SHARPENING THE FOCUS ON CORPORATE FRAUD

AN AUDIT FIRM PERSPECTIVE

ICAEW

CONTENTS

EXECUTIVE SUMMARY

Trust is hard won, and easily lost. The objective of an external audit is to provide confidence in the quality of financial reporting and improve trust in the corporate reporting regime more widely. When a company fails because of fraud, or a fraud is uncovered not long after an unqualified audit report has been issued, it damages stakeholder trust in financial reporting, as well as audit quality, auditors and, in particular, the audit firm involved. Reputational damage spreads far and wide.

Many players in the financial reporting ecosystem – not just auditors – directly or indirectly influence the quality and reliability of financial reporting and the likelihood that fraud will be prevented or detected. There is, however, a public perception that auditors can and should be doing much more to deter and detect fraud and prevent the unexpected failure of large UK companies due to fraud.

In late 2021, ICAEW spoke to auditors at the largest UK audit firms to learn more about the reality of fraud, to support a better-informed discussion about what is being done to improve the likelihood that auditors will detect it. This snapshot of recent and ongoing audit firm initiatives helps demonstrate the direction of travel and the scope, scale and significance of the transition that is happening across the audit profession, as firms take steps to better facilitate fraud deterrence and detection.

There are significant behavioural, logistical and other impediments to the timely apprehension of fraud. This publication describes the significant resources devoted to fraud-related activities within individual audit firms, and across the profession. Firms have developed self-improvement aims, objectives and plans, and introduced new initiatives to effect change within their own firms and in the wider financial reporting ecosystem. As Sir Donald Brydon noted in his December 2019 independent review into the quality and effectiveness of audit: it is directors and management who have the primary responsibility for deterring and detecting fraud.

Auditors, who do not set out to miss, ignore or perpetrate corporate fraud, believe that the glare of the anti-fraud spotlight too often focuses on them alone. Audit firms do not operate in a vacuum and they are not the only stakeholders whose influence and responsibilities have a significant impact on fraud deterrence and detection. Auditors believe that regulators too often take the easy way out by further regulating what is already regulated – audit. Auditors argue that regulators should instead face up to the challenge of seeking to regulate more directly the activities of those charged with the governance of entities, whose shareholders are the victims of frauds perpetrated by those entities.

We reflected on what we heard, and we have included in this publication a series of recommendations for consideration by audit firms, company directors, and government and audit regulators. The recommendations are summarised and grouped together below. They explain what more we believe can be done, and what can be done differently, by all of these groups to better deter and detect fraud, and thereby reduce the risk of disorderly corporate failure. We also set out what we think stakeholders can and should be doing now, in anticipation of the expected audit reforms reflected in the government's May 2022 response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems (the 'Feedback Statement').

SUMMARY OF RECOMMENDATIONS

Audit firms

- **consider doing things differently**: assess the need for greater specialist and forensic involvement at all stages of the audit, on a risk-assessed basis; step up efforts to change ingrained cultures, behaviours and mindsets.
- **consider doing more:** reinforce professional scepticism; embed fraud-related learnings across the firm; widen the scope of the risk assessment using external data and information; encourage the robust challenge of management.
- **prepare for change**: consider the implications of management and voluntary auditor reporting on internal controls; engage with investor representatives on the implications of and need for audit committees to develop audit and assurance policies.

Executive and non-executive directors

- **consider doing things differently**: reconsider the adequacy of the company's current approach to fraud risk management.
- **consider doing more**: better understand auditors' concerns about the risk of fraud and re-evaluate the overall company ethos.
- **prepare for change**: renew efforts to engage all stakeholders in the audit process; consider the value of evaluating and reporting on internal controls; develop an audit and assurance policy.

Government and audit regulators

- **consider doing things differently:** involve all stakeholders in a debate about fraud risk management to inform new fraud-related requirements for companies and related requirements for auditors.
- **consider doing more:** share more and better-quality examples of best practice in fraud deterrence and detection for auditors; engage with HMRC, the FCA and others to enable more effective sharing of fraud-related learnings; enforce existing sanctions against those who mislead auditors; share more and better-quality examples of best practice in fraud risk management for companies.
- **prepare for change:** encourage recognition among international auditing standard-setters of the increasing importance of technology; consider the role of sanctions in an improvement regime; encourage best practice among audit committees.

Auditors have risen to the challenge in response to heightened expectations around fraud and are continuing to do so. The initiatives the firms have implemented, by re-setting expectations, re-defining relationships, changing mindsets and utilising specialist skills and tools have laid the foundations for a more robust, challenging and effective audit. The current audit reforms require more of audit firms and it seems unlikely that they will shy away from the task. What is less certain is whether others in the financial reporting ecosystem will follow suit.

INTRODUCTION

Defining fraud

Fraud is a complex issue, with misunderstandings rife around what constitutes fraud and at what point auditors can be expected to spot it. Illegality is not always immediately obvious – and not just to auditors – and the difference between error and fraud can be unclear.

Financial reporting fraud can develop over time, when initially legitimate company practices and judgements become more aggressive and subjective over several reporting periods. The fine but critically important line between 'borderline acceptable' accounting practices, and fraudulent financial reporting, is not always immediately obvious. Asset fraud tends to be more common and somewhat easier to spot than financial reporting fraud, but often involves smaller values. Despite this, both types of fraud can cause a material misstatement in the financial statements.

Fraud is defined in law in general terms, which must be applied to the specific facts of any case, and always requires a dishonest state of mind. Any serious discussion about fraud must acknowledge the complexities in determining its existence, whether it is material, the line between fraud and error and the point at which auditors can be reasonably expected to detect it. There are no simple or definitive answers to these questions. But without greater awareness of these grey areas, they will continue to hamper a properly informed debate about what more can be done, and by whom, to deter and detect fraud.

Regulator and auditor responses to heightened concerns about fraud

Concerns were expressed in the 2019 Brydon review about many aspects of audit and corporate governance, including fraud. Among the recommendations made by that review were for the UK audit regulator and auditing standard-setter, the Financial Reporting Council (FRC), to revisit the UK requirements for auditors relating to fraud and, in particular, to clarify auditors' objectives relating to fraud in a financial statement audit.

The FRC responded promptly. In October 2020, it consulted on proposals to revise the auditing standard on fraud, ISA (UK) 240, designed to clarify auditors' obligations, enhance the risk assessment and set out clearer procedural requirements. These were limited scope amendments made in anticipation of the more root and branch review expected from the International Auditing and Assurance Standards Board (IAASB). In November 2019, the FRC also revised the auditing standard on audit reports ISA (UK) 700, to extend a requirement for auditors' reports to 'explain to what extent the audit was considered capable of detecting irregularities, including fraud', to apply to all audits, not just audits of public interest entities (PIEs) as previously.

However, the FRC has not, to date, taken action to strengthen accountability within UK companies for the effective functioning of internal controls.

The IAASB's project proposal for the revision of ISA 240 was approved in December 2021 and an exposure draft is expected by June 2023. The project aims to clarify auditors' responsibilities in relation to fraud as well as promote consistent behaviour and effective responses to fraud risks by establishing more robust requirements. The revisions also aim to increase the transparency of fraud-related procedures, including strengthening communications with those charged with governance.

For their part, audit firms have for several years been sharpening their focus on fraud, and they continue to step up their efforts – change of any magnitude takes time.

Audit reform

The approach to audit reform reflected in the Feedback Statement following the proposals in the UK government's 2021 White Paper 'Restoring trust in audit and corporate governance' does not go as far as some firms had hoped but, implemented properly, it is a step in the right direction.

The elements of the Feedback Statement most directly relevant to fraud prevention and detection include:

- government discussing how an accessible fraud case study register can be taken forward with the FRC and the professional bodies;
- mandatory audit and assurance policies being developed by audit committees of PIEs; and
- directors of PIEs reporting on the steps they have taken to prevent and detect fraud.

Proposals to mandate auditor reporting on whether the directors' statement is 'factually accurate' were dropped, and the introduction of a UK regime for reporting on internal controls is to be taken forward through the UK Corporate Governance Code, rather than through legislation.

Deterring and detecting fraud is an important objective of audit reform in the UK. Nevertheless, the audit firms we interviewed all believe that others in the UK's financial reporting ecosystem must clearly and publicly acknowledge that management and those charged with governance are the first line of defence against fraud. They too, must do more.

WHAT AUDIT FIRMS ARE DOING NOW AND WHAT MORE CAN BE DONE

AT THE AUDIT FIRM LEVEL

Investing in fraud: infrastructure and education

The audit firms ICAEW interviewed take fraud seriously. In recent years they have all taken action to develop resources, processes and support tools, within an infrastructure designed to increase the likelihood that they will prevent and detect fraud, now and in the future.

Expectations of what can be achieved have been raised among stakeholders. Auditing standards have been – and continue to be – revised. Everyone has been, rightly, gearing up for expected audit reforms, which will involve legal and regulatory change in response to Brydon's proposals, and further raise the bar for fraud deterrence and detection.

Each firm has its own range of fraud-related initiatives underway: some are focussed on audit firms' people and processes, others are directed at people in the entities that firms audit – and they vary significantly. Generally, firms are sharpening their risk assessments and facilitating enhanced fraud detection by looking at the issue from different angles. These include audit firm culture and governance, professional education, audit methodologies, technology, the use of specialists, including forensic specialists, and communications within the audit firm, the audit team, and with audited entities.

> **Audit is not a profession with its eyes closed to risks of fraud. It very much has its eyes open.** RF

Recent investments made by audit firms in the UK and across their global networks are significant and have been accompanied by some headline-grabbing announcements. In 2021, for example, one firm announced a global, three-year US$10bn investment plan in people, technology, and quality management systems to strengthen audit quality, including the detection of fraud, with around $2.5bn over three years used to fund technology initiatives, with a strong focus on artificial intelligence (AI).

Fraud-related training is high on firms' agendas, driven by heightened expectations among stakeholders, revisions to auditing standards and the audit reforms referred to above.

> **Fraud training has increased massively. It's extensive, cuts across all levels of experience and more is coming.** BF

During the pandemic, firms boosted their fraud-related information campaigns and education for all staff and expanded their scope, with many firms mandating fraud training for all of their audit staff in 2022.

> **Recent training on fraud focused on KPIs related to fraud risks. Understanding how those KPIs moved over the course of the year and the financial statement finalisation process really resonated in terms of better identifying potential fraud risks.** PL

Learning the hard way

Firms are taking steps to alert auditors to the dangers of being too trusting, and providing real-world examples which reinforce the message that fraud can happen at any time on any audit.

It is not unusual for seasoned auditors to discover fraud being committed by the people they would least suspect. Several interviewees spoke of audit partners who became much less trusting when they discovered that people they had known at audited entities for many years – with whom they had excellent working relationships – had been deceiving them all that time.

> **I've met a few people who have committed fraud in companies I've audited, and they're normal people. They come in all guises – men and women, likeable, seemingly trustworthy people – people you can have a good relationship with.** EJ

Many of the actions firms are taking to inform and educate auditors are aimed at a change of mindset. But changing hearts and minds is a complex, time-consuming, and specialist pursuit.

> **We are trained to be sceptical. We are not trained to be suspicious. But our forensic experts are helping our audit people to learn to have a suspicious mindset, when that is needed.** JE

THINKING AND BEHAVING DIFFERENTLY

In 2020, EY developed a 14-stage scepticism model that considers a range of fraud risk factors, including the conscious and unconscious biases of audit team members.

Performing the same work as last year, looking for information that is easily available and confirms existing thinking, and accepting answers because the client is familiar – all are long-standing risks which require a major shift in mindset.

'We want people to understand where their mind is and ask whether this is where it ought to be' says Bob Forsyth, a Partner at EY. Audit teams now consider this along with other fraud risk factors before doing any detailed audit planning on all EY audits. 'It's a quick, effective process.'

Audit firms should **consider doing more**: to reinforce professional scepticism throughout the firm through enhanced training, updated methodologies and informal encouragement of the right behaviours.

Firms are learning lessons from publicly available information on major frauds and investigations. This is routinely analysed, root causes are identified and then addressed through changes to procedures, systems and training. Firms are developing case studies and facilitating interactive discussions, based on the shared experiences of auditors. They are engaging and learning from an array of professionals with fraud-related expertise, including expert witnesses, lawyers, forensic investigators, and cybercrime experts. Storytelling, in particular, seems to be an effective tool.

LEARNING FROM FRAUDSTERS

When KPMG held its first 'Fraud Awareness Week' the inaugural speaker was fraud advisor and ex-CFO of the Enron Corporation, Andy Fastow.

'It was hugely beneficial for our teams to hear Fastow talk about how he won 'CFO of the year' for the same fraud he ended up in prison for,' says Emily Jefferis, Partner at KPMG UK.

Fastow highlighted what to look for when the numbers don't seem right, and the difficulties auditors have in the grey areas when the accounting rules seem to lead to an answer which isn't a true or fair reflection of a transaction.

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> **War stories show how easy it is to perpetrate some frauds. It’s important to bring home to people that there may be frauds going on at our clients that we don’t know about.** HM

> “
> **We draw attention to real life examples of fraud so that teams have more understanding of actual frauds committed as well as the underlying causes. This means that they can think about what could have been done to identify them and apply that knowledge in their audits.** PL

> “
> **Raising awareness around how fraud occurs is a priority. We showcase examples. There’s a real appetite from practitioners for understanding the details of how fraud manifests in real-life, as opposed to simple abstract scenarios.** DI

Audit firms should **consider doing more**: to embed fraud-related learnings across the firm, by raising awareness, sharing knowledge and improving understanding of how frauds are perpetrated.

Firms would welcome further engagement with the FRC and other regulators to develop a mechanism to more effectively collaborate and share fraud-related learnings. Audit reform proposals have introduced the concept of a fraud case study register which emulates the internal practices of some firms, whereby central databases allow auditors to share information and fraud-related learnings encountered across the firm. Government will invite the planned successor to the FRC, the Audit, Reporting and Governance Authority (ARGA), to discuss with the professional bodies how to enhance auditor education and continuing professional development.

Government and audit regulators should **consider doing more**: to share examples of best practice of fraud deterrence and detection by auditors, and engage with agencies such as HMRC, and regulators such as the FCA and others, to consider how they can more effectively combine and share their learnings on fraud.

Exploiting technology

The world's biggest audit firms continue to invest heavily in technology and have considerable expertise in this area. They have always been quick to explore and exploit the potential of emerging and existing technologies and they are now using these in the fight against fraud.

Firms are buying, developing and using a variety of tools and techniques to help auditors and experts in fraud and forensics. These increasingly smart tools can inform decision-making by enhancing the analysis of data sets, the management of processes and resources, and the communication and presentation of data.

TECHNOLOGY TOOLS

'Document authenticity tools are a really interesting area, because many frauds are perpetrated with falsified documents, be they electronic or hard copy' says Jonathan Middup, a Partner in EY's Forensic and Integrity Services Practice.

Manual authentication processes are slower, less reliable and more difficult to scale than automated processes. Specialist software can analyse the structure of a document to detect anomalies and identify even miniscule 'micro-misalignments' in a document that may have been altered or backdated, for example, by a graphics editing system.

> **We're comparing employee generated information on the web with things reported through the whistle-blower line. If discontent on social media isn't showing up in the whistleblowing line, what does it tell us?** JM

> **Data and analytics show us things that manual audits didn't. Not everything is a fraud, but we find more irregularities and things that don't look quite right. We wouldn't have had an indication of any of these findings before.** EJ

The term 'data analytics' involves a wide range of processes and applications. Enhanced journal entry testing and grading journal entries by potential fraud risk, enables audit teams to better direct audit testing. As well as looking for anomalies in data, analytics are being used in conjunction with more sophisticated AI tools and techniques to assist with the identification of fraud patterns. Comparative analytics are also enabling the recognition of patterns of transactions, for example pre- and post-pandemic, to assess how risk profiles have changed.

In a changing landscape in which audited entities, their systems and frauds are becoming ever more sophisticated, ensuring audit teams have access to the right information and skills is crucial.

Some firms are casting a wider net in their fraud risk assessment through 'risk sensing'. Market information, news of fraud in a particular sector or press attention, may drive a higher risk rating. This allows emerging risks to be identified and monitored much earlier.

Audit firms should **consider doing more**: to widen the scope of their risk assessment process by increasing the use of external data and information to allow emerging risks to be detected sooner.

The potential of data analytics, machine learning and other types of AI is vast, but these technologies cannot always be easily applied in ways that satisfy auditing standards, raising questions about their value. Audit firms are also aware of the limitations of these tools, and the importance of not underestimating the art of conversation when it comes to detecting fraud.

> **The commonest way frauds are picked up is by talking to people, asking forensic-type questions based on the enhanced data and risk assessment.** JM

Government and audit regulators should **prepare for change**: by encouraging recognition among international standard-setters of the increasing potential and importance of technology-enabled techniques in assessing and responding to fraud risk.

AT THE AUDIT ENGAGEMENT LEVEL

Ramping up the challenge, standing firm and supporting your people

All firms recognise the significance of audit firm culture in creating the foundations on which many of their fraud-related initiatives stand. Audit firm culture shapes thinking and behaviour. It provides a moral compass, enabling auditors and audit teams to support and challenge each other, and the entities they audit, in ways that will help to improve fraud detection. Being able to challenge, and being open to challenge, is key.

> **As an engagement lead, I need to be open to challenge myself, so that my audit teams can say, 'Are you sure that's the right answer?' These behaviours are really important.** JE

The relationship shift between the firm and the audited entity also arises from changes firms have made to internal communications and support structures, designed to make it easier for auditors to challenge management and to stand firm when difficult questions need to be asked and tough decisions made.

> **When an engagement team is asking management difficult questions, it's important to create an environment where they can reach out and be supported by the firm to challenge management and do the right thing.** RF

At certain times, power imbalances can be particularly acute in the audit relationship, creating impediments to the exercise of professional scepticism. It has always been difficult for junior audit staff to challenge senior management effectively, for example.

> **Junior members of the audit team are in a difficult place – are they really going to look the MD in the eyes and say, 'I really would like more information than that', or are they going to accept what they're told and go away?** JP

Audit firms are addressing this in various ways. Actions include more fraud education for more junior audit team members, improving their interpersonal skills and encouraging greater mutual respect and support between audit team members.

> **When a new team member raises something, the other people on the team have got to be ready to consider it. They can't just dismiss it.** HM

> **We're training teams to take a colleague with them when they need to have a difficult conversation. Somebody more senior to support and coach.** EJ

Audit firms should **consider doing more**: to encourage the robust challenge of management through formal training and informal support.

Seeing what's hidden: red flags

Understanding the power dynamics at play during key times of the audit allows auditors to identify vulnerable areas and boost efforts to strengthen these. In particular, the knowledge and experience of more senior members of the engagement team is essential in supporting junior team members.

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> **Inexperienced people on the audit aren't necessarily going to spot deception or collusion, particularly among senior management.** MH

Auditors are often criticised over their failure to spot red flags and carry out key audit procedures. The recent European Commission consultation into corporate governance, statutory audit and supervision is directly linked to recent high-profile corporate failures. Missed warning signs include management offering a helping hand in identifying items to test and providing the means to do so, for example. Walkthrough and systems testing is often carried out by the most junior members of an audit team, but it is here where the support and experience of more senior team members is key in pushing back and resisting management pressure to ensure independent and truly random sampling takes place. Similarly, banking documentation is often scrutinised by junior staff who need to be encouraged to question situations in which proper banking documentation is absent and auditors are asked to rely on client-generated alternatives.

Sustaining a level of unpredictability during audit work can be hard over long periods of time, but firms we interviewed agreed that doing something different can be powerful. Incorporating unpredictability into audit procedures has long been a requirement of auditing standards and can reduce the opportunity for management to influence testing, manipulate transactions and falsify evidence.

Government and audit regulators should **consider doing more**: to uphold and enforce existing sanctions against those who mislead or try to mislead auditors and **prepare for change** by considering the future role of sanctions in the improvement regime.

Effective tools include talking to a range of people at the audited entity – not the same people each year – varying the questions asked, and the audit staff asking them. Building an effective audit team is a delicate task and requires striking the right balance between auditor experience, knowledge of the audited entity and its systems, and having fresh pairs of eyes brought into the mix. Inviting and considering ideas from the newest and most junior team members first, during planning and team meetings, can also help to draw the widest range of ideas and insights and avoid group think.

Firms also recognise the potential significance and magnitude of small frauds, irregularities, and bias, and are introducing processes to monitor and track them. Immaterial matters and initially legitimate company practices can become part of an established culture and set a precedent, making them seem believable and harder to spot, particularly without the benefit of a multi-period perspective. For example, it is not uncommon for directors to legitimately lend money to companies as a means of support. This happened during the COVID-19 pandemic, for example. But large bank transfers always warrant careful consideration, whatever the circumstances.

BOUNCE BACK LOANS OBTAINED FRAUDULENTLY

During the pandemic, an audited entity, with pre-pandemic turnover in the region of £70-£80k, received a bounce back loan of £50k as part of a government support scheme designed to help businesses impacted by COVID-19.

During the audit work, the auditor requested supporting documentation in relation to the loan application and noted that the client had used bank statements with large balances as evidence for the income.

A thorough review of the bank statements in the months before the application was made revealed that the director had transferred large sums of money to the audited entity, which had been repaid by the company before the year-end, to overstate its turnover and to facilitate borrowing the maximum amount.

Managing the closedown

It can be hard to maintain the level of challenge towards the end of an audit when reporting deadlines loom. Management can appear to play a wind the clock down game: holding back information until the end of an audit, when it is more difficult for the audit team and audit partner to properly consider that information. This can make it easier to conceal fraud from auditors.

While it is not uncommon for auditors to become frustrated as sign-off approaches, audit firms are refusing to bow to pressure, increasingly embracing those difficult conversations and re-calibrating the norm.

> **We have a good track record of pushing back sign-off where we need to. It can annoy clients because they’ve committed to dates but ultimately, I think they understand. We’re not losing clients by doing that.** HM

Firms are making smarter and more extensive use of workflow and practice management tools to better manage audit timetables and the flow of information between auditors and audited entities during an audit.

> **Project management tools show us where things are with the audit to avoid late surprises. They mean audit teams have a better understanding of the status of the audit at any point in the audit process, that's why we spend time on them.** PL

> **We've got better at communicating our expectations to clients during the audit. Better project management technology means we can say '…you know what, you've not given us these things yet'.** JE

Steps taken by audit firms to ensure the integrity of the audit closedown include formal processes, such as: pre sign-off declarations for audit teams to complete; firms' internal risk panels providing challenge from a central team; and informal encouragement of certain behaviours to recognise and embed good practices and signal support by senior management.

> **It's essential to make sure our people in the audit stream are aware when we have delayed sign-off for a week, a month, whatever it took to obtain the assurance we needed, and that it's recognised as good, positive behaviour backed by the firm's leadership.** RF

Early on in the pandemic, a joint statement from UK regulators and guidance from the FRC helped raise awareness throughout the financial reporting ecosystem of the importance of all outstanding matters being completed before concluding an audit. This helped auditors stand firm in the face of pressure to lighten up on the level of audit challenge, accept flimsier, lower quality audit evidence and accept matters that would not pass muster in different circumstances.

> **Delays can upset management, but regulators are very supportive. If we delay our sign-off, as happens more and more now, regulators consider that best practice.** BF

Armed with this welcome development, audit firms put it to good use, pushing back against questionable behaviour. They undoubtedly prevented and detected more fraud than they would have otherwise. This rare, concerted effort offered a glimpse of what can be achieved when a more joined up approach to fraud is taken. Audit firms should not stand alone in their fight against fraud.

Complexity and the need for specialist expertise

Increasing corporate complexity and the frauds companies can perpetrate or be subject to increase the need for specialist resource among companies and auditors alike.

A recent revision of ISA (UK) 240 (A48-1) states: 'In some circumstances the auditor may consider it appropriate to use the specialist skills and knowledge of a forensic accountant'.

Many firms are taking steps to increase their use of specialists with forensic skills, but they are at different stages on this journey and their approaches differ. Initiatives include the use of behavioural experts, technology specialists with increasingly sophisticated IT tools, and the use of forensic and fraud experts. The latter are increasingly involved during the risk assessment stages of audit, and not just when a heightened risk or evidence pointing to fraud is identified.

> **Involving forensic specialists at the planning stage gets audit teams to think more widely about what the fraud risks might be. It makes for a much richer conversation about identifying fraud risks.** JE

> **One of the programmes we're running is a system of forensic challenge. We piloted the use of our forensic experience alongside audit to challenge the organisation on their approach to fraud risk. That's being expanded to target selected larger and more risky audit engagements.** JM

Some firms involve forensic specialists for journals testing, to advise on the best approach to picking up anomalies and frauds, for example, and where there is an increased risk because of the complexity of an entity or its operation.

> **There's significantly more focus on getting forensic skills into the audit where needed on a proactive basis at an early stage.** JM

Firms are, however, concerned that expectations should not be raised inappropriately about the extent to which forensic expertise can or should be used on an audit. Firms are keen to emphasise the need for a risk-assessed approach in this area.

> **We use experts to contribute to our audit responses to fraud, that's why we use specialists who are used to getting to the bottom of fraud day in and day out. However, audit is a risk-based activity, so which engagements they should be involved in is the result of good auditor judgement, not a blanket approach.** DI

> **In future I have no doubt that auditors will be making even greater use of fraud and forensic experts on a risk assessed basis in the same way as you might use a tax or a digital specialist on some audits.** JE

A number of firms highlighted the lack of a definition of a 'forensic accountant'. Firms' perspectives were diverse: some saw an audit background as a necessary asset in a forensic specialist, others did not. Many noted that forensic experts to date have expertise in investigating known frauds, rather than trying to identify and assess the risk of fraud, as auditors do.

The Feedback Statement includes a mandate for ARGA, rather than the Recognised Supervisory Bodies, such as ICAEW, to determine the eligibility of individuals and firms to be appointed as statutory auditors of PIEs, with the FRC recently launching a consultation on PIE auditor registration. ARGA may also have an important future role in assessing the competence of specialists who carry out assurance work for PIEs and it will need to be clear about the roles and responsibilities of those specialists.

It seems likely that auditors and forensic specialists working together is the most effective approach in many cases. As auditors increase their efforts to find fraud, and as frauds become more sophisticated, specialist expertise will increasingly be needed. A point made repeatedly was the effectiveness of particular combinations of specialist skills, such as forensics and IT, in developing valuable applications of technology.

Getting the most from available data and technologies in the pursuit of fraud also requires training for non-specialists and firms are taking multi-faceted approaches to the development and application of such skills.

> **All our auditors are trained to use our data analytics tools, which enables them to ask the right questions and get answers easily and quickly. But the value comes from knowing what questions to ask and what to do with the answers. That takes the involvement of auditors with the appropriate skill and experience.** DI

Existing and emerging technologies have broad applications, and audit firms are upskilling their staff in different ways. Awareness of how these tools work is certainly helpful.

> **We're actively encouraging audit trainees to understand Python. Some of them learn to code and write scripts so that they can pull data out of our data lakes in different formats, and scrape data from websites.** BS

> **We have a specialist technology team within our audit practice. We held a hackathon where they taught auditors how to do some basic Python coding, then set them some challenges.** EJ

Audit firms should **consider doing things differently**: by assessing the need for greater specialist and forensic involvement to provide enhanced support at all stages of the audit on a risk-assessed basis.

AT THE AUDITED ENTITY LEVEL

Redefining the client and managing the client relationship

Cultural shifts do not happen quickly. They emerge and evolve over time, but their impact can be profound and notions of who the 'client' is have changed radically in the last 20 years.

> **Winning a new audit involves engaging with management, but management isn't your client. As an auditor you are acting for the shareholders and supporting the Board and Audit Committee in their governance of the entity.** RF

The Brydon report starts with the words, 'Language matters. How audit is described influences how it is conducted and how users respond to it.' Thinking about the 'client' is a major factor in shaping behaviours that can promote the independent and sceptical mindsets the profession needs if it is to enhance its apprehension of fraud.

> **Years ago, firms saw the company as the client and the firm's role was to be helpful. That culture around who we are responsible to, and the boundaries of what support is now considered acceptable, have changed a lot.** BN

Some firms are enlisting the help of behavioural specialists, to better facilitate and reinforce independence and professional scepticism, and to foster a culture of challenge. This is achieved by reshaping auditors' perspectives, and changing expectations about the relationships, roles and responsibilities within the firm, and with audited entities.

Friendship and familiarity need to be avoided as they make it difficult for an auditor to be objective and strong incentives to maintain 'client relationships' still exist. A lack of objectivity can and does impede the effective challenge of management, a tendency exacerbated by the passage of time.

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> **Maintaining auditor scepticism is vital. Audit partner rotation is important for all clients, not just PIEs.** DI

Audit firms should **consider doing things differently**: by stepping up efforts to change ingrained cultures, behaviours and mindsets, through improved training,encouragement and support from the top.

Encouraging good governance

Firms are now interacting with audited entities in a manner designed to help influence behaviours and expectations. For example, they are changing the terms of engagement, improving communications and developing tools that nudge audited entities into thinking and doing more about fraud. How well audited entities understand, prepare and respond to more robust and challenging audits affects audit quality.

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> **We've been showing management and audit committees a 'this is what you can expect from an audit' video, done in the style of a pre-flight safety presentation – it's helped to manage expectations.** JE

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> **We've developed a proprietary fraud risk assessment framework. Management and audit committees that appreciate a proper, challenging audit – they understand why we do it. Others find it a bit of a strain.** BF

Government and audit regulators should **prepare for change**: by considering how to encourage best practice among audit committees, including the robust challenge of management.

Getting culture and the tone at the top right is as important for an audit partner and the audit team as it is for directors and other senior management. Management should value the challenge from auditors, rather than pressurising them to sign off. If management can better understand and respond to auditors' concerns in relation to fraud risk, it can provide them with improved insights and allow for a more joined up approach to fraud. If auditors are not satisfied, management should sometimes think more carefully before dismissing their concerns.

Executive and non-executive directors should **consider doing more**: to better understand auditors' concerns, and to re-evaluate the overall company ethos, including its culture, the tone at the top, and whether the actions match the words.

Companies should better consider their own approach to managing fraud risk. This includes focusing on the practices and behaviours within their organisations that can facilitate or even encourage fraud, as well as monitoring external fraud threats, particularly those relating to cybersecurity. Assessing what more they can do to better understand and mitigate the risks of fraud, and improve on their current approach, will help strengthen corporate governance.

Executive and non-executive directors should **consider doing things differently**: by reconsidering the adequacy of the company's approach to fraud risk management, in the identification, assessment and response to the threat of fraud from inside and outside the company. Does it need to be changed, better understood, or taken to another level? Does it address cyber-security threats as well as it could?

Audit reforms include requiring directors of PIEs to report on the steps they have taken to prevent and detect fraud but requirements for auditors to report on the factual accuracy of this statement have now been dropped.

Government and audit regulators should **consider doing things differently**: by involving all stakeholders, including auditors, in a debate about fraud risk management, to inform the development of new fraud-related requirements for companies and related requirements for auditors.

Reform proposals to include the implementation of a SOX-style internal controls regime for companies are now being taken forward through the UK Corporate Governance Code, rather than through legislation. Managing and assessing the approach to fraud risk is an important first step for companies in improving controls to help reduce the risk of fraud and unexpected failure.

Government and audit regulators should **consider doing more**: to provide companies with better-quality examples of best practice in fraud risk management, including control frameworks for fraud prevention, detection and risk assessment.

Strengthening the UK's internal control framework for companies (financial, operational and compliance) and the accountability of those responsible will go a long way towards creating a more effective financial reporting system, among other things. It will give companies and auditors another weapon in their fight against fraud. But the financial and logistical implications of transitioning to such a regime will need careful consideration. Reporting on internal controls will involve a steep learning curve for both companies and auditors, despite the fact that proposals to legislate have been dropped, and the requirement will be effected through the UK Corporate Governance Code. This will not be a quick, easy or inexpensive process. Nevertheless, many audit firms believe, based on their US experience, that evaluating and reporting on internal controls has the potential to improve financial reporting, strengthen the corporate governance regime, enhance investor confidence and reduce the risk of fraud.

For audit firms, increased resources, education and training will be essential to meet demand, narrow the skills and experience gap and build capacity for voluntary auditor reporting on internal controls. Larger firms are likely to have the resources and skills to train staff or recruit those with experience of the US regime, but smaller audit firms who audit smaller listed companies may face more of a challenge in upskilling their staff. Other logistical challenges include changes to systems and methodologies, and firms and companies will need significant implementation time to fully equip themselves for the new requirements.

The resources required to implement internal controls reporting for the first time, especially for companies operating a variety of systems in different locations, should not be underestimated. At present, only 25 of the UK's largest companies have direct, first-hand experience of the SOX regime and more will be caught under the new regime. They, too, should consider planning ahead now, so that a more connected 'whole-system' approach to fraud can be achieved.

Audit firms should **prepare for change**: by considering the resource, logistical and training implications of management and voluntary auditor reporting on internal controls, including the effect on methodologies and systems.

Where companies identify key fraud risk areas, or raise concerns around internal controls, they should consider the need for additional assurance to enhance the statutory audit through the development of an Audit and Assurance Policy. The development of such a policy by audit committees will become mandatory as a result of audit reform. Adoption of this policy will help improve audit quality, narrow expectation gaps, build trust and encourage better stewardship. Engaging investors, to ensure they understand the value and role of the policy, is also important.

Executive and non-executive directors should **prepare for change**: by renewing efforts to engage all stakeholders in the audit process, including investors, by considering the value of evaluating and reporting on internal controls and by developing an audit and assurance policy.

Audit firms should **prepare for change**: by engaging with investor representatives on the implications of and need for audit committees to develop audit and assurance policies.

Broadening stakeholder engagement in the statutory audit process and facilitating meaningful interactions with stakeholders, while challenging, will help companies understand the needs and expectations of stakeholders, improve transparency, enhance confidence, and encourage better-informed discussions about fraud risk and audit quality.

CONCLUSION

The insights and initiatives highlighted in this publication demonstrate how audit firms are actively embracing changing expectations about what financial statement audits involve in relation to fraud, and what they can and should be expected to achieve.

Fraud is a complex issue and audit firms are devoting time and effort to addressing the difficult structural and behavioural impediments to fraud detection. They are also making significant investments in the complex technologies that have the potential to transform fraud detection, as part of the wider risk assessment process, in ways unimaginable not long ago.

Firms do not set out to miss frauds. Nor do they relish the prospect of dealing with accounting issues that over time, become fraudulent in nature, even if they did not start out that way. Flagging the risk of fraud, and stopping it in its tracks, is just as important as detecting it.

Many, probably most, frauds are concealed in some way. They can be hidden altogether, involve falsified documentation, be made to appear to be something other than what they are, or attempts are made to rush them past auditors late in the day. Even where fraud appears to be hiding in plain sight, it is in effect concealed where, for example, highly complex accounting treatments, only comprehensible to specialists, are subsequently deemed by the courts to be fraudulent in nature.

Audit firms continue to learn from these often bitter experiences. A major cultural shift has taken place within firms over the last 20 years and management is no longer perceived to be the 'client'. Firms, supported by audit regulators, push back on sign-off dates and it is no longer acceptable, publicly at least, to be seen to be pushing auditors as far as they will go. A culture of challenge has been nurtured with a focus on auditors' mindsets and what professional scepticism really means. And in an increasingly complex business environment, excessive complexity in accounting treatments has long been a red flag for fraud. Now, there is acceptance that specialist expertise may be needed at all stages of the audit, including the risk assessment, on a risk-assessed basis.

Nevertheless, the first line of defence against fraud rests, and has always rested, with management and those charged with governance. Audit firms are seeking to ensure that other stakeholders play their part. A healthy financial reporting ecosystem needs all its key players to play their part by increasing the resource they devote to fraud prevention and detection. All of the audit firms ICAEW interviewed agree on the need for a better informed and less superficial dialogue about fraud, and a more intelligent, joined up response to the problem.

Directors, investors, regulators as well as auditing and accounting standard-setters must renew their efforts. Auditors believe that proposals to more clearly define the responsibility of these other stakeholders for fraud, underpinned by legislation, should not be watered down.

The next phase of audit reform requires audit firms, executive and non-executive directors, government and regulators to 'do more'. We reflected on what we heard while preparing this publication and have set out above, recommendations for steps that all stakeholders can take now, to prepare for the changes.

The audit firms we interviewed are seeking to meet and exceed expectations in delivering the changes expected of them. It is important that other players in the financial reporting ecosystem also step up to the mark.

APPENDIX – INTERVIEWEES

Andrew Bond (AB)
Andrew is a Partner in assurance and business services at Evelyn Partners, formerly Tilney Smith & Williamson, the wealth management and professional services group.

Christopher Drewe (CD)
Christopher is a Partner at Mazars, where he leads the forensic accounting team in the UK. He is an experienced forensic accountant having worked in a wide range of dispute resolution, investigation and other forensic accounting cases. He has testified on a number of occasions, both in the UK and overseas.

John Ellis (JE)
John is an Audit Partner, based in PwC's Reading office, looking after listed, inbound and private business across a number of industries.

Ryan Ferguson (RF)
Ryan is Head of Audit Quality and Risk at BDO and an experienced Audit Partner. He is a member of the firm's Audit Executive, driving audit quality across the audit practice and promoting a culture of challenge.

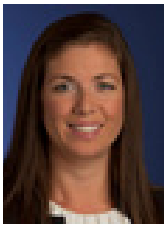
Bob Forsyth (BF)
Bob is an Audit Partner at EY. He leads the audits of FTSE 250 PLCs, large private groups and large inbounds. Previously the UK Audit Quality Leader, he now co-leads the professional scepticism pillar of EY's audit quality strategy.

Matt Howells (MH)

Matt is a Partner and Head of the National Assurance Technical Group at Evelyn Partners, formerly Tilney Smith and Williamson, with overall responsibility for compliance with audit and accounting regulation. He presents financial reporting and audit seminars and workshops to internal and external audiences and is a member of ICAEW's Technical and Practical Auditing Committee.

David Isherwood (DI)

David is Ethics Partner in the UK firm of BDO. He specialises in audit methodology, ethics and public policy matters and is a member of the UK firm's Business Interest Oversight Board. David is Chair of ICAEW's Technical and Practical Auditing Committee.



Emily Jefferis (EJ)

Emily is an Audit Partner with 20 years' experience auditing large listed and private businesses in the UK and New Zealand. Emily now specialises in the application of UK and International Auditing Standards and leads KPMG's Audit Department of Professional Practice.

Philip Lenton (PL)

Philip is a Partner in Deloitte's National Accounting and Audit Department. In that role, he deals with a variety of audit and assurance technical matters for public and private sector entities.

Jonathan Middup (JM)

Jonathan is a Partner in EY's Forensic & Integrity Services practice. He has provided insight to clients on forensic issues for more than 20 years. He leads the team liaising between EY's forensic and audit teams across Europe, the Middle East, India and Africa and has worked with clients, government and enforcement bodies globally.

Hugh Morgan (HM)

Hugh Morgan is a Technical Director at RSM where he leads the London technical team and is primarily responsible for organising and carrying out engagement quality control reviews on listed and high-risk clients. Hugh is a member of ICAEW's Technical and Practical Auditing Committee.

Bob Neate (BN)

Bob is a Partner at Mazars. He has 36 years' professional experience, much of which has focused on auditing large international groups in the engineering, manufacturing and transport sectors. He is a member of Mazars' Global Audit Board.

Jonathan Pryor (JP)

Jonathan Pryor has been an Audit Partner for many years and is responsible for Audit Quality within Evelyn Partners, formerly Tilney Smith & Williamson. He increasingly now focusses on expert witness work in relation to audit negligence and financial reporting disputes.

Becky Shields (BS)

Becky is a Partner at Moore Kingston Smith and leads its digital transformation team. She is passionate about helping clients embrace digital technology to streamline their processes, enhance access to key management information, and make strategic changes to help them thrive.

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