PricewaterhouseCoopers

ViewPoint

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Fraud

Fraud – time for straight-talking and constructive action*

*connectedthinking

Why talk?

Fraud has a corrosive and far-reaching impact on all key stakeholders in a business enterprise: employees, owners, investors, lenders, governments and regulators, and auditors. It comes as no surprise then that fraud prevention has become a major global industry in its own right, with a plethora of legislative checks and balances sitting alongside new money-laundering and whistle-blowing regulations. However, more needs to happen.

Our experience suggests that the time has come for key stakeholders to commit to greater openness in the dialogues already taking place on fraud. It is our view that the complexity and enormity of this threat can only be effectively combated once truly constructive and frank conversations start to take place.

In this paper we quote findings from PwC's 2005 biennial Global Economic Crime Survey of over 3,600 senior executives around the world.

45% of the 3,634 companies we surveyed reported suffering at least one significant fraud during the preceding two year period, regardless of company size or industry sector.

Understanding the fraud spectrum

Controls, regulations and standards are an important component of the drive to combat fraud, but they alone cannot contain this pervasive risk. Because fraud is about human and organisational behaviour, as well as individual and corporate values, it is a difficult concept to grasp. This leaves scope for misinterpretation, incompatible objectives and impaired efficiency when it comes to prevention, detection and remediation. Identifying when and where an organisation is at risk is one of the core challenges.

The danger of fraud is exacerbated by the fact that it not only affects all stakeholders but it does so in very different ways. One of the main difficulties is setting the boundaries. Where does the legitimate use of judgement, for example in cases where revenue recognition requires a degree of judgement, cross the line into deliberate manipulation? Where does an excess of caution in setting a reserve become improper earnings management? When do gifts or corporate entertainment become bribery?

The answer, of course, has a lot to do with intent. But because this is a state of mind, it is difficult to pin down. At heart, fraud is one person deceiving another, either by providing false information or by withholding critical information, and it operates in the grey areas that routinely exist between people in different business roles. That is to say, between managers and their board overseers, between companies, vendors and customers, between executive and non-executive management and between subsidiaries and head-offices – as well as between clients and their auditors. Cultural norms in some countries mean that it is practically a taboo subject for discussion.

The different types of fraud risk and the ways in which they evolve, make it hard to draw a line in the sand. What was 'acceptable' behaviour a few years ago may be viewed as deceptive practice today. And because most frauds are committed by first-time offenders, it is impossible to predict when and where human behaviour will change – from the post-room to the boardroom.

We recognise that governments around the world have different approaches to fraud and accordingly we recommend that corporate actions be consistent with, and take full account of, local legal requirements.

Fraud is a many-headed beast and fighting it is often problematic because of the fog of cultural differences, grey areas and subjectivity. Plain-speaking and grown-up conversation are the best way of gaining a clear understanding of this threat.

Know your enemy

Fraud and financial statement manipulation span a broad spectrum. Some of the most commonly-used terms (and what they include), are listed below:

- **Fraudulent financial reporting** – deliberate accounting misstatements, accounting manipulation, the creation of fictitious transactions and records and/or intentionally inaccurate or incomplete disclosures with the intention of misleading users of the accounts.
- **Asset misappropriation** – straightforward theft of cash, securities, inventory or fixed assets, the circumvention of company controls and procedures (e.g., procurement and payroll fraud), the theft of business secrets or other intellectual property and the diversion of revenues, asset stripping and other breaches of fiduciary duty.
- **Unauthorised receipts and expenditures** – an umbrella term for engaging in corrupt business practices to influence the awarding of business opportunities, or subverting government objectives.
- **Disclosure fraud** – intentionally providing inaccurate or incomplete information, not just limited to the financial statements in order to paint a false picture.
- **Aiding and abetting** – facilitating the misconduct of others, e.g., entering structured financial transactions designed to assist the client or a business partner in manipulating its financial statements.

A common interest in deterring fraud

Each time a significant fraud comes to light, trust in the integrity of the capital markets is undermined and this affects all the key participants in these markets. Nor is the fall-out from fraud limited to quantifiable bottom-line costs for the companies concerned. In fact, the collateral impact is often devastating, resulting in reputational damage and loss of market confidence, damaged business relationships, impaired credit ratings, increased audit and legal fees, exposure to litigation, higher insurance premiums and CEO/CFO displacement and even bankruptcy.

In the wake of fraud incidents, 40% of the companies responding to our survey indicated that they had suffered significant 'collateral damage', such as loss of reputation, decreased staff motivation, and declining business relations.

The effective control of fraud and management misconduct does not just mitigate these risks. It can also deliver numerous benefits by:

- Maintaining faith in the capital markets
- Reducing the cost of capital
- Reducing legal, compliance and regulatory risks
- Providing cost-saving opportunities
- Enabling successful entry into high-risk markets, products and services
- Protecting the most valuable asset for any company – its reputation.

More generally, the enhancement of controls to mitigate fraud risks can also help to reduce costs across the business by exposing other operational inefficiencies (as many SEC-registered companies have discovered following compliance with s404 of Sarbanes-Oxley).

It's time for constructive dialogue

Because there are so many aspects to this threat, so many grey areas and so many interests involved, it has become increasingly difficult to pinpoint where key risks lie – as well as who should be assuming responsibility for combating them.

This issue of ***ViewPoint*** asks what can be done – by all stakeholders – to address this situation by initiating a more constructive dialogue about fraud. More specifically, it asks what those who sit in the full glare of the corporate governance spotlight (auditors, executive and non-executive management) can do to shift the dynamics of the conversations between these parties to create constructive channels of communication.

This is particularly timely in light of the ongoing regulatory agenda calling for adjustments to auditor/client relationships. As a profession, audit firms are being encouraged to become even more sceptical and questioning in the way they approach audit assignments (the auditing standards ISA 240 and SAS 99 are clear manifestations of this trend).

While we do not necessarily accept that concerns about the quality of auditor/client relationships are warranted in all cases, we nevertheless welcome any development that constructively supports and improves the effectiveness and rigour of audits for the benefit of all stakeholders.

Part and parcel of good corporate governance and financial reporting is an open, frank series of conversations between those preparing financial information, the audit committees[1] that monitor their effectiveness and the external auditors that must sign off on company accounts before they reach the capital markets.

1 In this ViewPoint, our reference to 'audit committees' is construed broadly to include non-executive or supervisory boards in countries where audit committees are less prevalent.

The challenge of fraud deterrence is too extensive for any one group to shoulder alone.

Who needs to talk?

It is precisely because of the far-reaching damage wreaked by fraud on companies of all sizes that all the key stakeholders have a vested stake in ensuring that this risk is properly controlled. This risk is in addition to the general exposure to civil and criminal liability. Specifically, these groups are:

- Individual and institutional owners and investors who lose money when frauds take place, sometimes with devastating consequences
- Governments and regulators, whose effectiveness in maintaining orderly, corruption-free commerce and a secure capital market environment is called into question
- Management and supervisory boards, who suffer loss of personal and corporate reputation
- Senior and middle management who face disciplinary action for poor oversight, sometimes resulting in ruined careers
- Auditors who face regulatory action, civil lawsuits and high practice protection costs, as well as damaged reputations.

What should they be talking about?

The challenge of fraud deterrence is too extensive for any one of the above groups to shoulder alone. Each has an important part to play in understanding the scope of this challenge, as well as the part it has to play in building a climate of co-operation. Each should therefore be encouraged to reassess its contribution to the dialogue that needs to take place.

Investors. This diverse community ranges from financially powerful institutions to individuals of modest means, and from private equity houses to members of occupational pension funds. Their key challenge is to find a common voice with which to assert their interests. Whether by forcing companies to be more transparent about the steps they are taking to control fraud risk, or by challenging audit committees to show how they are holding management to account, investors should be doing more to ensure that their voice is being heard.

Governments and regulators. Because their principal concern is to maintain a secure and stable environment for capital markets, it is understandable that they should feel compelled to intervene decisively. However, their involvement needs to extend beyond the imposition and policing of rules. They need to be continually assessing the effectiveness of existing regulations, evaluating relative costs and benefits, and this means establishing effective communication channels with all stakeholders.

The best approach is for governments and regulators to understand the impact that fraud has on the capital markets and that a policy of ‘confess and remedy’ rather than ‘confess and be punished’ is likely to have greater benefit for all capital market participants.

It is, however, the roles and responsibilities of companies and auditors, as well as the relationship that exists between them, which forms the crux of this debate.

Companies (management <u>and</u> audit committees). Because the production and dissemination of financial and other performance-related information is rigorously regulated, a checklist, compliance-obsessed mentality can take root in some companies. It is essential that management and audit committees are aware of what more they should be doing to build an organisation-wide commitment to best practice processes and controls. In practice, this means that management and audit committees should reassess the completeness and accuracy of the information that they exchange, discussing whether it is sufficiently comprehensive and objective to serve the corporate decision-making process which it is intended to support. They should also be having this discussion with their external auditors.

In 89% of financial misrepresentation cases, which can lead to the most significant financial losses and penalties, companies only saw fit to inform their Boards of Directors in 84% of cases – and the audit committee in only 50%.

Auditors. Both auditors and management have been affected by the dramatically increased focus on the role of internal controls in combating fraud. Most radically, the role of auditors for US-listed companies has been extended (by Auditing Standard 2 issued by the PCAOB) to include attestation not only on the financial statements themselves, but also on the effectiveness of internal controls over financial reporting. Certainly auditors are not looking to shirk these responsibilities; indeed it is very much in their own interests that clients should protect themselves from fraud and business misconduct by establishing adequate controls.

Over a third of frauds (34%) are most commonly detected by chance (e.g., through tip-offs), however, internal audit is the single most successful control for detecting incidents of fraud, playing a role in the initial discovery of 26% of cases reported.

To ensure that the audit process is as efficient as possible, auditors need to be engaging their clients (at executive and non-executive levels) in a serious and frank dialogue about the nature and scope of the work they do – confronting client expectations and reassessing roles and responsibilities. Where management expects audit to play a part in fraud detection, these discussions might centre on the need for forensic audits that go beyond the scope of the normal audit.

Now is an ideal time to start building the foundations for these dialogues. Certain auditing standards (SAS 99 in the US and ISA 240 internationally) envisage, in quite specific terms, a dialogue taking place between auditors and company management on the subject of fraud. As a result, management boards are already scrutinising the dynamics of the relationships – and the conversations – that they have with their external auditors.

Openness is the keystone around which these dialogues must be built.

Fraud is, at root, a people issue.

Taking a new look

Openness is the lynchpin of effective fraud control – and this openness should characterise the relationships that exist between management boards and audit committees, as well as the relationships that each of these groups has with the organisation's external auditors.

1 Where to start?
If these relationships are to be robust foundations for effective fraud risk assessment, they must be grounded in the right mindset. With fraud, no area of the business is off-limits. This means that management boards, audit committees and auditors must be prepared to adopt an open mind. Put bluntly, it means starting with a blank sheet of paper and asking some basic questions, such as:

- What is the nature of the business?
- What is the prevailing organisational culture?
- What transactions and processes does the business entail?
- What vulnerabilities do these open up – in other words, what might go wrong?

Despite the growing number of companies reporting fraud year-on-year in our surveys, only 21% of those interviewed consider it likely that their company will be a victim of fraud over the next five years.

While management integrity and effective controls are vital components in an effective anti-fraud environment, no meaningful assessment of fraud risk can start with preconceptions about either. Where management is concerned, past performance is not necessarily a guide to future performance. Fraud is, at root, a people issue and people are notoriously changeable creatures. Controls, meanwhile, can become ineffective over time, they can be circumvented and they can be overridden. Focusing on controls too early in the process only increases the likelihood that previously unidentified (or underestimated) risk areas will continue to be overlooked.

2 Recognising the warning signs
Having established this open mindset, how best to recognise the warning signs? First and foremost, it is essential that management boards, audit committees and auditors share

a common understanding of the types of fraud to which the business is exposed, as well as particular areas of vulnerability. A useful approach is to consider whether certain risk factors (categorised below) are present in the organisation:

- incentives/pressures
- opportunities
- rationalisations/attitudes.

Consideration of incentives and pressures focuses attention on factors operating on, or within, a company that might motivate management or others to commit fraud. The opportunities dimension covers those aspects of the business which could facilitate fraud – complexity and judgement in revenue recognition or asset valuation, large-scale or decentralised structures, or activities in countries where different standards of corporate governance apply, to name but a few of the many possibilities. Rationalisations and attitudes encompass features within organisational cultures indicating attitudes to fraud risk and prevention.

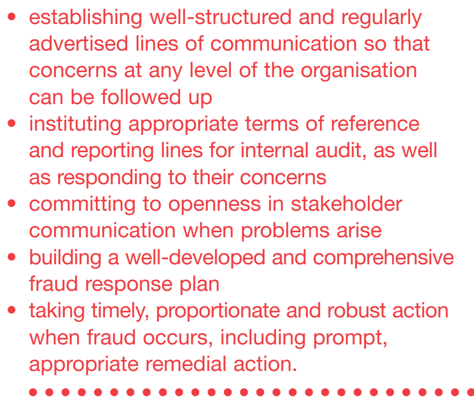
By adopting this framework for an ongoing, iterative process of fraud risk assessment, management would not only develop a keen awareness of specific vulnerabilities, it would also ensure that conversations with external auditors could be conducted in a commonly-understood language.

3 Embedding an anti-fraud culture

The attitude of management and audit committees to fraud risk assessments and the manner in which these attitudes pervade the company are central to the effectiveness of any anti-fraud regime. A clear message of 'zero tolerance' of fraud and other impropriety must be consistently conveyed at every opportunity. This means improving the quality of conversations between management and audit committees, inviting the constructive evaluation and criticism of executive management's response to fraud risk. A commitment to openness in these conversations plays an important part in establishing an organisation-wide culture of transparency. See below for other important factors.

Besides setting a 'tone from the top', effective anti-fraud cultures are built by:

- implementing high-quality codes of conduct
- making business unit leaders individually accountable for fraud in their own area of responsibility



- establishing well-structured and regularly advertised lines of communication so that concerns at any level of the organisation can be followed up
- instituting appropriate terms of reference and reporting lines for internal audit, as well as responding to their concerns
- committing to openness in stakeholder communication when problems arise
- building a well-developed and comprehensive fraud response plan
- taking timely, proportionate and robust action when fraud occurs, including prompt, appropriate remedial action.

4 Now we're ready to talk

Having carried out an adequate risk assessment and taken steps to promote an appropriate anti-fraud culture, management is ready to talk to the organisation's external auditors. The groundwork has been done and there can be a meaningful agenda for discussion.

The dialogue that ensues will only be constructive if management recognises that an open, frank conversation is to the advantage of all concerned, and if auditors are mindful of the limits of their statutory responsibilities – and alert to any expectation that they should be providing a forensic audit. This spirit of openness will ideally spill over into all the overlapping conversations that need to take place. In this way, management boards and audit committees will benefit from a more constructive dialogue between themselves, with other parts of the organisation and, crucially, with the external auditors.

Once this happens, there will be the basis for an unambiguous allocation of key roles and responsibilities. Specifically this means that management boards will assume responsibility for addressing risk controls. Audit committees will recognise their responsibility for challenging management performance. And auditors will form their own views on, and tailor their audit approach to the key fraud risks, evaluating anti-fraud programmes and controls at multiple levels and assessing the stance taken by both management and audit committees. They must be prepared to probe and ask difficult questions. And they must, where the situation arises, recognise and respond to any warning signs that management is itself engaged in fraudulent conduct.

The element of 'planned unpredictability' that must now be introduced into the statutory audit will help to usher in a change of relationship between management, audit committees and auditors that should provide the impetus for new, more constructive dialogues between these key stakeholders.

Towards effective fraud prevention

All business community and capital markets stakeholders have a vested interest in these dialogues taking place – and succeeding. The stakes are high. Companies risk squandering hard-won reputational capital if they fail to measure up to the expectations being placed on the integrity of their executive and non-executive management.

Openness is the key: openness to the possibility of fraud; openness to dialogue within the company and between management/audit committees and auditors about the risks and incidences of fraud; and openness with regulators and investors to demonstrate a commitment to building healthy anti-fraud cultures – and to taking decisive action when fraud occurs.

If you would like to discuss any of the issues raised in this paper please contact

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