable reason for not reporting a fraud to the authorities was concern that it would become public knowledge” (p.6). Other reasons included “a perceived lack of police interest, an inability to identify a particular individual as the fraudster and a decision that the small scale of the fraud did not justify the management time and disruption to the business that would be caused by an investigation”. Therefore, some of the factors that appear to discourage people from reporting fraud have already been identified. This study aims to examine the motivations behind why some alleged frauds are reported whilst others are not, and to see whether there are identifiable factors that influence this. It will concentrate on the external reporting of “employee fraud” and of fraud inflicted on a business by third parties.

### **Approach to the Study**

The initial idea of the study was to elicit the views of external auditors as to whether their clients would report suspected fraud. It was felt that given the sensitive nature of the topic, there would be very little point in approaching companies directly. After all, if they did not want publicity regarding an alleged fraud, they would be unlikely to confide in a total stranger. One interviewee later suggested that even if companies were willing to discuss the reporting of fraud, they may not tell the whole truth – i.e. they may say what they would like to happen (or what they want others to think happens) rather than what actually happens. A great perceived advantage of interviewing external auditors was that each person would have a good idea of what happened in a range of (client) companies, whereas a director may only have experience of relatively few companies. Even though the external auditors may not have actually discovered a suspected fraud, it is most likely that they would be informed about what appears to have happened – after all, SAS110 (para.29) requires that:

“When auditors become aware of information which indicates that fraud or error may exist, they should obtain an understanding of the nature of the event and the circumstance in which it has occurred, and sufficient other information to evaluate the possible effects on the financial statements. If the auditors believe that the indicated fraud or error could have a material effect on the financial statements, they should perform appropriate modified or additional procedures.”

Therefore, initially it was expected that directors would inform their external auditors of any suspected fraud.

In April 1998 a semi-structured questionnaire was designed. Three pilot interviews were conducted (with an audit partner, a professor of criminology, and a police officer) and these resulted in minor alterations being made to the questionnaire. In June 1998, eighteen requests for interviews were sent to senior auditors usually based on their firms’ London head offices. The potential interviewees were promised that none of their comments would be attributed to individuals, firms or companies. Thirteen positive responses were received (during the period in question two separate sets of mergers occurred thus reducing the original sample to sixteen firms) – this included eight

out of ten largest firms in the UK. Semi-structured interviews were then conducted with senior auditors or sometimes forensic accountants between July and September 1998.

## **The Findings**

The analysis of the interviews had concentrated on the opinions and suggestions of the interviewees rather than attempting anything statistical with such a small but informed sample. Inevitably, due to the backgrounds of the people interviewed, their comments were probably more related to large and medium sized enterprises.

The imprecise definition of the word “fraud” was again identified as a major problem:

“What is fraud? This is part of the problem. Between black and white there is a very large grey area, for example:

- the manipulation of results
- the timing of sales resulting in a bonus or promotion, these are not stealing.”

As a consequence, “a lot of companies do not see these things as fraud... unless there is the taking of ‘cash’ they don’t think of it as fraud”. Another person considered that the situation was complicated by the fact: “The dividing line between fraud and business misjudgement on the face of it is often indistinguishable... a product may be a loss leader, you don’t say it’s fraud”. In view of these comments, perhaps an attempt could be made to improve the definition of the word “fraud”, or alternatively, greater emphasis could be placed on the specific offences and the word “fraud” could be downplayed. After all, any new legislation would have to be specific and so the current imprecision of this word would mean that it is unlikely to be adopted. Another problem encountered at the initial stage of the study related to the meaning of the word “report”. The obvious question was: “Reporting to whom and for what purpose?”. Is the objective of reporting to enable the full scale of fraud to be appreciated? If this is the case which figure should be recorded – all suspected fraud (dependent, of course, on the definition of fraud used), or the specimen examples which result in a prosecution, or just the charges for which a defendant has been found guilty? It can be readily appreciated that each of these would result in substantially different measures of fraud.

This study took the word “report” to mean informing an external third party. Possible external parties cited by the interviewees included:

- the police
- the SFO
- relevant regulators
- solicitors
- insurance companies.

Given that reporting to regulators is not optional and that reporting to solicitors and insurance companies would be done on a confidential basis, the focus of the study was on whether directors would want a criminal investigation into a suspected fraud. Later in the study, other potential types of “reporting” were considered. Therefore, initially the interviewees were asked:

### **Is there really a reluctance by directors to report cases of alleged fraud?**

Eight out of thirteen people interviewed felt that there was a distinct reluctance by their clients to report suspected fraud. One person considered that: “In truth most frauds are not reported”. Another person stated: “In our experience... clients only want to actively prosecute in 1 in 30 cases”. A factor which may influence whether a suspected fraud was reported was “how it is discovered and what it says about the system of internal controls”. The implication being that if the fraud reflects badly on the management team then it would not be reported, “...public interest is not top of the agenda”. Someone else stated that he had seen “four frauds over the last six months, only one involved reporting to the police”. Another person stated: “There is [a reluctance] – a lot

lies with the police... the police are not really interested". This was a theme repeated by a number of people later on in the interviews.

Not all the interviewees thought that directors were reluctant to report fraud: "I am not sure there is a reticence – directors are willing to take things further". Another person stated: "If I look at my clients (not that many) there is less reluctance now than there was fifteen to twenty years ago. In the past they were more likely to just sack the person". And: "There is a reluctance, but it is not as bad as some people expect"> Therefore, reporting may depend on the nature, scale and implications of a suspected fraud. As this decision rests with management, in order to achieve consistency (within an organisation), the question was asked:

### **Do client companies have a policy document regarding the treatment of a suspected fraud?**

The responses to this question may depend on the size of the interviewees' client companies. One person considered that it was "definitely a good thing to have a policy document"> However, the general impression was that: "Very few [clients] have one – for larger companies it would be helpful". In smaller companies, it was "a good idea, but not practical in an owner-managed business". Rather than having a specific document one person suggested that the disciplinary section of the staff handbook could deal with such matters, and that fraud awareness training was highlighting the problem.

One justification for not having a policy document regarding the treatment of suspected fraud was that "each case is usually taken on its own merits... it is an area of sufficient sensitivity not to lay down prescriptive measures". So, given that companies with a policy on reporting to the police and pursuing a prosecution appear to be in the minority, this tends to imply that such actions are at the discretion of the directors. Therefore:

### **What is the motivation for reporting an alleged fraud?**

As was stated at the outset, the views reported are the interpretations by the people interviewed of the actions taken by management. Therefore, the comments made are subjective, but as this is an exploratory study, they may help form the basis for more detailed future work.

Though some interviewees stated the reason their clients had reported an alleged fraud was because of "the principal of the fact... it's the right thing to do" and "people do believe that business ethics have to be maintained", however, these attitudes to the reporting of fraud were in the minority. The most prevalent reason given for reporting an incident was: "It is a deterrent to others". Often the aim was "to make an example of someone and thereby show that the company is taking a robust stance against fraud" and "to send out a strong message to the employees and third parties that the company will not tolerate such behaviour". Another person stated that "people forget that unless you create a zero tolerance, people will do it". Therefore, the reporting of a suspected fraud could be viewed as a policy of warning off others. Though it was also suggested that this could be viewed in terms of "self interest" and a "recognition that not reporting would have a detrimental impact", therefore, in some situations the directors needed to be seen to be doing something. In particular, "Where something becomes public the company is under more obligation to take action".

In some companies, increasing attention is being paid to the issue of control culture, resulting in a policy of "we will prosecute in every possible instance". However, it was stated that often these types of fraud tend to be committed by junior people, are not very sophisticated and so the evidence tends to be convincing. With senior staff the nature of the problem is usually more difficult and so clear cut action is not as easy. "If the evidence is good there is no choice but to take action – otherwise you may just change the controls". On the discovery of a suspected fraud, one view was that:

“There are three options for the directors:

- to take some sort of disciplinary action
- to make a recovery of the monies defrauded, and
- to go for a prosecution with a criminal penalty.

If the fraud is committed by an employee of the company, disciplinary action (depending on the nature of the fraud) could range from asking for a refund, to a reprimand, or result in dismissal. Though this may be seen as a quick and cheap option, there is the danger of a claim for unfair dismissal. Therefore, “employment practice... means you need to go through a process to sack people”, hence the motivation for reporting the incident. In a similar vein, if the directors hope to make a claim on their insurance or take action against their auditors, the first stage may be to report externally.

Another factor cited was “to get even”, however, whether this is an appropriate reason for taking such action is debatable. As one interviewee stated: “To see that the person who committed the fraud is sent to jail is often the first thing that comes to mind, and then they want their money back, but actually, rationally, the reverse is true”. So it may be that a suspected fraud is more likely to be reported if the alleged perpetrator does not have assets necessary to make it worth going down the civil route.

Though some companies may imply that they take a tough stance on reporting fraud, one person said: “I believe there is a gap between stated intentions and what actually happens”. Therefore:

### **Why may directors not want to report externally?**

The responses to this question elicited a wide range of reasons for not wanting to report fraud. It was difficult to identify one overriding reason for non-reporting, therefore, the following section reports a whole host of reasons cited without trying to rank their relative importance.

A concern was expressed that “the obligation [to report] is not particularly clear” and that “there is a limit to good citizenship”. One view was that the identification of a suspected fraud was “nothing to do with the outside world”, hence the reason for not reporting. Though not everyone would agree with this, the point is “there are not a lot of brownie points for disclosing a fraud” and “people don’t feel sorry for the fraud victim”. Another problem identified was that: “What is a fraud in one decade is not one in another decade” and “a whole range of activities are often not seen as frauds”. Therefore, the vague definition of the word “fraud” and the imprecision of directors’ responsibilities may be the first hurdles that need to be tackled.

One person considered that in relation to reporting fraud: “There is very little motivation – it [the fraud] has happened, the doors need to be locked firmly so it won’t happen again”. Another person thought that reporting fraud was “pointless – there is nothing in it for the company”. This was:

“...not because you want to keep it [the fraud] quiet, but you just don’t see the point. You will try and recover the assets [through the civil route] and get on with business”.

It was suggested that: “Most commercial companies want to see an early end to an episode – so they get rid of the person concerned, with the exception of a few companies who want to make an example of the person”. Another view was that: “Human nature is to avoid problems... people don’t want to know the full extent of the problem”. Therefore, it was suggested that some clients did not want to investigate too thoroughly for fear of what they might find, i.e. “uncertainty as to the effect [of investigating and reporting]”. Another problem identified was that “fraud is a serious allegation” and so one has to be very careful about the way a suspected fraud is approached:



“Reporting fraud is a painful thing:

- it's costly
- substantial evidence is needed
- it's difficult to prove
- the police lack resources, and
- it takes up the time of your own people.

Therefore, there are few advantages to reporting fraud”.

A major concern was the amount of management time required to collect the evidence and construct a case: “If it [the fraud] is complicated or done by someone who can ‘lose’ records (i.e. the records are a shambles)...it may not be worth the effort to bring in the police”. In order to construct a strong case the quality of the evidence is critical, however “crucial evidence may not be captured (e.g. loss of trial) or crucial evidence may become inadmissible (e.g. the evidence has been tampered with)”. Another problem is that “collusion may make it difficult to prove what has gone on”, therefore, imprecision regarding the amount involved and when the fraud actually occurred, may undermine any attempt to take the matter further. The identification of weak internal controls may result in difficulties in making a convincing case. Therefore, management need to make a judgement as to how much effort should go into an investigation and assess the cost/benefit relationship of taking the matter further. It was suggested that: “the directors don't want the hassle” and that this investigation process was often “management time wasted”. An example of a management's frustration can be seen from the following quotation:

“We find a fraud, report it and are then let down by the system. It didn't go to court despite a case being produced for the police”.

Another example was that “internal audit worked on a case for six months and it was still not decided [by the police] what should be done”. An added complication is that “whilst a police investigation is going on one can't pursue a civil prosecution – once it is in the hands of the police it is outside your control”. This concern was expanded upon by another person:

“One problem is the interaction between the civil and criminal processes – you could do both, but in practice it is often difficult. As soon as you go to the police the criminal process takes precedence over the civil process. People may be more concerned about getting their money back, but this is delayed if the matter is reported to the police, as it is necessary to wait until the criminal case is over to avoid prejudicing the criminal trial. If you go the criminal route you are no longer managing the process, it is out of your control”.

Indeed, “non-reporting [to the police] may mean you get your money back” and so if this is management's aim then “reporting to the police is secondary”.

A reason often cited for not wanting to report a fraud was “bad publicity”. A concern was expressed that once an incident is made public “it takes on a momentum of its own”, and there is a danger that “companies that have been defrauded are not looked upon... as safe”. One result being an “impact on share price and impact on the perception of a well run businesses”. It was stated that relatively small incidents can give a very bad impression about the senior management of a group and that such sensitivities are critical when a company's share price is under pressure. One person stated that the disclosure of a fraud “may have a cataclysmic impact on share price”. Though another view was that “the share price may be hit – but this is very short term” and “directors are less concerned with the publicity – a modern company would see it [i.e. disclosing fraud] as a good sign”.

Other reasons cited for not reporting suspected frauds included “embarrassment” (“It doesn't reflect well on management.”), “the realisation of incompetence”, “laziness” (“Let's forget about it, the money has gone”) and “no loss”. One person even stated “the fraudster may have incriminating

evidence about someone senior in the organisation” hence no action is taken against them. Given that the directors decide whether or not to report an incident, what other factors could influence this?

### **Possible factors influencing the likelihood of reporting a suspected fraud**

In view of the reticence to report fraud, an attempt was made to try and identify some of the factors that may have an impact on whether or not an incident is reported. Based on initial discussions and the literature, six factors were investigated: 1) whether the suspected perpetrator of the fraud was based internally or externally, 2) industry sector, 3) business size, 4) background of the suspected perpetrator (white-collar versus blue-collar), 5) an individual’s assets, and 6) whether reporting was in the best interests of the shareholders.

In response to the question as to whether an internal or external fraud (i.e. the perpetrator is not an employee of the company) was more likely to be reported, ten out of thirteen people interviewed considered that an external fraud was more likely to be reported: “In general, frauds committed internally are much less likely to be reported than external ones – so the company can say that it is taking action against a common ill”. Someone else stated: “If it is external it is more likely to be seen as a crime, if it is internal it is more likely to be kept quiet”. Thus, “if it’s external, one is probably more inclined to do an investigation”. It was suggested that internal fraud was less likely to be reported because “it reflects on the people in the business”. Another reason was:

“If it is internal (you know them – hence embarrassment and emotion) and you are in a position to exercise a moral judgement. With an external perpetrator it’s more impersonal, and so it’s more likely to be reported”.

So, an internal fraud may not be reported externally because “I felt sorry for the person and I can understand why he/she did it”. These situations would tend to involve petty types of frauds.

Three people thought that the classification of internal versus external fraud was not really relevant when their clients came to deciding what should be done – this distinction was “not important for most companies”.

The general view regarding whether industry sector has an impact on reporting was “I suspect that it does”. The “industries” cited as being most likely to report a suspected fraud were; the Financial Services sector (“I suppose within the Financial Services sector I would expect the police to be involved”), though “the banking sector is far less open” as “banks are sensitive about publicity”; “engineering and manufacturing are more likely to report”; “in retailing one would expect the police”; and “the motor trade is more likely [to report], if they don’t report they are seen as a soft touch”. As to the sectors least likely to report a suspected fraud, one person stated that “a fraud in the construction industry will not be reported” though another person thought this may be true “at the lower levels, but maybe not if it [the fraud] is at a high level”. Another person thought that “the least likely to report are charities”. However, again the problem encountered was that “you need to define fraud” – a possible implication being that a fraud in one sector may not be viewed (and treated) as such in another sector.

In view of the time and effort required to build up evidence in a suspected fraud case, there was a possibility that only larger organisations would have the resources necessary for this. Though eight of the interviewees thought that business size was not a significant determinant of whether or not a fraud was reported, there was some support for the view that:

“...the larger the fraud, the more likely it is to be reported. Therefore, by definition this would be the larger types of business”.

Another factor that could have an impact on the actions taken following the discovery of a suspected fraud is whether someone is of managerial status (for example Ernst & Young [1998,

p.9] report that “regardless of the size of the crime, white-collar criminals are generally treated more leniently by the courts than other criminals who have perpetrated a crime for personal gain”). Therefore, the interviewees were asked whether the background (e.g. white-collar versus blue-collar) of the suspect had an impact on whether an incident was reported. The majority of interviewees thought that this distinction was not significant, but a third thought that there was likely to be a difference. The reason being that “blue-collar fraud is more often reported” because “blue-collar fraud is easier to tackle” and:

“Blue-collar is easier to report due to the evidence. White-collar is more likely to be deception/corruption.”

Therefore, it may be easier to take decisive action with a blue-collar fraud, whereas with white-collar staff the situation may not be so clear cut. Though “there was a time (e.g. 1970s) when it was harder to prosecute blue-collar workers”. This was because of the power of the unions.

The retailing sector was cited as an example where a very tough stance would be taken against employees lower down the organisation but “they are less likely to make public a case with management”. The added complication with management is that “you have given them the trust in the first place”. It was suggested that:

“Most of the big frauds by white-collar staff (i.e. by management) are because they have more access. White-collar fraud will be of higher value, and so there may be more of a chance of it being reported, but there is also more chance of it being swept under the carpet... blue-collar fraud is easier to prove”.

Given that directors have a choice as to whether they take criminal or civil action, one factor which could influence their decision is whether the suspected perpetrators have assets from which a recovery could be made. Though not everyone thought this was important, it did find some support: “A pot of gold is an important issue on the civil side”. One person set out management’s choice as follows:

“If they are looking for the recovery of money, they will go down the civil route. If they do not expect to get the money back they would go to the police”.

So, there appears to be less chance of a fraud being reported to the police if the suspected perpetrator has assets, but:

“They rarely have assets – the fraud is to cover up uncontrolled spending or losses. Few people take money and turn it into wealth”.

Therefore, recovery of assets may be a reason for non-reporting of fraud. However, the counter argument to this may be that a criminal prosecution is required in order to prove that someone has committed a fraud and thus have a stronger chance of recovering the missing assets.

This raises the question as to whether the directors consider what is in the best interests of the shareholders when they are deciding if a fraud should be reported. Interestingly, the majority of interviewees did not think that shareholders’ interests were paramount when it came to deciding whether or not a suspected fraud should be reported. One person stated: “I don’t think that shareholders enter into it, I don’t think their interests are considered”. Whilst another person stated: “I honestly think most directors of public companies don’t use this as a general rule”. However, “lawyers may raise this issue”. Though one would have thought that shareholders’ interests should be important, but “managers have their own agenda”, therefore, they may view the problem in terms of “the best interests of the business”. The danger here is that:

“If reporting hits the share price – it is best not to report. But this can mean anything”.

To report fraud, “short term it is painful” but doing so would be “in the long term interests of shareholders”. This potential conflict of interest would be less likely to arise in a smaller owner-managed type of business. Therefore, in terms of larger companies:

### **Do shareholder have a right to know what has happened in their company?**

If an alleged fraud has occurred should shareholders be informed? Though one person’s initial thoughts were “Yes is the immediate answer”, however, he went on to state “one could marshal arguments against it”. What would be reported to shareholders – suspected fraud, allegations of fraud reported to the police, or convictions for criminal offences? At the moment:

“There is no obligation to report to shareholders. If it’s material it’s difficult not to say something”.

One person stated: “If material, yes, the shareholders have a right to know... we forced through a disclosure in the accounts and then resigned”. Therefore, factors which would need to be considered include the significance of the event and “how key is the fraud?” Another person stated: “If it’s something major, then definitely they [the shareholders] should have a right to know – it may put the existence of the company in jeopardy”. However, others thought that shareholders had “no more right [to know] than other matters” and that it should be remembered that shareholders “have no interest in individual assets of the company... it’s the company that has had something stolen”. It was stated that shareholders are concerned about “whether management have proper controls and whether they are working” and “if there is a fraud then there aren’t proper controls”. Someone else thought:

“My personal view is they don’t have a right to know... However, if the entity is being mismanaged they [the shareholders] will know through the accounts”.

However, this contrasts with the view that “shareholders don’t have a clue as to what’s happening in their company”. Therefore, unless there is a specific comment regarding a fraud, it may not be possible to rely on them working out for themselves whether the directors were being effective in the fight against fraud. So, though management may have reasons for not informing shareholders:

### **Are the external auditors informed if a fraud is suspected?**

The reason the decision was taken to approach external auditors was because it was initially assumed that they would be informed if management discovered a suspected fraud. Whilst conducting the pilot interviews it became clear that this may not necessarily be the case, i.e. management may not inform the external auditors if a fraud is suspected. Therefore, it was decided to enquire whether the external auditors are informed. Typical of the responses was:

“It depends on the size and type of organisation. The bigger ones with internal auditors may use that resource to investigate. Therefore, the external auditors may not be told immediately”.

However,

“If it is a mega fraud, the auditors get to know pretty damn quickly. With a mundane fraud they are probably informed fairly early – after lawyers have been appointed”.

Therefore, management “mat handle it themselves and tell the auditor at the end” – this may be at the audit planning meeting or at another regular meeting with the auditors. If the auditors are told at

once, it is often because “the clients are shocked” and they want the auditors to do some work, such as establishing what has happened or the size of the fraud – “these are the companies that probably don’t have a response plan, or don’t have the resources”. The alternative is to bring in another investigator unconnected with the auditors. When a fraud is suspected the auditors have to ask themselves: “are we at risk?”. In other words is there a potential for a claim of negligence to be brought against the auditors? If there is a risk it is probable that “they [the audit firm] would interpose the risk management people to do the investigation but not look at the audit working papers”. If the client is not contemplating action against the auditors, then the advantages of bringing the auditors (even though the forensic department may do the work) were described as being:

- they know the business
- they have a long term relationship – outsiders don’t know them
- outsiders may think ‘How much money can we get out of this?’
- auditors are supposed to be independent”.

So, given this relationship:

### **Does the auditor have a say as to whether a suspected fraud is reported externally?**

The overwhelming response to this question was that “the client decides”, and though “one’s advice is sought, it is not always listened to”. It was considered that the “auditors are rarely in a position to report it themselves – often it is mainly suspicions of fraud, or it may not be material to the accounts”. If the fraud “is really material to the results, it must come into the audit area” and thus the auditor may have to comment on it if management was not willing to disclose the matter. The two situations cited as examples of when the external auditor may have a direct say in whether a fraud should be reported were “in a regulated organisation” and “where we are aware of a fraud by a member of the Institute”. It was stated that “the liquidator has a say” as to whether an alleged fraud is reported, in many situations the external auditor will not have a direct influence on whether something is reported, so:

### **Do auditors feel any dilemma regarding the potential conflict between their public versus commercial relationship?**

Though some of the interviewees “haven’t had that experience”, the alternative view was “there is always a conflict of interest!”

“Auditors may feel some conflict but they don’t have to give in to it. They are guardians of good communication”.

One person who thought there was not a dilemma stated:

“I feel it is the company that has the responsibility to report. I do feel some discomfort with a public interest responsibility. The auditor is a third party and should say to the client ‘I see this happening, you should decide what to do’”.

Rather than viewing any potential dilemma in terms of public interest, one person described the auditor’s “first concern is whether they are going to have a go at me next”. Therefore:

“When a fraud has taken place the auditors will feel nervous. If with some clients there is a real problem, e.g. the ethics of management, then the dilemma is whether to resign”.

This point was reiterated by someone else who stated: “we would not stand again if management was slippery”.

Ass the initial impetus for this study was based on the assumption that the non-reporting of alleged fraud was in some way detrimental to the conduct of business life, the interviewees were asked:

### **Would a greater reporting of fraud make a difference?**

A number of interviewees considered that greater reporting of fraud “would make for a cleaner environment and better corporate governance”. It was suggested that: “In the long term... we would know what has happened, there would be greater discussion, and other companies would think we are not alone”. Therefore, a perceived benefit was “the educational aspects of learning from experience”. Increased reporting could also have “a deterrent value”. So, though in theory the greater reporting of fraud could be beneficial, a number of serious reservations were expressed, including: “I am not sure how practical it is”. The already identified problem of defining “fraud” was again raised. Another problem was: “Who are we doing this for?”.

“Management/employee fraud is fundamentally a management responsibility issue. The case has not been made that companies want this [i.e. the greater reporting of fraud]... To make any change you need to capture their attention. It is/could be a problem to them. You need to demonstrate it graphically and illustrate its impact on strategy. There is an enormous hurdle of the board saying it can't happen here. In terms of implementation we need to make a case that it helps achieve business goals with little downside risk – a lot of carrot and not much stick. Company directors are fed up with Cadbury and regulation – they need persuading”.

The study has taken the word “reporting” as meaning informing an outside party of a fraud, and this is usually taken to imply the police and it has already been established that there are a variety of reasons for wanting to inform the police. Therefore, it would be necessary to be clear about the objective of greater reporting. If it is simply to gauge the extent of fraud, then obviously in terms of public interest there could be a benefit if more fraud is reported. However, if the objective of reporting is that “something has to be done about it”, then the greater reporting *per se* “I don't think it would make a great difference... one reports to the police but no action is taken!” This frustration was reflected in another comment: “The Met. Fraud Office will not take on a fraud unless it's half a million pounds, so you're referred to the local police station, but it is at the bottom of their priority list”. Another person stated that he had known a situation where “the liquidator took the decision to report to the SFO but they declined to take it on (it was complex and it was a specific accounting fraud)”. Therefore, greater reporting “would only be significant if the police have greater resources to investigate and want to use their resources in that way”. It was suggested that at the moment “the police don't have the manpower” and consequently people have been disappointed when they do go to the trouble of reporting an alleged fraud. Before reporting a suspected fraud, directors ask themselves: “Is it worth going to the police?” In order to help answer this question, it was suggested that “a memorandum of understanding setting out the relationship with the police in clear terms” should be drawn up. This would “clarify the relationship with the police... [and set out] a firm understanding of the offences the police will prosecute and the quality of evidence required”. The advantage of having such a memorandum is that directors would then know whether it would be worthwhile spending time and effort gathering evidence for a prosecution. It must be appreciated that “a memorandum of understanding” *per se* would not necessarily lead to an increase in the reporting of suspected fraud. When management realise what the police will investigate, it could actually result in a reduction in the number of suspected frauds being reported!

Another person articulated his concern about the emphasis on external reporting as follows:

“I am hesitant about increased reporting [externally], the real key is the reporting of incidents/sharing within companies. It is incredibly important to learn from what has occurred”.

It was also suggested that the danger from increased reporting was “the more it is public, the more people will copy-cat”. One person thought the real problem was that:

“Individual companies need to review their own systems. This is where we should be concentrating our efforts – on risk management”.

This was reiterated by someone else who stated “I reckon fraud happens because of a breakdown in the system of controls, etc., it is nothing to do with reporting”> Therefore:

### **Should anything be done to encourage the reporting of suspected fraud?**

There were very few responses that actively suggested ways of encouraging the reporting of fraud. One complaint was there were “too many authorities to report to”:

“One thing ought to be clear – how fraud can be reported. If I discover a fraud how do I know what is the best way to report it?... [going to] the police station will not get much of a response... make access to the police better – a national fraud squad?”

“Streamline the judicial system”, was another suggestion:

“Simplify the law and enable prosecutions and juries to convict. The deterrent effect is being whittled away. If I report [a fraud] and am disappointed by the police, SFO or CPS, the next time I will keep it to myself. We need to do whatever we can to make fraud easier to prosecute”.

However, not all the interviewees thought that management should be encouraged to report suspected fraud: “I can’t think what the real benefit would be to businesses”. Another person stated their doubts as follows:

“I don’t feel strongly about this. I think the real battleground is not on the reporting of fraud... but on the need to put across the importance of good risk management... Risk assessment should run parallel to the strategic and business planning process in the management calendar. It should not be positioned towards the end of the year linked to a form filling exercise”.

In view of the comments in this section it is not surprising that there was not much support for the proposition in the next question:

### **Should there be a statutory duty to report suspected fraud?**

It was suggested that “the question is too simplistic – what is fraud?” and “the whole problem is definition”. Also:

“It is impossible to police... suspected fraud would be huge- people would be reporting all over the place. How far do we go (paper clips?)?”

One person stated: “I don’t think the regulating authorities could cope”. Other problems raised included; “Do you think people would report it?”; “You would have to have penalties for not doing it”; and “Would it change anything?” Consequently, “‘fraud’ would have to be very closely defined”.

One person thought “the duty to investigate is more important” that a statutory duty to report externally. Given the earlier comments about some managers not wanting to delve too deeply into a suspected fraud for fear of what they may find, the benefits of learning from experience will be

lost if a proper investigation is not conducted. After all, “it is important to learn from a fraud” in order to ensure that it does not happen again. One opinion was “you need a fraud for people to be aware it can happen to them”, but, having said this, there was concern:

“People are not aware of the incidents that have happened in their own group. They are not aware of what has happened to competitors, or to other corporations (maybe not directly in their industry) but which could have big implications for them, i.e. there is no database”.

In view of these statements:

### **What other steps could be taken in tackling fraud?**

“Fraud should not just be a worry for senior management, it needs to be recognised at all levels in an organisation – it is like a cancer”, therefore, one suggestion was “we need initiatives on risk management”:

“The prime responsibility for preventing fraud is line management’s. Companies need a risk forum and risk profiling and for it to be integrated into the calendar. The present discussion is all linked to the reporting end, but it is, in fact, an operational issue. The present approach is upside down. We want better reporting but we need to operationalise it. The specialist risk management function is the real battleground. The things that have lead to collapses are frauds – not the non-reporting through a risk statement”.

Someone else suggested that:

“If people have proper internal controls then the risk of fraud should be minimised. In most fraud situations they [the internal controls] have been poor”.

One opinion was that “segregation of duties is the most important control”. In order to ensure that internal controls and risk assessment had kept up with developments in an organisation, one person suggested that companies should consider “an annual forensic review”.

One of the early questions related to whether companies had a policy on reporting fraud. It was suggested that this could be part of an overall “fraud action plan”, because:

“Fraud response is generally an area of great weakness. In many organisations, the barrier is ‘it can’t happen here’. Until we can break down this barrier, we can’t go anywhere”.

The problem being that when a fraud is discovered, without a plan “people aren’t really sure what to do”, however, “the key to surviving fraud is acting quickly”. One person stated:

“Very few organisations have a really good fraud response plan. How ever good their other aspects of risk management, if they haven’t got an effective response it means they are missing out on 50% of what they should be doing”.

Therefore, an action plan would show that thought had been given to the possibility of fraud arising and what should be done and who should be informed if a fraud was suspected. Linked in with this was the idea of “an anti-fraud compliance officer”.



“We have dealt with 1,000 cases [of fraud] in the last few years. In half of these cases someone knew or half knew what was happening, but they didn’t feel able to talk”.

The advantage of having an anti-fraud compliance officer would be that there is an identifiable person within an organisation to whom other employees could report their suspicions/ This person could also be responsible for the implementation and monitoring of a company’s anti-fraud policies. There was some support for the notion that audit committees could be a focal point for further anti-fraud initiatives, however, others were very concerned that “audit committees are critical, but whether they are independent is another question”. Even more sceptical was the person who stated:

“Audit committees are in the dark – they have little understanding of risk. Very often audit committees have a poor perception of risks and fraud as they receive very filtered information”.

As to greater responsibility for internal audit, they “should not have the responsibility for the management of risk or detecting risks, they should be responsible for ensuring compliance”. In fact, there was very little support for internal audits being given greater responsibility for preventing fraud, as has already been stated this was seen as line management’s responsibility.

Given that frauds are committed by people, one particular weakness that was identified related to personnel checks when recruiting. There was almost unanimity with the view that “recruitment screening is a very weak area”.

“This is an area where not every organisation goes as far as it should. Organisations that have been caught tighten up these procedures”.

It was thought that “there is not enough awareness of the danger” and it was “typically not well done”> Another person went further stating “most companies are hopeless”> It was stated that “in a survey of operational risk in the financial service sector, only 12% linked risk management with their personnel policy, whilst 20% linked it to recruitment”. Though “people take up references, there is not a lot of checking of the references”. Even if a genuine response is received:

“References are not worth the paper they are written on. People are petrified about what to say in their references”.

Though there appears to have been an increase in the number of referees being contacted by telephone, but “even if they phone up the previous employer, they would not question his/her credentials”. One person stated that “there is a growing trend to ask to see a person’s passport”. It must be remembered that personnel checks may not just be appropriate on recruitment: “A person may be recruited for one job and then transferred to another... we need a rolling program of vetting”. Therefore, the recruitment process was seen as a key area of major weakness and so could be a fruitful area for further research.

One of the people interviewed as part of the pilot study asked the question: “What does a fraudster need?” His answer was:

- honesty and trust (to take advantage of)
- naivety
- organisational change (e.g. downsizing – possibly resulting in a loss of knowledge and experience).

He suggested that the main factors that contribute towards fraud were company culture, work loads, lack of loyalty and utilisation of temporary staff. A concern was also expressed that:

“... directors don’t understand the business core/non-core activities... If you look at the big cases they have been in non-core areas or overseas”.

A possible solution to these problems was “if you want to avoid fraud, you have to pass up profits for simpler, easier controlled methods of trading”. As this is very unlikely to happen, indeed, commercial activities are only likely to become more complex, therefore, it is more important than ever before that directors focus on fraud minimisation strategies.

## Conclusion

It appears that there is a reticence to report fraud externally. Three factors that appear to have exacerbated this are the imprecision of the word “fraud”, the vagueness of directors’ responsibilities and confusion over the reason for reporting fraud (is it to gauge the magnitude of fraud, or to deter potential perpetrators, or to punish fraudsters?). If directors wish to recover lost money or goods, civil proceedings may be preferred to reporting the matter to the police. A “memorandum of understanding” setting out the nature of the offences the police will prosecute, the time scale anticipated and the quality of evidence required, may help clarify any dilemmas directors have about reporting to them.

Generally, the treatment of a suspected fraud is at the discretion of the directors (though external auditors do have a “public interest” duty). As part of their Corporate Governance responsibilities, consideration could be given to requiring directors to ensure that suspected “frauds” are thoroughly internally investigated. A policy document on the treatment of a suspected fraud may help clarify the directors’ responsibilities. Companies should also give consideration to the establishment of the post of “anti-fraud compliance officer” within their management structure. This would also ensure they would have a focal point within their organisations to whom suspected frauds could be reported. Much greater consideration appears to be needed regarding the vetting of potential employees. Extra effort prior to employing someone could save a lot of money later on.

As the complexity of business seems set to increase, one can only assume that the problem of fraud is here to stay. Providing that companies recognise the ever present threat of fraud, it is hoped that the above actions may help to reduce their exposure to it.

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**Why is management reticent to report fraud? An exploratory study**  
**Personal interview schedule**

- 1) What is meant by the word “report”?
- 2) Is there really a reluctance by directors to report cases of alleged fraud?
- 3) Do client companies have a policy document regarding the treatment of a suspected fraud?
- 4) What is the motivation for reporting an alleged fraud?
- 5) Why may directors not want to report externally?
- 6) Do the following appear to influence the likelihood of the incident being reported?
  - internal versus external perpetrator of the suspected fraud
  - industry sector
  - business size
  - background of a person suspected of a fraud (e.g. white-collar versus blue-collar crime)
  - whether it is in the best interests of the shareholders.
- 7) Do shareholders have a right to know what has happened in their company?
- 8) Are external auditors informed if a fraud is suspected?
- 9) How/when does this usually happen?
- 10) Does the auditor have a say as to whether a suspected fraud is reported?
- 11) Do auditors feel any dilemma regarding the potential conflict between their public versus commercial relationship?
- 12) Would the greater reporting of fraud make a difference?
- 13) Should anything be done to encourage the reporting of suspected fraud?
- 14) Should there be a statutory duty to report suspected fraud?
- 15) What other steps could be taken in tackling fraud?