

THE AUDITING PRACTICES BOARD

***CONSULTATION PAPER***

**Fraud and Audit: choices for society**

November 1998

## ***FRAUD AND AUDIT***

Fraud presents continual challenges to auditors. This Consultation Paper draws together the APB's current thoughts on fraud in the light of both its recent work and the ideas and suggestions that have already been the subject of consultation.

The APB believes that deciding on the role of auditors with respect to fraud involves a number of complex issues, including issues relating to company law and corporate governance. It also involves striking an effective balance between, on the one hand, the consequences of increased regulation and, on the other, encouraging an environment which promotes commercial success.

The APB has, therefore, concluded that this Consultation Paper should be published to companies, shareholders, regulators, government and others with an interest in the corporate sector. By doing so the APB's objective is to inform and stimulate debate on the actions which should be taken to establish the right balance between the benefits to society from increasing the probability of detecting fraud, especially management fraud, and the costs and consequences that would flow from any such changes.

The Paper sets out a number of choices for society concerning the way that it protects itself against fraud and the role that auditors should play. APB invites views and suggestions on those choices and on the specific questions set out on page 4. Responses to the Paper should be addressed to

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## **CONSULTATION PAPER**

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## ***FRAUD: THE CHOICES***

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- i Fraud takes many forms, impacts the public and private sectors of the economy, and affects society in many ways. In order to combat fraud, society needs to be able to detect fraud. Detection enables offenders to be punished, which in turn has a deterrent effect. Equally, if not more importantly, detection enables government and regulators to learn how to prevent or limit the potential for such fraud in the future.
- ii The cost of fraud can be quantified in a number of ways. The instinctive approach is to aggregate known individual losses and view that as the impact on society over a particular period. However, that approach fails to recognise the extent to which those losses involved re-distributions of resources within an economy, as opposed to losses to the economy as a whole. To evaluate the impact of fraud properly, it is necessary to take account of the effect of fraud on the economy, viewed as a whole. In the private sector, this approach would bring into account the consequences, for example, of any loss of confidence in the capital markets. It would also take account of the costs involved in investigating and prosecuting frauds and their perpetrators, and in establishing and running regulatory systems to control the way in which business is conducted with the aim of preventing future frauds. Such costs are not limited to the immediate costs of those activities, but can extend to the implications of any adverse impact on business innovation or the willingness of overseas businesses to operate in the domestic markets.
- iii As society has increasingly counted the cost of fraud, a number of bodies with responsibility for the control and regulation of business activity, including the conduct of the capital markets, have signalled their determination to fight financial crime. The Financial Services and Markets Bill, for example, includes important new measures for the Financial Services Authority to deal with market abuse, including insider trading, and with money laundering. The role of audit has also been questioned, and the accounting profession challenged to consider how best it can contribute to the fight against fraud. Such challenges can be seen in the European Commission's green paper on the role of statutory auditors, and the priority given to fraud by IOSCO, the body which regulates security commissions around the world.

- iv From its establishment in 1991, the Auditing Practices Board (APB) has been concerned to play its part in the combat against fraud. The steps that it has taken include issuing a Statement of Auditing Standards dealing specifically with the detection and prevention of fraud<sup>1</sup>; consulting with the accounting profession and business community on potential ways of improving the effectiveness of the audit process<sup>2</sup>; and undertaking various studies into the auditors' role in relation to fraud.
- v Recent work undertaken by APB has included a study of major frauds, undertaken with the assistance of both the accounting firms and others involved in investigating frauds. This study revealed that:
- most material frauds involve directors and/or senior management,
  - management fraud, particularly if it also involves collusion with third parties, is unlikely to be detected as part of the statutory audit of financial statements, and
  - at the same time, shareholders, creditors and the public expect auditors to find material fraud.
- vi APB has in the past canvassed a number of ways in which the effectiveness of the audit process might be improved in relation to fraud. Suggestions made to date involve:
- activities which could be undertaken by the auditing profession, but which result in a more costly and intrusive audit,
  - structural changes to the management of companies which would reduce the potential for management fraud, but which are regarded as too restrictive on management, and
  - ways in which the investment community could play a greater role in governance, but which involve responsibilities which that community is currently unwilling to assume.
- vii A recurrent theme in the responses which the APB has received to date is that imposing additional burdens on the business community in order to address the consequences of the wrongdoing of a few is undesirable. This theme highlights the key dilemma facing the APB in its attempts to respond to the expectations of investors and the public (which continues to expect auditors to detect fraud) and the demands of governments and regulators who expect the accounting profession to increase its contribution to the prevention and detection of fraud.

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<sup>1</sup> The APB issued SAS 110 'Fraud and error' in January 1995.

<sup>2</sup> The APB issued *The Audit Agenda* in December 1994 and *The Audit Agenda – Next Steps* in February 1996.

- viii Society has to address these conflicting expectations. Doing so involves a number of difficult choices as to whether the current balance between avoiding unnecessary constraints on business and preventing fraud is right.
- ix This Consultation Paper discusses various changes (some of which would require statutory implementation, whilst others could be the subject of regulation by the appropriate body) to the audit process and to the structure of corporate governance which might be considered when addressing the fundamental question raised in the preceding paragraph. APB invites views on the Paper and specifically on the following questions as to the choices to be made in relation to audit and fraud:

- Question 1 *Do you think this paper summarises the main issues related to fraud and the audit? If not, what other factors should APB take into account?*
- Question 2 *Is the current balance between avoiding unnecessary constraints on business and preventing / detecting fraud appropriate?*
- Question 3 *If yes, is there a need to rebalance public expectations in the light of the comments in this paper regarding the likelihood of auditors detecting management fraud?*
- Question 4 *If no, what actions set out in sections 3, 4 and 5 of this Paper would you support?*
- Question 5 *Can you suggest any additional action that could be taken to prevent or detect management fraud?*
- Question 6 *Do you believe investors and the business community are prepared to bear the costs, financial and otherwise, that would be involved in implementing any recommendations?*

## 1 APB'S WORK ON FRAUD

Since its inception, APB has regarded fraud as a priority and has

- ◆ issued **new Auditing Standards** clarifying auditors' responsibilities in relation to fraud
- ◆ made a number of **proposals to improve auditors' contribution towards reducing fraud**.

APB has **continued to research issues relating to fraud**. Recent work has given a number of fresh insights into fraud and audit.

- ◆ **A review of recent major frauds**, conducted with the help of both the accountancy firms and the authorities responsible for investigating frauds, shows that
  - *most material frauds involve management*
  - *more than half of frauds involve misstated financial reporting but do not involve diversion of funds from the company*
  - *management fraud is unlikely to be found in a financial statement audit*
  - *far more is spent on investigating and prosecuting fraud in a company than on its audit.*
- ◆ **A review of the effectiveness of new Auditing Standards on fraud** indicates that auditors have increased the emphasis they place on fraud in the course of their work.
- ◆ Other aspects of APB's work suggest that
  - there is still a major gap between auditors' and users' understanding of the assurance provided by audit
  - further consideration should be given to work on systems of controls
  - more consideration may need to be given to the interaction of the legal framework for audit and Auditing Standards.

## **1 APB'S WORK ON FRAUD**

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- 1.1 APB was established as a response to issues facing auditors at the end of the 1980s: high profile fraud in listed companies was a major component in the difficulties then faced. The role of auditors in relation to fraudulent activity has therefore represented an important element in the APB's work.
- 1.2 Key stages in the APB's work to date have been:
  - (a) the issue of new Auditing Standards in 1995; and
  - (b) proposals to increase auditors' contribution towards reducing the incidence of fraud; and
  - (c) continued research of fraud and audit.

### **New Auditing Standards**

- 1.3 The issue of new Standards in the Statement of Auditing Standards 'Fraud and error' (SAS 110) clarified auditor responsibilities in relation to the detection and prevention of fraud. In doing so the SAS introduced an explicit requirement for auditors to assess the risk of material misstatement arising from fraud and to design audit procedures so as to provide reasonable assurance that published financial statements are free from material misstatements caused by fraud.
- 1.4 To assist auditors, the SAS included (for the first time) a description of factors which could increase the risk of fraud, and hence would require consideration in assessing risk.
- 1.5 In one important respect, the SAS was and remains unique. The APB is the only standard setter on a world-wide basis that requires auditors to assess the need for them to report a fraud to the authorities. APB believes that this is essential in ensuring an effective contribution from audit to an overall aim of preventing fraud.

### **Proposals to increase auditors' contribution towards reducing fraud**

- 1.6 SAS 110 set auditors' responsibilities at an appropriate level in the context of their obligations under company law. These obligations extend only to



expressing an opinion whether a company's financial statements give a true and fair view, and to reporting by exception if they have not received all the information and explanations considered necessary to form that opinion, if proper accounting records have not been kept by the company, or if financial statements do not agree with those records, or if transactions with its directors are not disclosed as statute requires.

- 1.7 Concurrently with the development of SAS 110, therefore, the APB gave consideration to whether auditors could do more. General expectations of auditors were, and remain, that a key element of their role involves 'finding fraud', often without reference to the nature of the fraud or to the materiality (or otherwise) of the amounts involved.
- 1.8 The APB therefore debated ways in which the experience and information obtained in the course of fulfilling existing responsibilities could be used to best effect, and whether additional work by auditors would be beneficial. Such debates resulted in the issue of proposals in two consultation papers, *The Future Development of Auditing* (1992) and *The Audit Agenda* (1994), and in a further paper *Audit Agenda - Next Steps* (1996), summarising action proposed in the light of comments on these papers.
- 1.9 The proposals in these papers fall into two groups

- (a) *additional reporting on systems to prevent and detect fraud*

In this context, *Future Development of Auditing* contained the proposal that the audit role might include review of various aspects of the way an organisation conducted its business. *Audit Agenda* suggested that auditors of listed companies might be required to report to boards and audit committees on the adequacy of the arrangements in place to deter fraud. APB further suggested that boards and audit committees ought to consider commissioning 'forensic audits' involving a more in-depth investigation in areas determined by the directors;

- (b) *education and training of auditors*

*Audit Agenda* noted a need for improvements in education and training so as to increase auditors' awareness of indicators of frauds. However, APB's responsibilities do not involve either setting requirements for professional education or arranging training for auditors. These are matters for which the individual accountancy bodies are responsible. We continue to encourage them to improve education and training in this area.

### **Rejection of proposals for an expanded role to help companies establish effective systems**

- 1.10 Feedback from those who responded to the various suggestions in *The Future Development of Auditing* and *The Audit Agenda* for moving beyond the position

set out in SAS 110 have, in overall terms, been negative. There seem to be three principal reasons for the reaction.

- (a) *Companies and some institutional investors unwilling to bear additional audit costs.*

At the time APB consulted, there appeared to be strong views that audit costs were already too high. Institutional investors also commented to the effect that auditors should 'stick to their last' and provide better value for money in their existing role. There was also some evidence to suggest that the proposals were seen by a significant number of non-auditors as a 'make work project' to increase income to the accounting firms.

- (b) *Concern about extending auditors' responsibilities.*

At the same time, feedback from some corporate commentators suggested that increased auditor involvement in the way businesses undertook their activities would put undue constraints on the freedom of directors to organise companies' activities as they considered most effective. Additionally, the ability of auditors to comment on matters outside the financial statements was challenged by a number of respondents - particularly insofar as issues relating to the proper conduct of business were concerned. Institutional investors were also, apparently, willing to make their own judgements on the competence and honesty of those running companies in which they invested.

- (c) *Auditors were unwilling to accept a larger role without some mitigation of the risks of litigation.*

In the absence of consensus on criteria for the way control systems should be designed to protect against fraud, auditors had concerns that new reporting responsibilities might lead to new 'expectation gap' issues and hence expose them to greater risk of litigation.

## **Continuing research into issues related to fraud**

1.11 Despite rejection of the proposals made to date, APB has continued work intended to identify a way forward on fraud. For this purpose, a number of studies have been undertaken:

- (a) a review of recent major frauds;
- (b) a survey of the implementation of SAS 110;
- (c) a study of views on the meaning of the terms 'reasonable assurance' and 'materiality';
- (d) a review of other models for reporting on fraud issues, primarily in the public sector;

- (e) an international comparison of current auditing standards relating to fraud; and
- (f) a consideration of the definition of fraud.

***Information from review of recent major frauds***

1.12 The central element of the APB's study consisted of a review of evidence from major frauds, in order to gain a better understanding of the characteristics of material frauds and ways in which they can be identified. Importantly, thanks to the co-operation of auditors and the relevant authorities, it has been possible to take account of information from recent cases, not available from current published sources.

1.13 The principal findings of this work are unsettling, both to auditors and to those who use companies' financial reports. Our work indicates that:

- (a) *most material frauds involve management.*

Directors or other senior management were actively involved in most of the major frauds included in the survey. In view of the amounts involved, these frauds have given rise to significant public concern and affected the financial well-being of a wide range of individuals;

- (b) *a majority of frauds involve misstated reports to the market but do not involve diversion of funds from the company.*

'Fraud' is often seen as being a corollary of theft, involving loss of money or other assets - and consequently as being relatively straightforward to detect. However, the meaning of the term involves a much wider range of characteristics, with the common theme of deception.

Our study indicates that most of the major cases to which the term 'fraud' has been applied do not involve direct financial gain for the perpetrators or direct financial loss to the company. 65% of the cases of fraud examined involved the misstatement of financial information, for a variety of motives - including maintaining share price, or disguising losses. In these cases, there was no diversion of funds from the company. Hence a significant element of known frauds are not frauds against the company concerned so much as frauds by its management using the company - arguably, frauds by the company;

- (c) *management fraud is unlikely to be found in a financial statement audit.*

There are two aspects of the study to take into consideration. First, in a significant number cases, the fraud took place early in a company's life and before audits commenced. Secondly, frauds involving senior management usually also involved complex mechanisms and collusion designed to prevent detection;

- (d) *costs of investigating and prosecuting fraud are considerable.*

Costs of investigating and prosecuting those frauds included in APB's survey were over ten times more than audit costs in the companies concerned. This understates the real comparison because fraud investigations are usually focused on a particular suspicion, while the audit involves examination of all aspects of the company's financial statements.

### ***Assessing the effectiveness of new Auditing Standards: more emphasis on fraud***

- 1.14 Given the comparatively recent issue of SAS 110, it was important to obtain feedback on the way the SAS had been implemented. To do so, the APB undertook a survey of audit practitioners to assess the extent to which they considered the SAS had changed practice.
- 1.15 Responses to the survey suggest that, in general terms, practitioners are now placing more emphasis on fraud in the planning and conduct of audits. There is also anecdotal evidence that the SAS's requirement for reporting suspected frauds has helped to ensure improved follow up of matters discovered by auditors.
- 1.16 However, a significant proportion of auditors considered that differences in expectations about those responsibilities still exist.
- 1.17 SAS 110 indicates that auditors provide 'reasonable assurance' that financial statements are free from material misstatements arising from fraud - in line with other standard setters internationally - but it goes on to comment on the extent of assurance that is 'reasonable' and to draw attention to the fact that when senior management is involved, the degree of assurance possible within the normal scope audit is likely to be significantly reduced. Many of the auditors who took part in the survey consider that the term 'reasonable assurance', particularly where senior management is involved in fraud, is not likely to be understood in the same way by those outside the profession.

### ***Reasonable assurance and materiality***

- 1.18 Another aspect of the APB's work has consisted of a study of the concepts of reasonable assurance and materiality, including a survey of its own members' views on whether auditors should find particular types of fraud. APB's membership includes both auditors and non-auditors, so providing a useful forum for discussion of differences in views between auditors and their customers. Amongst many findings, the survey indicates that
- (a) there is still a major gap between auditors' and non-auditors' understanding about the extent to which an audit of financial statements can provide 'reasonable assurance' of finding material frauds;

- (b) nonetheless, if senior management collude (especially with third parties outside the company) auditors and non-auditors agree that fraud is unlikely to be detected.
- 1.19 Feedback from this internal survey is consistent with the views expressed by those who contributed to the review of known cases of fraud. It does not auger well for the auditing profession: the short message is that some types of fraud are not detectable within current constraints but expectations remain.
- 1.20 'Materiality' is defined by the Accounting Standards Board and the APB, and in international standards of accounting and auditing, in terms of whether a particular matter is likely to affect a user of financial statements. In order to gain an understanding of the extent to which a fraud is likely to affect particular groups of potential users, consideration has been given to the financial effect of a fraud, and the parties who suffer that effect.
- 1.21 As noted in 1.13(b) above, a fraud does not always result in loss to the company concerned. Whether it does or not, shareholders, employees and creditors may all be affected, although to differing degrees. These different viewpoints on the significance of fraud add further complexities to the question of auditors' responsibility for fraud detection in the context of a true and fair view opinion (see section 2 'The continuing problem').

### ***Review of other models for reporting on fraud issues***

- 1.22 Auditors of public sector bodies already have some responsibilities for reporting on matters relating to fraud. In particular, auditors of local authorities appointed under the Local Government Finance Act 1982 and the Local Government (Scotland) Act 1973 have a duty to assess the adequacy of the arrangements in place for the prevention and detection of fraud and corruption.
- 1.23 To obtain an understanding of such existing models, APB reviewed the way in which local authority auditors fulfil their responsibilities, and has sought to identify other models for auditors to report on matters relating to fraud, in order to determine whether existing approaches to the topic are transferable to other sectors - particularly the listed corporate sector.
- 1.24 The model utilised in local authority auditors primarily involves evaluation of aspects of internal control relation to employee and third party fraud, in the context of established criteria for managing risks of such fraud. APB's review suggests that, while all aspects of the model were not directly transferable to the private sector, there may be value in mandating more detailed assessments of systems of control than currently required by Auditing Standards. However, in the environment in which local authorities operate - and the measures used to assess performance - reduces the significance of management fraud to the model and hence its wider applicability. Furthermore, replication of the conditions for reporting by auditors in that environment may not be feasible more widely - especially in relation to listed companies, given the sensitivity of share prices to certain disclosures.

### **International comparison**

- 1.25 SAS 110 is consistent with the requirements of International Auditing Standards insofar as planning and conduct of the audit is concerned. However, as mentioned earlier, it sets higher standards in requiring auditors to determine whether an actual or suspected fraud should be reported to an authority in the public interest, whether by the entity or its auditors.
- 1.26 In the United States, new requirements in relation to fraud were issued in SAS 82 'Consideration of fraud in a financial statements audit', in February 1997. These aimed at improving auditor performance by:
- (a) including extensive commentary on risk factors (this covers the same matters as SAS 110's commentary, but in a greater degree of detail); and
  - (b) requiring documentation of the auditors' assessment of those factors.
- 1.27 We understand that the US SAS was based on a view that audit performance can be improved in such a way as to meet current expectations concerning detection of fraud whilst not changing the nature of the auditors' responsibilities or significantly extending audit scope. This contrasts with APB's view, based on its studies of recent major frauds, which suggests that most management frauds will not be detected without a significant increase in scope of the audit.
- 1.28 The approach adopted in US SAS 82 may also be facilitated by underlying differences between governance arrangements and auditors' responsibilities in the UK and US. Company law in the UK sees audit as a report to shareholders on the stewardship of their company by the directors - the auditors are appointed by the shareholders at one annual general meeting and report to them at the next. Fraud by the directors that is undetected by the auditors may therefore be seen as breach of duty by the auditors to the shareholders. In the US the auditors are normally appointed by and report to the company's directors. Governance arrangements also vary in that directors in the US are less likely to have executive responsibilities. The result is that the auditors' duty in the US, insofar as fraud is concerned, tends to be seen as focusing on fraud on, rather than by, the directors.

### **Definition of fraud**

- 1.29 APB has also considered the need for a more precise definition of fraud. Whilst no precise legal definition exists, SAS 110 defines fraud as comprising:

*'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, or*
- *wilful misrepresentations of transactions or of the entity's state of affairs.'*

1.30 Feedback on the implementation of SAS 110 and discussions with firms and lawyers in the course of reviewing recent major frauds have not suggested that more precision could be achieved - or is necessarily desirable.

1.31 While there seems to be support for a wide generic definition of fraud, there may be benefit in distinguishing between two major categories:

- (a) fraud by directors, employees or third parties undertaken with the objective of misappropriation of assets from the entity (employee and third party fraud). The financial effect of such fraud is rarely material to financial statements, even when the amounts involved are considerable in absolute terms;
- (b) fraud undertaken by directors or senior management with the objective of issuing misleading financial statements - whether involving personal gain or not. Such fraud is normally carried out specifically with the intention of causing a material effect on financial statements.

1.32 A distinction between 'employee and third party fraud' and 'management fraud' may assist in consideration of

- (a) the mechanisms by which such frauds might be prevented or detected, and
- (b) the cost/ benefit of such mechanisms.

1.33 While APB recognises the damage that can be caused by employee and third party frauds (especially within the public sector and financial institutions) in recent years, its research indicates that such fraud is not the major cause of material misstatement of financial statements. For this reason, management fraud is the primary focus of the remainder of this Consultation Paper.

## 2 THE CONTINUING PROBLEM

Auditors cannot ensure that they will discover management fraud:

- ◆ **the nature of evidence available to auditors** means that they rarely have sufficient evidence to resolve suspicions that fraud has occurred and normally must report in the context of **suspicious not certainty**. It is also **normally necessary to rely on management representations** about some issues - particularly in relation to items in the financial statements whose valuations involve a considerable extent of judgement by the directors. Furthermore;
  - **directors and senior management can over-ride controls** over financial and other records
  - **collusion can destroy the value of audit evidence**, and is common when fraud occurs,
- ◆ **auditors' investigatory powers are limited**. They have no legal right to seek evidence from third parties, such as suppliers and customers, without authorisation from directors;
- ◆ **'true and fair' is a blunt instrument for focusing audit work on fraud**. 'True and fair' is a valuable concept for assessing the overall adequacy of financial reports, but
  - company law and accounting standards contain **no requirement for disclosure of fraud**
  - 'true and fair' incorporates the concept of **materiality**. Initially, frauds are often immaterial;
- ◆ **time constraints for reporting** - especially by listed companies - bring severe consequences for any delay, which can be exploited to discourage auditors from seeking evidence to resolve uncertainties such as suspicions of fraud;
- ◆ **investigating suspicions of fraud can involve heavy costs for auditors.**



## **2 THE CONTINUING PROBLEM**

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- 2.1 APB's work suggests that the underlying expectation - that auditors will find fraud - remains, particularly when a fraud involves factors that threaten the entity's ability to continue in business.
- 2.2 At the same time, auditors cannot ensure that they will discover management fraud, despite steps taken by both APB and audit firms to improve performance. There are a number of reasons for this, including:
- the nature of evidence available to auditors;
  - limitations on auditors' investigatory powers;
  - financial reporting and audit focuses on 'true and fair' rather than on the incidence of fraud;
  - time constraints can be exploited by fraudsters;
  - investigating fraud brings heavy costs.

Each of these factors is discussed below.

### **The nature of evidence available to auditors**

- 2.3 The nature of evidence available to auditors, and its quality, have significant effects on the extent to which auditors can find fraud:
- (a) auditors can rarely determine with certainty that fraud actually exists - ultimately, that is a matter for the courts. At most, they will identify grounds to suspect that it exists and must form an opinion and report in the context of such suspicions;
  - (b) representations from management are normally a necessary part of auditing financial statements;
  - (c) collusion can significantly reduce the quality of evidence available to the auditors.

### ***Dealing with suspicions not certainty***

- 2.4 There is no precise definition of fraud: it is for the courts to determine in a particular instance whether fraud has occurred. Information obtained by auditors in the course of their work may give rise to suspicions, but is unlikely to be definitive. This is hardly surprising: auditors are likely to be the only individuals outside the entity concerned - apart from those involved in or affected by a fraud - who are in a position to find evidence of its existence at a relatively early stage. However, it means that auditors reporting within the timescales required for financial reporting normally have no choice but to form an opinion based on available information giving rise to suspicion of fraud, and rarely have access to conclusive evidence one way or other.

### ***Use of management representations***

- 2.5 Explanations from management, including directors, ('management representations') are an important element of the audit process, both in order to explain the reasons for key judgments and assumptions underlying the preparation of the financial statements, and to affirm the completeness of information made available to the auditors. Thus it is essential that auditors obtain representations - both formally and informally - in order to understand the financial statements on which they are to report.
- 2.6 In the course of the audit, auditors assess management representations in the light of evidence from independent sources. However, auditors are not always in a position to know whether evidence they obtain is actually independent.
- 2.7 Recent developments in financial reporting are increasing the extent of judgement involved and hence the matters on which auditors have little evidence available to them apart from management representations. This simultaneously increases the importance of representations to the audit process and reduces the quantity of 'hard' evidence available to auditors against which those representations may be assessed.

### ***Directors and senior management can over-ride systems of controls***

- 2.8 Currently, no specification exists as to how companies generally should exercise control over their activities. The directors are responsible for the implementation and maintenance of systems of control within the company, and are free to design and change such systems as they see best suits the needs of the company. Such flexibility can be used positively, to ensure that the company continues to operate in an effective and cost efficient manner: more negatively, it gives those intent on fraud with considerable room for manoeuvre.

### ***Collusion***

- 2.9 The effect of collusion is two fold. First it defeats the procedures put in place by an organisation to protect itself against fraud. Secondly, it undermines the

value of evidence used by the auditors to assess whether material misstatements are present in the financial statements on which they are to report - false documents may be presented to the auditors; analytical procedures used by them may produce misleading results if based on data believed to be independent but in fact manipulated by others co-operating in a fraud with the specific purpose of disguising the true nature of transactions; further, any commentary or explanation auditors seek from management may be misleading.

- 2.10 In short, collusion is a powerful tool in avoiding discovery of fraud. Its existence can undermine the basis on which auditors test representations made to them.
- 2.11 The way the value of audit evidence can be undermined, particularly when collusion is involved, is illustrated in Appendix 1.

### **Limitations in investigatory powers**

- 2.12 Auditors' powers to obtain evidence are restricted to seeking information from the organisation and its directors. They do not have authority to approach customers or suppliers of the company whose financial statements they are auditing without authorisation from its directors; still less do they have direct access to information about such third parties from their auditors. From a general viewpoint, this position is both understandable and acceptable: the fact that an organisation is required or chooses to have its financial reports audited ought not to mean that information about its affairs is no longer confidential. However, the handicap it presents to the auditor of an organisation whose directors are perpetrating a fraud is obvious.

### **'True and fair': a blunt instrument for focussing audit work on fraud**

- 2.13 Current company law requires auditors to state whether or not a company's financial statements give a true and fair view of its state of affairs and profit or loss - and otherwise comply with accounting requirements set out in statute. This responsibility is substantively different from considering and reporting on whether fraud has occurred, and results in a particular focus for auditors' work. It has two important implications, discussed below.

#### ***Financial reporting requirements do not focus on fraud***

- 2.14 The criteria for determining whether financial statements give a true and fair view are set out in statute and by the Accounting Standards Board - which is charged with responsibility for setting standards for financial reporting in the UK and Republic of Ireland. Disclosure of the information specified by company law and accounting standards is, save for exceptional circumstances, regarded as sufficient to give a true and fair view. Currently neither includes requirements for disclosure of actual or suspected fraud. Neither do they provide preparers or auditors of financial statements with an incentive or support for making such disclosures.
- 2.15 Accounting standards internationally take a similar position.

2.16 Auditors plan and conduct the work needed to report on financial statements in accordance with Auditing Standards. Those Standards - both in the UK and internationally - require auditors to focus on the key qualities, or 'relevant financial statement assertions' that must exist if financial statements are to meet the necessary criteria. These financial statements assertions are described in the *Glossaries* of both APB and the IAPC as:

- (a) existence: an asset or a liability exists at a given date;
- (b) rights and obligations: an asset or a liability pertains to the entity at a given date;
- (c) occurrence: a transaction or event took place which pertains to the entity during the relevant period;
- (d) completeness: there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
- (e) valuation: an asset or liability is recorded at an appropriate carrying value;
- (f) measurement: a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
- (g) presentation and disclosure: an item is disclosed, classified and described in accordance with the applicable reporting framework.

2.17 Whilst there is overlap between these assertions and the effect of a fraud, and whilst Auditing Standards address the need for auditors to consider the risk of financial statements containing material misstatements as a result of fraud, it remains that the focus of auditors' work, following the framework provided by accounting and auditing standards in the UK and internationally, is not to find and report fraud.

2.18 Furthermore, because the auditors' statutory obligation is expressed in terms of whether financial statements give true and fair view, auditors perceive that they will be exposed to legal action if they include in their reports details of uncertainties arising from unsubstantiated suspicions.

### ***Materiality***

2.19 In addition to these factors, the term 'true and fair' incorporates the concept of materiality.

2.20 Materiality is described in accounting and auditing standards, both in the UK and internationally, in terms of whether a particular matter is important enough for its omission or misstatement to influence decisions by intended users of financial statements. Thus the APB's Glossary states:

*'A matter is material if its omission or misstatement would reasonably influence the decisions of an addressee of the auditors' report. Materiality ... has both qualitative and quantitative aspects.'*

- 2.21 The definition proposed by the Accounting Standards Board for financial reporting is similar in concept, but contains an important difference in that it refers to materiality being judged in relation to the decisions not just of shareholders (to whom auditors of companies address their reports) but of a wide range of users of financial statements - including actual and potential investors, employees, lenders, suppliers and other trade creditors, governments and their agencies, and members of the public with access to financial statements.
- 2.22 Part of the auditors' difficulty in respect of fraud is that views as to whether a fraud is material in terms of the amounts involved can differ significantly both between different groups and over time. Without disclosure of the quantitative measure of materiality applied in preparing and auditing a set of financial statements, it is easy for misunderstanding about the extent of audit work to arise.
- 2.23 In a number of instances, although a fraud has occurred, the entity itself may have suffered no loss. However, the quantum of loss suffered by individuals and other organisations as a result of the fraud may be considerable. They might well take the view that their economic decisions would be affected by knowledge of a fraud, and their view of whether the fraud is material is likely to be greatly influenced by the amount of loss they have suffered and its significance to them irrespective of the relative size of the amounts involved in the context of the financial statements as a whole. The range of outcomes involved - and hence the variants in what may be regarded as a 'material' in colloquial terms - can be seen in Appendix 2.
- 2.24 Qualitative factors may also affect views as to whether a fraud is material. 'Key' frauds that do most damage to the individual organisation, the economy and to auditors are the large frauds involving those responsible for running an organisation. Rightly, society tends to react severely to such frauds because they involve a breach of trust on the part of those responsible for running businesses in which the population as a whole has a considerable stake - whether as employees, investors (directly or through their membership of a pension scheme) or more generally.
- 2.25 It follows that any fraud by directors or senior management may be seen as 'material' to shareholders, even if the amounts involved are relatively small.
- 2.26 At the same time, because auditors seek to concentrate their work on areas that are material to the financial statements on which they are to report, they plan their work accordingly. They do this normally by using a quantitative measure of materiality determined as a proportion of expected reported profits (commonly between 5% and 10%), or of other key components of the financial statements. Items whose value falls below the amount so determined - which,

in a large company, may in absolute terms be very considerable - will receive less or no attention in the course of the audit.

- 2.27 In practice, many frauds - whether involving management or others - are likely to involve comparatively small amounts in their initial stages. The result of using materiality to guide auditors' work - whilst efficient in terms of reaching an opinion on the view given by a particular set of financial statements - is that small, immaterial frauds, or indicators of fraud in small components of the financial statements, are not likely to be found, unless specific procedures are undertaken. Currently, carrying out procedures specifically designed to detect immaterial frauds may have occurred is not regarded as a normal part of the audit process.

### **Time constraints can be exploited by fraudsters**

- 2.28 Auditors work within a cycle of annual financial statements, which brings with it a natural limit on the time available to them to follow up concerns and obtain evidence. To a very large extent, the skills needed for effective auditing involve those of managing a process of evidence collection so as to be able to provide reasonable assurance on financial statements within a reasonable time and for reasonable cost - hence the importance of auditors' skills in:

- (a) rapid assimilation of information about a business and the areas in which it operates;
- (b) identification of factors increasing risks of misstatements arising;
- (c) obtaining the evidence needed for their report and obtaining it without undue costs to shareholders.

- 2.29 As auditors make their judgements about the evidence they need, those involved in fraudulent activity often attempt to influence their decisions in a number of ways - delay in providing information requested is one such tactic. Its effectiveness - so far as deflecting the auditors' attention and so allowing a fraudster to avoid discovery - varies in different audits:

- (a) when auditing a public sector body, because later publication of financial information becomes a matter of public comment on the competence or integrity of management, an auditor's ability to obtain evidence from management can actually increase as delays increase;
- (b) the reverse is true in practice for auditors of listed companies. In this context, fixed dates for publication of financial information can be a powerful weapon to minimise discovery of a fraud. The reason for this effect lies with the market's reaction to delays in reporting by listed companies. Any failure to meet planned dates will commonly have two effects:
  - a fall in share price;

- loss of confidence in the company.

Either involves financial consequences for shareholders that may far outweigh the loss of money as a result of fraud - albeit that loss is not in the interests of a company's shareholders (or other stakeholders). Further, auditors can find themselves subject to legal action if they are considered to have caused delay without due cause. Hence, auditors of listed companies can find themselves under increasing pressure to make their report without waiting for particular pieces of evidence that the directors may argue are immaterial and inconsequential. At the same time, auditors are not in a position to express concerns about the quality of evidence available to them unless such concerns can be demonstrated with near certainty.

- 2.30 The current and growing trend towards accelerated reporting dates - evidenced, for example, by the ASB's recent suggestion that listed companies make their preliminary announcements within 60 days after the year end - accentuates the difficulty for auditors of listed companies.

### **Investigating fraud brings heavy costs**

- 2.31 It is normal practice for a budget for audit costs, based initially on the auditors' assessment of the quality of the entity's arrangements and systems of controls and other relevant factors, to be agreed with the company - normally through the executive directors - in advance of the audit.
- 2.32 Subsequent changes to the budget to accommodate additional work in response to new factors identified as work progresses can be difficult. Discovery of suspected fraud can prompt a revision of all the various judgements and assumptions underlying the auditors' initial budget: some increase in costs is virtually unavoidable. At the same time, the directors of the company will be concerned either to ensure the additional costs are contained to a necessary minimum, or (if suspicions are justified and the directors are involved) to prevent full investigation. In either case, there is a real possibility that the company will not pay the costs incurred by the auditors in investigating suspected fraud.
- 2.33 Adverse financial consequences for the auditors may be aggravated by the possibility of legal action against them, whether to seek enforcement of reporting on the planned reporting date or to challenge their right to disclose relevant information in their report.
- 2.34 Over-rigorous control of audit fees by executive directors inhibits auditors' ability to discover fraud. In the hands of directors who are themselves involved in a fraud, it can be used as a powerful threat. Greater involvement of non-executive directors in determining audit fees - and other matters related to the conduct of the audit - would help to resolve this issue.

### 3 CHANGING CURRENT AUDITING STANDARDS

Although the factors militating against discovery of management fraud are considerable, APB is committed to an ongoing review of Auditing Standards so as to achieve continual improvement in the effectiveness of financial statement audits.

- ◆ APB's current work programme includes steps that will achieve incremental change through **review of key Auditing Standards** on
  - fraud
  - quality control for audit work
  - assessing risk and systems of control

But significant improvement in the detection of management fraud requires **more radical change**. APB has developed a number of ideas for how this might be achieved, which would involve:

- ◆ **increasing the emphasis on professional scepticism**. Scepticism is primarily an attitude of mind. Changes in Auditing Standards for the conduct of audit work can help to reinforce the habit of scepticism, but cannot achieve change on their own. Increasing the degree of scepticism auditors bring to their work depends on
  - a commitment to effective education and training throughout auditors' professional lives
  - a working environment that allows scepticism to be applied in practice;
- ◆ **introducing tighter rules of evidence**. Auditing Standards could be altered to introduce more specific requirements for particular types of evidence or procedures;
- ◆ **changing requirements for auditors' reports on financial statements to highlight issues relating to the quality of evidence**. Auditors could be required to identify material matters for which corroborating evidence is not available (and could not reasonably be expected to be available) and are therefore supported solely by representations by directors and senior management.

**Such changes are not cost free.**

- ◆ **Tighter rules of evidence could bring significantly increased costs**, including:
  - **higher or more variable audit fees**. Tighter rules for audit evidence are likely to increase the cost of audit, both through a need for more audit time and through increases in the amount of information companies would need to provide to their auditors;
  - **possible delays in reporting by auditors or more qualifications in their reports**: At present, delay or qualification normally results in an adverse effect on the market's confidence in the company concerned, often reflected in its share price;



- *more intrusive audit*. Tighter rules for evidence would change the existing relationship between auditors and management. Audit may be seen as an increasingly unwelcome interference in companies' commercial processes, and may damage the open and co-operative relationship that is required for audits to be effective - particularly within tight time constraints.
- ◆ ***Additional disclosures concerning reliance on representations*** would involve less direct cost. Its introduction would bring
  - *longer, more discursive auditors' reports*. Requirements for auditors to highlight reliance on directors' representations without corroborating evidence would lengthen their reports; *but*
  - would provide *valuable additional information on judgmental issues*.

### **3 CHANGING CURRENT AUDITING STANDARDS**

- 3.1 The difficulties of identifying management frauds within the current specification of auditors' legal responsibilities and powers are, as discussed in Section 2, considerable. Nevertheless, there are a number of possible ways in which the financial statement audit might be made more effective.

#### **Incremental change: review of key Auditing Standards**

- 3.2 APB has sought to provide, in SAS 110, a framework that will assist the identification of, and response to, risks of material frauds. When it was issued in 1995, SAS 110 was arguably the most demanding auditing standard relating to fraud in the world. In 1997, however, SAS 82 was issued in the US which, whilst broadly consistent with SAS 110, requires more detailed analysis and documentation of fraud risk factors during the planning stage of the audit.
- 3.3 APB's research suggests that since SAS 110 was issued auditors have placed greater emphasis on fraud when planning and undertaking their work. Practitioners consider the framework set out in SAS 110 to be reasonable. Placing greater emphasis on detailed analysis of risk factors at the planning stage (as in the US) might heighten expectations to an unrealistic degree - particularly in relation to detection of management fraud. Such a step would also increase audit costs. APB nevertheless believes that it should consider this step further in order to establish its effectiveness in improving detection of fraud generally and of management fraud in particular.
- 3.4 APB's research, while providing support for SAS 110, also suggests that it would be possible to improve auditor performance in relation to fraud by tightening other Auditing Standards. Possible areas for change are set out in Appendix 3 to this Paper. Reconsideration of Auditing Standards in two areas in particular may be of value in helping to increase the likelihood that auditors find frauds:
- (a) *additional requirements concerning quality control over audit work may assist in guarding against uncritical acceptance of evidence and directors' views. APB will review SAS 240 'Quality control for audit work' and consider whether to mandate techniques such as placing specific quality*

assurance responsibilities on the audit engagement partner, consultation with partners independent of the engagement, and documentation.

- (b) *changes in the way auditors assess an entity's overall control environment and its systems of controls may provide the auditor with better awareness of fraud risk and control weaknesses.* APB will review SAS 300 'Accounting and internal control systems and audit risk assessments' and consider whether a more structured approach to the evaluation of the control environment should be required and whether a closer link with fraud needs to be established.

### **More radical change**

- 3.5 Whilst the changes discussed above may help to improve the effectiveness of audit, APB believes that, alone, they will not result in a significant improvement in detection by auditors of management fraud. Improving the likelihood that management fraud would be detected as part of a financial statement audit would require more radical change, involving
  - (a) increasing professional scepticism;
  - (b) tighter rules for audit evidence; or
  - (c) disclosure by auditors of concerns about reliance on representations from management.

### ***Increased emphasis on professional scepticism***

- 3.6 Many of those who contributed to APB's research indicated that what was needed was not necessarily additional or stronger Auditing Standards but that auditors apply the existing Standards with increased scepticism.
- 3.7 Scepticism is a personal quality that relates to the attitude of individual auditors: it is characterised by a questioning, probing - almost suspicious - approach being applied throughout the audit. Many involved in APB's research indicated that they are concerned that the level of auditor scepticism has declined in recent years and seek to strengthen it. The issue is how best to achieve this given that it is difficult to measure (whether during, or after, the audit) the degree of scepticism applied in practice.
- 3.8 APB's view of the importance of scepticism in auditing was demonstrated by its inclusion in *The Auditors' Code*, which was issued by APB as a summary of the fundamental principles underlying effective auditing. One of those principles states that:

*'Auditors approach their work with thoroughness and with an attitude of professional scepticism.'*
- 3.9 When developing *The Auditors' Code*, APB consulted with the Chartered Accountants' Joint Ethics Committee. It has since continued to work with that

Committee with a view to ensuring that the ethical requirements of the accountancy bodies provide a framework that encourages the independence and objectivity necessary for a sceptical approach to audit work.

- 3.10 If the degree of scepticism is to be increased, action is required by those responsible for leading the profession and audit firms to develop and implement arrangements that encourage the open-minded persistent approach that accompanies a sceptical attitude. Education and training of auditors are important elements of those arrangements. On a profession-wide basis, scepticism can be encouraged as part of the qualification process. Arrangements for education and training within individual audit firms are also a key determinant of the degree of scepticism applied by individual auditors. APB believes that it is essential for firms to ensure that their education and training programmes ensure that those involved in audits operate with the benefit of up-to-date information about the operation of businesses generally, and about fraud indicators and techniques in particular.
- 3.11 To be effective, however, training must be reinforced by an operating environment that allows scepticism to be applied in practice. Conflicts can exist between scepticism and the commercial interests of partners and audit staff, for example,
- investigating suspicions often leads to cost overruns, with the risk of unpaid fees;
  - directors or staff of the client entity may object to particular requests for evidence, or be unaware of their significance, and lodge complaints that the audit is being run in an inefficient manner.

### ***Tighter rules for audit evidence***

- 3.12 While more could be done to embed scepticism within ethical requirements or Auditing Standards, APB would not expect this to achieve a significant change in practice. Auditing Standards could also be changed to force changes to practice which might have similar results to heightened scepticism - although requiring specific procedures to be carried out cannot guarantee a sceptical attitude of mind in those undertaking those procedures.
- 3.13 Current Auditing Standards require auditors to obtain sufficient appropriate evidence from that which is reasonably expected to be available. This broad specification allows auditors to exercise professional judgement in the light of particular circumstances. APB could introduce more specific requirements which might either place greater emphasis on 'hard' sources of audit evidence such as inspection of physical assets or mandate certain specified procedures, such as obtaining confirmations from third parties.
- 3.14 Specifying evidence requirements and procedural standards in more detail would, however, be a difficult exercise. It implies a 'one size fits all approach' is feasible, while in reality audit approaches will vary greatly depending on the nature and scale of the entity's business activities as well as its corporate

governance arrangements. What would be the 'right' procedures for a large manufacturing company with a sophisticated control environment, including a large internal audit function, would clearly not be the 'right' procedures for a poorly controlled financial services business.

- 3.15 Specifying evidence requirements and procedural standards in more detail would also move the audit away from being risk based process (where auditors make decisions as to the nature and extent of audit evidence needed based on their assessment of risk) to a more procedural approach. Some might see this as an unwelcome move towards audit as a "box ticking" exercise rather than one based on the judgements of experienced professionals. If APB was to pursue this approach it would need to set standards for evidence at a relatively detailed level, both as to components of the financial statements and particular industries, and Auditing Standards would proliferate as a result.

#### ***Requiring disclosures in the auditors' report***

- 3.16 A preferred approach may be to introduce a requirement for auditors to identify in their published reports any material matters that they have not been able to corroborate independently and are, as a consequence, only supported by management's representations.
- 3.17 To maximise the value of these disclosures, the APB and the auditing profession would need to ensure that they were used only in exceptional circumstances and that 'boiler-plate' language was avoided.

#### **The cost of achieving more radical change**

- 3.18 The changes set out in this section will not eradicate fraud nor lead to all frauds being detected. But if the consequences of change are accepted, APB believes that audit could provide more assurance that fraud will be detected. The greater the extent of those changes, the more assurance will increase, but also the greater the consequences for preparers and users.

#### ***Increased emphasis on scepticism and tighter rules of evidence***

- 3.19 Changes in Auditing Standards to reinforce scepticism or to introduce tighter rules of evidence would mean that audits might take longer and would become more intrusive than at present. In particular, companies and shareholders would need to accept the possibility of:
- (a) ***higher or more variable audit fees.*** More stringent rules on evidence are likely to result in an increase in the costs of audit - both in terms of the audit fees, and less directly, by increasing the amount of information required to be provided by a company to its auditors. It is difficult to evaluate the effectiveness of further audit work in detecting management fraud, although identification of additional costs and benefits may be easier in relation to employee fraud;

- (b) ***either more delays in reporting by listed companies (to allow evidence to be gathered) or more qualifications in auditors' reports (to signal that the evidence had not been gathered)***. Changed rules on evidence could result in either delay or qualification. At present either outcome normally results in an adverse reaction within the capital markets and a significant loss of confidence in the individual company concerned;
- (c) ***more intrusive audit***, and a changed relationship between the auditors and the directors. Tighter rules for audit evidence would be likely to change the existing relationship between auditors and management. Audit could be seen increasingly as a "straight jacket" and relationships might increasingly suffer. The APB is concerned here, not with the commercial relationship between companies and their auditors, but with maintaining the open and co-operative relationship that is required for audits to be effective.

#### ***Requiring disclosures in the auditors' report***

- 3.20 Costs involved in making additional disclosures in auditors' reports regarding material aspects of the financial statements upon which the auditors are dependent on management representation are not likely to be great.
- 3.21 Initially, additional disclosures are likely to be viewed as 'red flags' by investors. In due course, however, the provision of additional information by the auditors may be viewed as valuable additional insights into key judgmental issues.

## 4 EXPANDING THE AUDITORS' ROLE

Radical change to the audits of financial statements is one way for auditors to contribute more to finding fraud. There are other ways in which auditors could do more, including:

- ◆ **requiring auditors to report to boards and audit committees on the adequacy of controls to prevent and detect fraud.**

This work would focus on employee and third party fraud, to assist the directors in making the reports now required by the Stock Exchange, without diluting the directors' responsibility for making a balanced report on their company's systems of control. Knowledge that the auditors' role included such reporting would also provide shareholders with assurance that concerns as to the robustness of such systems will be discussed with both executive and non-executive directors;

- ◆ encouraging the use of targeted **forensic fraud reviews**, based on assessment of risks of fraud inherent in a business.

Such reviews could be commissioned voluntarily by directors, as part of the board's process for ensuring adequate discharge of its responsibilities, or might be required by regulators,

- ◆ considering whether **more reporting of suspected frauds** would be beneficial .

Auditors of regulated entities are normally required to report frauds. Current Auditing Standards require auditors of other entities who suspect fraud to report to an appropriate authority if they consider it necessary in the public interest. There may be benefit in reviewing these arrangements to determine

- whether auditors should report suspicions in a wider range of circumstances, and
- what arrangements would be needed to ensure that regulatory authorities are in a position to give effective follow up in the event of greatly increased reporting.

## **4 EXPANDING THE AUDITORS' ROLE**

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- 4.1 The steps suggested in the Section 3 would enhance the assurance provided by an audit of financial statements. APB believes that the auditors' contribution to preventing and detecting fraud could be further increased by implementing measures to supplement the financial statement audit. However, the feasibility and effectiveness of such steps depends not only upon acceptance of the related costs and constraints but also upon making complementary changes in the framework of corporate law and governance. APB cannot make the necessary changes alone.

### **Reporting on controls to prevent and detect fraud**

- 4.2 The operation of internal controls is an important element in containing the incidence of fraud, especially employee fraud.
- 4.3 APB has also suggested, in *The Audit Agenda*, that companies and shareholders would benefit from auditors reporting privately to boards and audit committees on the appropriateness of systems of controls. Such reporting would assist the directors in making the reports suggested by the Cadbury Committee, and now required by the Stock Exchange, without diluting the directors' responsibility for making a balanced report on systems of control.
- 4.4 APB is less sure that reporting by external auditors on internal controls should be mandated. Directors may have alternative methods of assessing effectiveness of their systems (eg internal audit or control risk self assessment). Concerns also exist as to the feasibility of public reporting on the effectiveness of internal controls.
- 4.5 APB and others have devoted significant resources, since issue of the Cadbury Report, to determine how auditors of listed companies could provide assurance publicly on systems of controls. The lack of consensus on the criteria used to delineate the types of controls necessary to support public reporting has impeded progress in this area. Concerns also exist as to whether such an approach would be cost beneficial - as well as about the implications for directors' and auditors' liability.



## Forensic fraud reviews

- 4.6 *The Audit Agenda* also suggested that boards of directors give consideration to obtaining assurance about the adequacy of their companies' arrangements to minimise fraud from in-depth forensic style work. Such 'forensic audits' would be commissioned periodically to review the operation of systems or follow up particular concerns. Whilst responses to *The Audit Agenda* did not support this proposal, APB continues to hold the view that the assurance provided to boards from in-depth forensic work is a highly valuable means whereby directors can determine the effectiveness of arrangements they have put in place to safeguard the company from loss.
- 4.7 Forensic reviews would involve specialist auditors applying forensic skills to examine in detail aspects of the business that are especially exposed to fraud. Such reviews could be commissioned voluntarily by directors, as part of the board's process for ensuring adequate discharge of its responsibilities, or might be required by regulators.

## More reporting of suspected frauds

- 4.8 Auditors of entities which undertake regulated financial activities have an additional statutory duty to report to the appropriate regulator any matters of material significance discovered in the course of their work. Suspected fraud would normally be regarded as being of material significance. Auditors of some public sector entities have equivalent duties.
- 4.9 Outside the financial and public sectors, SAS 110 requires auditors to report actual or suspected fraud to a proper authority if they consider it necessary in the public interest - which particular authority (or authorities) is appropriate will depend upon the particular circumstances. Auditors making such reports have legal protection, under common law, for disclosing relevant information that would otherwise remain confidential.
- 4.10 APB believes that such reporting is rare, however. In part, this reflects the fact that a financial statement audit may uncover information pointing to suspicious circumstances without necessarily having access to the level of evidence needed to conclude that a fraud may, indeed, have taken place.
- 4.11 In addition, *the public interest* is a demanding test and will not justify auditors reporting **all** suspicions of possible frauds to an authority. Thus company auditors have neither the protection nor any obligation to report actual or suspected fraud save in extreme cases. As a result, auditors who become aware of information suggesting that material fraud involving directors exists may have no way of bringing that information before any party capable of taking the action necessary to clarify and correct the position - even if there is a clear identified risk of significant loss to shareholders and creditors of the company.
- 4.12 There may be benefit in reviewing the rights and obligations of auditors to report possible fraud involving directors with the aim of providing a better

mechanism for action by an authority with the responsibility and power to take appropriate and effective action. This is particularly important in the context of listed companies.

- 4.13 Clearly, the value of extending the scope of auditors' responsibilities would be greatly diminished if appropriate action by the regulator(s) concerned is not apparent. Hence attention also needs to be given to the way in which business activity is regulated. A right or obligation for auditors to report frauds should be introduced only if the identity of the regulatory body responsible for receiving and acting upon such reports is clearly determined, and consideration also given to the resources available to that body for responding to matters reported by auditors.
- 4.14 In addition, APB believes that there is a need to consider the possible benefits of encouraging or requiring authorities who are aware of suspicions of fraud in relation to a particular entity to communicate those concerns to that entity's auditors, so as to supplement the auditors' own assessment of risk and better direct audit effort.

## 5 CHANGING CORPORATE LAW AND GOVERNANCE

Audit cannot be considered in isolation from the framework of law and governance in which business activity takes place.

APB believes that there is a need to consider changes to that framework to make it more robust against risk of fraud. Principal matters to consider are:

- ◆ **placing more emphasis on fraud prevention** by clarifying directors' responsibilities for establishing safeguards against fraud. There is currently no recognition in statute or regulation (outside the regulated financial sector) of the importance of the directors' role in preventing and detecting fraud;
- ◆ **clarifying companies' responsibilities for directors' fraudulent acts.** The practical effect of current common law is that companies may dissociate themselves from an individual director's actions if these are fraudulent, even though the actions were undertaken on behalf of the company. This creates an environment that gives little incentive for collective responsibility within boards of directors, or for shareholders to take an active interest in ensuring that funds invested in a company are properly used;
- ◆ **changing other key aspects of company law**, for example to
  - introduce **more robust requirements for systems of internal controls**. Current company law is silent on the issue of whether companies should maintain systems of control;
  - **tighten duties of directors (and others) to provide information to auditors**. At present, it is a statutory offence for directors to mislead auditors, but no obligation exists to provide information other than in response to specific requests. A director who is aware of a material fraud affecting the company's financial statements is under no obligation to disclose that fact to the auditors. Nor does the statutory offence extend to employees of the company, although in practice the majority of auditors' requests for information will be directed to employees rather than directors;
  - **improve arrangements for audit changeovers**, particularly to facilitate exchange of information between auditors. Current statute and common law place significant constraints on auditors sharing concerns about fraud risks with other auditors. Greater disclosure of reasons for a change in auditors may also be beneficial.

## 5 CHANGING CORPORATE LAW AND GOVERNANCE

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- 5.1 Changing the Auditing Standards that apply to the audits of financial statements, or expanding the auditors' role, will help auditors find more fraud. But frauds will nevertheless continue, and despite these changes not all frauds will be found by auditors.
- 5.2 Other action to influence the general framework within which business is conducted should be considered in parallel.

### Placing more emphasis on fraud prevention

- 5.3 Although a company's directors have executive responsibility for its actions, there is currently no recognition, outside the regulated financial sector, in statute or regulation of the importance of their role in preventing and detecting fraud. If those who use the capital markets and society more generally are to be better protected against those who conduct business in a fraudulent manner, the starting point must lie in the way that companies are run.
- 5.4 There is at least an arguable case for more active specification and monitoring of acceptable business practice in listed companies so as to reduce risks of fraud. This might take a number of different forms:
  - (a) *a Code of Conduct for listed company directors.* Both the CBI and the Institute of Directors are well placed to introduce a voluntary Code, drawing on the experience of their members and taking into account the need to take risks, in a more general sense, in the ordinary course of trade. They and institutional investors would then have better criteria for determining whether risks of fraud are properly minimised;
  - (b) *new statutory provisions concerning the responsibilities of directors could be put in place.* Legislation could clarify the obligations of directors. In particular, company law could establish that the directors have the primary responsibility for compliance with the requirements of the Companies Act and the Stock Exchange.
- 5.5 In taking steps to prevent fraud, directors should also seek to encourage appropriate use of 'whistleblowing' within a company, both in terms of establishing a working environment in which employees are able to play an

effective part by bringing forward concerns, and in ensuring prompt and thorough follow up of matters reported. In this respect, APB is encouraged that legislation is now in place to protect employees making such reports both within and (if necessary) outside the company<sup>3</sup>.

### **Clarifying companies' responsibilities for fraudulent acts by directors and employees**

- 5.6 The practical effect of current common law is that companies may legally dissociate themselves from directors' and employees' fraudulent acts. This creates an environment that gives little incentive for collective responsibility in boards of directors or for shareholders to become more actively involving in monitoring directors' activities.
- 5.7 Under UK (and Irish) law at present, fraudulent acts by directors are regarded by the courts as acts by the directors as individuals, and not acts committed by the company itself. Hence the company is regarded as being another 'victim' of the fraud, and although it may be held responsible for compensating those who may have lost money because of a fraud committed (in effect) in its name, a company is also able to seek compensation. In many cases, that compensation is sought from the auditors, not the directors who perpetrated the fraud.
- 5.8 By inadvertently encouraging compensation to be obtained from a party without responsibility for committing or preventing the fraud - and given the various difficulties in relation to detection discussed earlier in this paper - the operation of law draws attention away from the need for boards and shareholders to play their part in ensuring that funds invested in a company are properly used.

### **Changing key aspects of company law**

- 5.9 More generally, changes in the legal framework for companies and for the conduct of audit should be considered. The APB has expressed to government its view that the current review of company law should address core issues concerning the nature of the relationships between a company's directors, auditors and its shareholders and other stakeholders. An important element of reviewing those relationships involves reconsidering the way that fraud risk is managed.
- 5.10 A number of specific changes in company law should be considered in addition to the need to clarify directors' responsibilities in relation to fraud prevention.

#### ***More robust requirements for systems of internal controls***

- 5.11 Current company law requires companies to keep adequate accounting records. The difficulty of separating such records from systems of internal controls, and the importance of adequate systems of controls, has been discussed at length in many publications. Controls are of increasing

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<sup>3</sup> The Public Interest Disclosure Act 1998

importance in the context of large complex organisations using computerised accounting.

- 5.12 The length and outcome of the debate on the recommendation in the Cadbury report that directors report on the effectiveness of internal control should not be allowed to obscure the fact that robust control systems are the only tool available to supplement integrity of individuals in stopping fraud. Clear unambiguous responsibilities for directors to put in place appropriate systems of control would be a significant step in helping to provide an environment that deters fraud.

***Tighten directors' duties to provide information to auditors***

- 5.13 Section 389A of the current Companies Act imposes a duty on directors and officers to provide such information and explanations as the auditors consider necessary for the performance of their duties, and establishes that it is an offence to mislead the auditors. The number of prosecutions under this section have been few when compared with instances involving fraudulent financial reporting, which hampers assessment of its effectiveness in practice as a means of ensuring that accurate information is provided to auditors.
- 5.14 Nonetheless, a number of difficulties with the provision can be identified. First, the obligation only requires directors to respond to the auditors' requests. It does not place any obligation on directors to provide information and explanations which they themselves consider necessary to the proper performance of the auditors' responsibilities. Secondly, it does not specifically extend to employees of the company, even senior executives who are not directors. In practice, auditors direct the majority of their requests for information and explanations to employees rather than directors.

***Better arrangements for audit changeovers***

- 5.15 Auditors' current responsibilities in relation to audit changeovers could be enhanced to allow more effective sharing of suspicions of fraud, particularly when directors may be involved.
- 5.16 Two difficulties exist with current arrangements:
- (a) outgoing auditors do not have a legal duty - or indeed a right - to make disclosures to their successors. More disclosure, both in public statements on ceasing to hold office as auditor and between audit firms, would help to share information about concerns and may also act as a deterrent to fraudsters;
  - (b) secondly, although, in the case of companies, notice of the change of auditors is put on public record at Companies House, there is no obligation to inform a regulatory body. Such an obligation exists only in relation to regulated financial businesses.

- 5.17 Changes in company law are likely to be needed in order to ensure that disclosures of concerns about the risk of fraud by outgoing auditors to incoming auditors are protected. Currently, auditors are reluctant to communicate doubts regarding the integrity of their former clients to shareholders, creditors or incoming auditors where their only defence against a claim alleging defamation or breach of duty of confidentiality is common law qualified privilege. It is necessary for auditors to be confident that they are adequately protected when disclosure is needed. Insurance, banking and financial services legislation clearly states that auditors are not in breach of their duty of confidentiality or any other duty, in communicating such suspicions.
- 5.18 Additionally, the current Companies Act does not require company auditors to disclose the reason for their resignation or failure to seek re-appointment, instead requiring, under section 394, a statement of

*'any circumstances ... which he [the auditor] considers should be brought to the attention of members or creditors'.*

In practice, there is little disclosure by auditors under this section. The reason for the limited use of the section may be the result of interaction between its requirements for reporting on ceasing to hold office and the auditors' primary duty, under the Companies Act, of reporting to the members (but not creditors) on the financial statements. If, as is normal, an auditor resigns, or does not seek re-appointment, following publication of the statutory financial statements and the accompanying auditor's report, it may be difficult to establish any justification for making an additional statement on ceasing to hold office as the company's auditor.

- 5.19 The position under UK company law can also be contrasted with the position under US SEC rules, which require explanations for a change in auditor in order that appropriate action can be taken by the regulatory body.

## EVIDENCE AVAILABLE TO AUDITORS

*This Appendix contains four short descriptions of the way in which the value of evidence available to auditors can be undermined. All are drawn from published material relating to each case.*

### EXAMPLE 1

**Banco Ambrosiano** had a banking subsidiary in the Bahamas which in the late 1970s and early 1980s purportedly made deposits of hundreds of millions of dollars with Istituto per le Opere di Religione (IOR), the state bank of the Vatican.

The auditors obtained written confirmations from IOR of its indebtedness at each year end. In respect of its creditworthiness the procedures which the auditors could use were constrained by the fact that IOR did not publish its accounts or any other financial information. The auditors relied on representations by the management of Banco Ambrosiano supported by assurances from a high-ranking official of IOR whom they contacted directly and by their own informal enquiries of external parties.

When Banco Ambrosiano collapsed, IOR denied responsibility for these deposits on the basis of a hitherto undisclosed letter from Robert Calvi, the chairman of Banco Ambrosiano, which instructed IOR to act simply in a fiduciary capacity and apply all monies received from the bank for the account of a company in Panama. The existence of that letter and of the arrangement to which it related had been hidden from the auditors by both Calvi and IOR.

### EXAMPLE 2

Following the ultimate success of its hotly contested bid for The Distillers Company, **Guinness** paid out very substantial sums in settlement of invoices from a number of different parties for what were variously described on the invoices in terms such as 'professional fees', 'advice' or 'consultancy' in connection with the bid. These invoices were approved at the highest level of Guinness management.

In fact the invoices were falsely expressed. They were actually in respect of indemnities and success fees to participants in an illegal share support operation.

### EXAMPLE 3

Evidence from criminal trials resulting from the collapse of **Bank of Credit and Commerce International (BCCI)** reveals the scale of the top management deception and third party collusion which underlay what is evidently the biggest banking fraud in history.



For example, BCCI made massive loans totalling more than US\$1 billion to the Gulf Group, a large international group of shipping companies run by Abbas Gokal. Both Gokal and the senior management of BCCI knew that the Gulf Group was in a very poor financial state and there was little or no prospect of the loans being repaid. A large part of this lending had to be made secretly so as to conceal the true position from the bank's auditors and regulators.

In order to maintain this secrecy, BCCI conspired with Gokal to create a complex structure involving large numbers of apparently independent companies which received large loans from BCCI but which were in fact sham companies secretly controlled by the Gulf Group.

At its headquarters BCCI had a separate 'Special Duties Department' dedicated to deceiving its auditors by fabricating thousands of documents to support the lending to these companies, including letters of introduction, loan documentation, financial statements, credit reviews, Board minutes and resolutions, and audit confirmations.

The aim was to create the impression that there was real and substantial commercial activity with genuine third parties and that the Gulf Group companies were keeping up interest payments on their loans, when in reality vast sums of money were simply going round in a circle every day between BCCI and the Gulf Group laundered through special conduit accounts at two New York banks.

Dr Pharaon was another major borrower from BCCI. BCCI procured two loans to Dr Pharaon totalling \$105 million from NCB, an unrelated bank. NCB made these loans on the condition of a guarantee from BCCI supported by the deposit with it by BCCI of an equivalent amount in cash, so that the whole of the risk was left with BCCI.

Senior officers of BCCI colluded with Dr Pharaon to conceal from the auditors the existence of the guarantee and the relationship between the deposit with NCB and the loans extended by NCB to Dr Pharaon.

Separately, and on a lesser but nevertheless substantial scale, the chairman of a publicly listed property group (Nazmu Virani of Control Securities plc) signed audit confirmations in respect of loans purportedly made by BCCI to private companies controlled by him. In fact the loans were bogus and the false confirmations were provided in order to deceive BCCI's auditors in return for benefits for Virani and his companies from BCCI in the form of cash and loans.

#### **EXAMPLE 4**

In the DTI report on **Barlow Clowes** the Inspectors identified the substantial income from 'software licensing' recorded in the Barlow Clowes partnership accounts as being '*one of the most clear-cut frauds amongst the large number of misdeeds described in this report*'. This income was said to derive from a major contract under which the computer operations were licensed to Hermes, a third party based in Gibraltar, which in turn licensed the software to a large number of other users.

Evidence was provided to the auditors to confirm the cash received under this agreement. It included copy invoices and statements, a copy of the license itself and a file of correspondence passing between Barlow Clowes and the managing director of Hermes over an extensive period. Senior management formally represented that there was no connection between Barlow Clowes and Hermes and that the income represented arms' length fees for services and facilities provided.

In fact Hermes was a sham; all the documentation was forged; and the cash received under the agreement came via a circuitous route from Barlow Clowes' own investors' funds.

## APPENDIX 2

### MATERIALITY

*The following table illustrates the differing perceptions that may exist about the significance of a fraud, depending upon whether the viability of the entity concerned is threatened as a result of the fraud and on the differing effects suffered by different groups.*

Parties affected by fraud	Company continues to trade		Company collapses
	Physical loss (theft of cash or assets)	Manipulation of accounts	Either physical loss or manipulation of accounts
<b>Company</b>	a) A one-off loss (profits and net assets are reduced). b) Reduction in earnings power, growth potential.	No loss (loss of investor confidence may lead to reduction in new capital available to finance it).	Loss including writing down of assets to break-up value.
<b>Shareholders</b>	a) Market value may decline; the P/E ratio may magnify the loss. b) Loss of a dividend.	a) Market value almost certain to decline; the P/E ratio will magnify the loss. b) lower future dividends.	Total market value of the company (asset value and future earnings).
<b>Employees</b>	No loss; but loss in company's earnings power may cause cuts in future pay rates/ bonuses.	No loss; but loss in company's earnings power may cause cuts in future pay rates/ bonuses.	Loss of future earnings (and, depending on nature/extent of fraud, compensation payments and pension rights).
<b>Creditors</b>	No loss.	No loss.	a) Loss of amounts owing (subject to security held over individual assets). b) Loss of future business.

**POSSIBLE AREAS FOR CHANGE TO AUDITING STANDARDS**

*The following table sets out areas in which changes to current Auditing Standards may help to increase the effectiveness of financial statement audit in relation to fraud, as discussed in Section 3 of this Paper. Incremental changes (paragraphs 3.2 to 3.4) are shown in light type. Section 3 also suggests that significant change in detecting management fraud needs more radical change, not all of which can be achieved through Auditing Standards. Areas of Standards which would need consideration in achieving radical change in detection of management fraud are shown in bold.*

Auditing Standard	Potential Areas for Clarification/Further Guidance
SAS 110: Fraud and Error	<ul style="list-style-type: none"> <li>• The effect of the overall control environment on fraud risks.</li> <li>• The use of more detailed assessments of fraud risks, distinguishing between               <ul style="list-style-type: none"> <li>- fraud and error, and</li> <li>- management fraud and fraud by employees or third parties.</li> </ul> </li> </ul>
SAS 210: Knowledge of the Business	<ul style="list-style-type: none"> <li>• More detailed guidance on establishing an understanding of               <ul style="list-style-type: none"> <li>- the nature of business and its susceptibility to fraud,</li> <li>- management’s processes, culture and interests.</li> </ul> </li> </ul>
SAS 240: Quality Control for Audit Work	<ul style="list-style-type: none"> <li>• More specific guidance on               <ul style="list-style-type: none"> <li>- assignment of staff to high risk audits</li> <li>- direction, supervision and review of their work.</li> </ul> </li> <li>• More specific requirements for               <ul style="list-style-type: none"> <li>- quality control responsibilities of the audit engagement partner</li> <li>- arrangements for consultation within the audit team and with other parts of the audit firm.</li> </ul> </li> </ul>
SAS 300: Accounting and Internal Control Systems and Audit Risk Assessment	<ul style="list-style-type: none"> <li>• Requirement for more structured approach to the evaluation of               <ul style="list-style-type: none"> <li>- overall control environment</li> <li>- more detailed systems of controls.</li> </ul> </li> <li>• Clearer link between risk assessments and subsequent audit procedures.</li> </ul>
<b>SAS 400: Audit Evidence</b>	<ul style="list-style-type: none"> <li>• <b>More emphasis on applying scepticism to the consideration of the</b></li> </ul>

Auditing Standard	Potential Areas for Clarification/Further Guidance
	<p><b>quality of evidence, for example</b></p> <ul style="list-style-type: none"> <li>- in determining evidence needed when ‘fraud flags’ exist</li> <li>- in relation to management representations</li> <li>- where evidence obtained from different sources is not consistent.</li> </ul> <ul style="list-style-type: none"> <li>• <b>More emphasis on independent corroboration of evidence from the company/ directors.</b></li> <li>• <b>Consider cost/benefit of specifying particular types of audit evidence or procedures (eg. attendance at stocktaking, circularisation of third parties etc).</b></li> </ul>
SAS 410: Analytical Procedures	<ul style="list-style-type: none"> <li>• More detailed guidance on the limitations in use of analytical procedures as a substantive procedure.</li> <li>• Clarify circumstances when analytical procedures are less likely to be reliable (e.g. where there is a high risk of management fraud).</li> </ul>
<b>SAS 440: Management Representations</b>	<ul style="list-style-type: none"> <li>• <b>Strengthen existing standard concerning the acceptance of management representations as audit evidence.</b></li> <li>• <b>Provide guidance on circumstances where management representations may be called into question and where auditors should apply higher levels of scepticism.</b></li> </ul>
SAS 460: Related Parties	<ul style="list-style-type: none"> <li>• Consider value of more detailed guidance for auditors on determining the existence of related parties, identifying transactions with related parties and examining identified related party transactions in the context of the risk of management fraud.</li> </ul>
SAS 500: Considering the work of Internal Audit	<ul style="list-style-type: none"> <li>• Provide more detailed guidance on developing effective working relationship and internal audit on subjects such as fraud.</li> </ul>
SAS 510: The Relationship Between Principal Auditors and Other Auditors	<ul style="list-style-type: none"> <li>• More detailed guidance on the role of the principal and other auditors where there is the potential for fraud. (e.g. significant intra-group transactions, different reporting requirements/period ends etc).</li> </ul>
<b>SAS 600</b>	<ul style="list-style-type: none"> <li>• <b>Require auditors to give information on areas in which they have relied on management representations in reaching an unqualified opinion.</b></li> </ul>
SAS 610	<ul style="list-style-type: none"> <li>• Added emphasis on reporting concerns about fraud risks to an audit committee. Guidance on substitute procedure in entities with no audit committee.</li> </ul>

## **NOTICE TO READERS**

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