

## RESTORING TRUST IN AUDIT AND CORPORATE GOVERNANCE

Issued: 08 July 2021

The Fraud Advisory Panel welcomes the opportunity to comment on the Department for Business, Energy & Industrial Strategy's consultation on restoring trust in audit and corporate governance (CP 382), launched on 18 March 2021, a copy of which is available from this [link](#).

We are very happy to discuss any aspect of our comments and to take part in all further inquiries on the issues we've highlighted to BEIS.

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## GENERAL COMMENTS

1. The Fraud Advisory Panel welcomes the opportunity to respond to the Department for Business, Energy & Industrial Strategy (BEIS) consultation on *Restoring trust in audit and corporate governance: proposals on reforms*, launched on 18 March 2021.
2. Our response has been prepared by a small steering committee of our members and has also been informed by a series of short surveys conducted with our wider membership in early 2020 on the recommendations as set out in Sir Donald Brydon's report into the quality and effectiveness of audit (the Brydon Review)<sup>1</sup>.
3. We have limited our response to the issues of fraud (Chapter 6.4) and whistleblowing (Chapter 11.7) set out in the consultation paper and agree with the Government's view that a holistic approach to tackling fraud is needed.
  - a. While we do not specifically respond to questions relating to broadening the definition of Public Interest Entities (chapter 1.3, Questions 1 to 11), we support enhancing directors' and auditors' responsibilities to tackle fraud beyond Public Interest Entities.
  - b. While we do not specifically respond to questions relating to stronger internal company controls (chapter 2.1, Questions 12 to 14), we support strengthening the internal control framework to manage risk, encourage good practice, and help tackle fraud, including requirements on directors to explain the adequacy of their internal controls over financial reporting.
4. The Fraud Advisory Panel (the 'Panel') is the UK's leading counter fraud charity. We act as the collective voice of the counter fraud profession and provide practical support to almost 300 corporate and individual members. Our members come from a wide range of professions and sectors who are united in their determination to stop fraud.

## TACKLING FRAUD

### Question 42

Do you agree with the Government's proposed response to the package of reforms relating to fraud recommended by the Brydon Review? Please explain why.

5. Yes. Fraud is a significant and increasing threat to the UK and requires a whole system approach to tackling it. Clarifying the roles and responsibilities of directors and auditors in respect of material fraud – and making these more explicit – is an important step towards achieving this goal.

<sup>1</sup> Brydon, Sir Donald (December 2019). *Assess, Assure and Inform. Improving audit quality and effectiveness. Report of the independent review into the quality and effectiveness of audit.*

6. Some internal frauds (including financial statement fraud) occur over multiple financial years before being detected. Research suggests that the longer they remain hidden, the greater the financial loss.<sup>2</sup> Therefore it is important that frauds are detected early to limit losses. However, based on experience from studying past fraud cases, they are often concealed over a period of time by the perpetrator(s), thus making them difficult to detect through controls or internal and external audits. While these recommendations will not stop fraud, we believe they will go some way to detecting frauds earlier and hopefully lead to lower losses.
7. Both the Brydon review and current consultation make recommendations in respect of material fraud in financial statement reporting only. We consider that the distinction between material and non-material fraud warrants further clarification by Government so that the concept of 'materiality' is more easily understood by the public at large and therefore better addresses the expectation gap which currently exists.
8. We note that auditors are focussed only on financial statement fraud. Small scale fraud, perpetrated against a company by customers, suppliers or executives, does not necessarily result in the financial statements being materially misstated. However, it is possible for a large number of small frauds to have a material impact over time. Care, therefore, needs to be taken to ensure that users of the accounts do not assume that fraud does not exist within a company simply because the auditors have not detected it.

### **Directors' responsibilities and related reporting**

9. We strongly support proposals to introduce legislation to require directors of Public Interest Entities (PIEs) to report on the steps they have taken to prevent and detect material fraud, subject to our comments in paragraphs 7 and 8 above. We also believe there is merit in requiring directors to support this disclosure with a fraud risk assessment or explain why they have not performed a fraud risk assessment.
10. This will improve transparency and reinforce the responsibilities of directors and may also lead to a greater overall focus on managing the risk of fraud within entities. It should also make it easier for auditors to review and understand the steps taken by directors to prevent and detect fraud and to seek (and receive) supporting evidence.
11. Furthermore, it might make directors more reluctant to engage in aggressive accounting practice or illegal activities and assist with enforcement action against those that do. Although we consider the potential meaningful risk of personal liability of directors as a positive deterrent, we note that it is unlikely to deter directors who are determined to commit fraud and is not a silver bullet.
12. The introduction of this new requirement should be accompanied by supporting guidance to assist directors to fulfil their responsibilities properly and the Corporate Governance Code would seem to be an appropriate mechanism to do this for premium listed companies.

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<sup>2</sup> Association of Certified Fraud Examiners (2021). [\*Report to the Nations: 2020 global study on occupational fraud and abuse\*](#). (Financial statement fraud typically lasts two years before being discovered).

13. We note that companies can be subject to a wide variety of fraud committed by internal and external actors or a combination of both. Therefore, it is crucial that any such guidance provides a clear, unambiguous explanation of what constitutes ‘material fraud’ and the types of fraud included in this context to avoid setting unrealistic expectations in the eyes of the public that cannot be met.
14. Consideration may also need to be given to how the requirement will fit with the outcome of the Law Commission’s current consultation on corporate failure to prevent and corporate criminal liability offences and any guidance created thereunder.<sup>3</sup>

### **Auditor’s responsibilities regarding fraud detection**

15. We note that the Financial Reporting Council (FRC) has now released the revised UK auditing standard on the responsibilities of auditors in relation to fraud [ISA \(UK\) 240](#). Timing-wise this is a little bit out of sync with the current consultation and the new obligations on directors being proposed (see paragraphs 9 – 14 above).
16. In our view, a more joined up and holistic approach could have achieved a more immediate practical benefit in addressing the public expectation gap. However collectively this package of reforms should improve transparency and accountability in respect of fraud and help address the expectation gap in respect of the auditor’s role in detecting fraud.<sup>4</sup>

### **Auditor reporting on fraud**

17. We broadly support proposals to legislate to require auditors of PIEs (as part of their statutory audit) to report on the work they have performed to conclude whether the directors’ statement on the actions taken to prevent and detect material fraud is factually accurate, subject to the following caveats.
  - a. The Brydon Review recommended that ‘...the auditor’s report state explicitly the work performed to conclude whether the directors’ statement regarding the actions they have taken to prevent and detect material fraud is appropriate...’<sup>5</sup> rather than ‘factually accurate’ as set out in the current consultation.
  - b. In our view this wording is not ideal and does not reflect traditional audit terminology. The preparation of financial statements involves significant elements of judgement, and there is typically a range of acceptable application of accounting standards. For this reason, auditors provide ‘reasonable assurance’ rather than absolute assurance as to ‘factual accuracy’. Similarly, the actions taken by directors is unlikely to be something that can be assessed easily as true or false /

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<sup>3</sup> Law Commission (June 2021). [Corporate Criminal Liability: A discussion paper](#).

<sup>4</sup> Fraud Advisory Panel (January 2020). [A response to the Financial Reporting Council consultation on the revision of the International Standard on Auditing ISA \(UK\) 240 \(updated January 2020\): The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements](#).

<sup>5</sup> Brydon, Sir Donald (December 2019). [Assess, Assure and Inform: Improving audit quality and effectiveness](#). (see paragraph 14.3.5)

factually accurate or inaccurate. The word 'factually' implies more certainty than is likely to be possible.

- c. Furthermore, even if the auditor were able to determine whether the directors' statement was accurate, the term 'accurate' itself does not provide any indication as to whether the actions taken to prevent and detect material fraud are appropriate or sufficient for the size and industry of the entity and where it operates.
  - d. Ultimately, whichever term is used will need to be clearly defined with supporting guidance for auditors to ensure a consistent approach and interpretation is adopted.
18. We are mindful of the relationship between the auditor and an entity's directors and believe that careful consideration needs to be given to ensuring that auditors are not seen to be responsible for policing directors. In our view this would create an unhelpful relationship between audit client and audit firm which could compromise the quality of the audit. Furthermore, it may not drive the best outcomes for fraud prevention and detection.
19. We support proposals to require auditors to report on the steps they have taken to detect any material fraud and to assess the effectiveness of relevant controls. We note that this information is already included in some audit opinions and welcome the enhancement and standardisation of these. We believe that this is more important than the need for auditors to report on whether the director's statement is accurate and will improve transparency, make material fraud a more prominent part of the audit, and bring fraud to the forefront of auditor's minds rather than being treated as a tick box exercise.

### **Auditor education and skills**

20. It is crucial for auditors to receive fraud awareness training both as part of their formal qualification and continuous learning requirements. Such training should focus on highlighting the areas of key fraud risk in audit, how fraud can manifest itself (i.e. red flags) and how it can be detected so that auditors can recognise the circumstances when further investigation is needed.
- a. Fraud awareness should feature more prominently within the syllabus for those studying professional audit qualifications.
  - b. Audit firms should provide access to frequent and up-to-date training on fraud awareness, prevention and detection, utilising the expertise of their inhouse forensic teams where possible and appropriate. Fraud courses are also widely available from third-party providers, including the Fraud Advisory Panel.
  - c. Professional bodies and regulators should play an active role in encouraging audit firms to improve and maintain fraud awareness amongst their staff. This could include the introduction of requirements on auditors to complete continuing education on fraud (either generally or more specifically on fraud affecting the

financial statements) which meets minimum standards set by the professional bodies. We note that such requirements exist in other jurisdictions.<sup>6</sup>

21. Furthermore, we believe that there should be closer cooperation between audit and forensic teams within firms so that auditors can (where appropriate) draw upon forensic expertise.

### Fraud register

22. We agree that a fraud case study register could provide a useful educational tool for auditors but recognise that such a register would be difficult to manage and maintain and question whether resources could be better used elsewhere. Examples of fraud are already available in the public domain and could be signposted to instead.
23. Nonetheless, should the Government determine that a fraud register is needed then we believe that it should fall under the remit of the ARGA rather than audit firms collectively to ensure it is affordable and accessible to the entire audit services market.
24. The identification of suitable case studies for inclusion on the register could form part of ARGA's enforcement activities with the facts of individual case studies being agreed as part of any settlement. Because these cases are often high profile it is likely that much of the relevant information will already be in the public domain, thus addressing some of the issues of confidentiality. Such case studies would still, however, enable auditors to learn from real life examples to better understand the circumstances in which fraudulent financial reporting can be committed, how it can go undetected, and what ARGA considers to be the failings in terms of auditing standards.
25. Any case studies included on such a register will need to be anonymised.

### **Enforcement decisions**

26. We agree with the Government's view that arrangements for determining the culpability of auditors in fraud-related cases should not differ from those applying to other cases. The FRC's Audit Enforcement Procedure already provides for an independent and impartial decision-making Tribunal and we are unconvinced that any additional benefit would be derived from establishing a new panel that looks only at fraud.

## **WHISTLEBLOWING**

27. Overall, we broadly support the Brydon Review's recommendation that whistleblowing protections should be extended from employees to encompass other individuals with a direct economic relationship to the audited entity but believe that this should form part of a wider review of UK whistleblowing arrangements and/or corporate reform.

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<sup>6</sup> For example, Certified Public Accountants that are licenced to practice by the State of California must complete fraud training every two years. See the California Society of Certified Public Accountants (CalCPA) [CPE Requirements \(calcpa.org\)](https://www.calcpa.org/cpe-requirements).

28. Whistleblowing plays an important role in the prevention and detection of corporate fraud. Research conducted by the Association of Certified Fraud Examiners (ACFE) has consistently found that most internal frauds are uncovered through tips, usually from employees, but also from outside parties such as customers, vendors and competitors. It is worth noting that very few of these reports are made to the external auditor.<sup>7</sup>

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<sup>7</sup> Association of Certified Fraud Examiners (2021). [\*Report to the Nationals: 2020 global study on occupational fraud and abuse.\*](#) This first report in this series was published in 1996.