ICAEW THOUGHT LEADERSHIP
FUTURE OF AUDIT

Fraudulent financial reporting: fresh thinking

Audit is currently undergoing an unprecedented level of public scrutiny around the world. The expectations of investors and other stakeholders – including employees, customers, suppliers and pension-holders – have increased in recent years, and the purpose, scope and practice of audit need to keep pace.

ICAEW's Audit and Assurance Faculty is developing a series of thought leadership essays that consider issues directly or indirectly relevant to the international debate about the future of audit. This series is intended to help directors, audit committees, shareholders, politicians, journalists and policymakers understand the key issues, and it will, among other things, help to inform the development and implementation of recommendations in the UK regarding audit, its regulation and the market for audit services.

The faculty has published a number of papers in the series, which are available to all at icaew.com/futureofaudit. Further papers will be issued. If you have views on any of them, or experiences to share, we would very much like to hear from you. Please email your comments to Nigel.Sleigh-Johnson@icaew.com

Contents

At a glance

Fraud, by its very nature, is deliberately hidden, and is therefore harder for auditors to spot than other irregularities affecting the financial statements. In this essay we focus on ways in which the skills and insights of auditors can be brought to bear to maximise the likelihood of identifying fraudulent financial reporting.

Auditors should always look beyond the numbers. Their privileged exposure to an organisation, its culture and people, should be harnessed when planning and testing for the existence of fraudulent financial reporting. This means paying particular attention to:

- Organisational culture – how do people behave and communicate in the business?
- Management style – what tone is set at the top?
- Motivations and pressures – what factors might drive relevant individuals to manipulate the numbers?
- Behavioural controls – how does the organisation promote a culture of honesty and openness?

While primary responsibility for preventing and detecting fraud in an organisation rests with directors and management, auditors can also play a part in promoting a strong organisational culture, which proactively acknowledges and corrects mistakes, and where individuals have the courage to speak up when things go wrong.

We invite individuals and organisations to share with us not only their comments on the analysis and suggestions in this essay but on their own experiences and ideas in relation to the challenges of fraudulent financial reporting. These will help us to develop our contribution to the coming period of intense consultation and reflection that will determine the future of audit in the UK, and beyond.

Introduction

Fraud has always existed, and is always likely to. But the inevitability of fraud does not mean we should give up and accept it. It simply means that organisations and auditors must be constantly vigilant and innovative in their approach to combatting corporate fraud. It also means that all players in the financial reporting system must play their part to protect against fraud.

This essay is presented as a contribution to the next stage of audit reform, which is likely to see intense discussion about the challenges of achieving clear and decisive progress in an area in which there is arguably little positive to show for many years of debate. By combining clear analysis of the current position and fresh thinking, we hope to add to the momentum for change.

In his recent report on audit quality and effectiveness in the UK[1], Sir Donald Brydon described the question of fraud as "the most complex and most misunderstood in relation to auditor's duties"[2]. He set out a number of recommendations in this area[3] including his proposal for a new audit profession. This would introduce auditor training in fraud awareness and forensic accounting so auditors "learn to be able to apply the same mindset as do forensic accountants in relevant circumstances"[4]. ICAEW will contribute in due course to the expected BEIS consultation on how best to take forward these and other ideas set out in the report. In the meantime, we believe that we can start to improve on the current model for combatting fraud with fresh thinking about how the skills and insights of auditors can be better brought to bear to maximise the likelihood of identifying fraudulent financial reporting.

Fraud is difficult to detect and the ways of committing it are continually evolving. We believe auditors have a key role to play in addressing it. While auditors are experts in financial reporting, their work also involves interacting with many different and sometimes difficult personalities. They observe how people respond to challenge and gain first-hand experience of the culture of a company. Therefore auditors should routinely look beyond the numbers, and use these behavioural and cultural insights to help the company identify areas that may be vulnerable to fraud, ultimately helping the company to prevent it, or detect it if it has already occurred. Many do this to a greater or lesser degree already. We encourage others to follow.

The scope of the essay is intentionally limited to focusing on these behavioural and cultural insights. We do not, for example, explore here how improvement could come about through the development of additional, optional assurance methodologies targeted at fraud detection. Auditors have the skills and tools now to do far more – outside the framework of the statutory audit – to assist companies address the risk of fraud by targeting specific shareholder or management concerns. The value of new types of assurance to supplement the statutory audit is explored in our recent essay, *User-driven assurance: fresh thinking*.

The recommendations in this essay will require in any case debate and development by the profession and policymakers. A one size fits all approach will not be appropriate; reforms will need to take into account proportionality and cost-benefit considerations. Our suggestions have been framed in the context of limited companies and large companies in particular, but we believe that the ideas will resonate with auditors of a wide range of organisations.

1 Assess, Assure and Inform: Improving Audit Quality and Effectiveness, Report of the Independent Review into the Quality and Effectiveness of Audit, 18 December 2019
2 Ibid, paragraph 14.0.01
3 The 'fraud package' set out in section 14 of the report includes amending auditing standards to clarify the auditor's objectives, enhanced routine reporting by directors and auditors, the establishment of ARGA of a register of cases, and an independent panel to consider and act on the results of investigations into auditor failure to detect fraud.
4 Ibid, paragraph 14.3.2

What is fraudulent financial reporting?

Fraudulent financial reporting is the intentional overstatement and – or – understatement of balances in the financial statements. Identifying this type of fraud can be difficult as accounting treatments are often judgmental, resulting in a fine line between optimistic, but acceptable financial reporting, and fraud. The Association of Certified Fraud Examiners (ACFE) finds that although financial reporting fraud is the least common form of fraud, when it occurs, it results in the highest median loss for companies[5].

Financial reporting fraud is quite distinct from misappropriation of assets and can be more difficult to spot. The latter is more common but involves smaller values, for example through using deception to steal inventory or commit billing fraud for personal gain[6]. The former, on the other hand, may not involve any direct monetary gain. Instead individuals may, typically, be motivated by internal or external organisational pressures to hit performance targets and associated indirect benefits, for example, avoiding the loss of a bonus payment or an increase in share price.

WHY IS FRAUDULENT FINANCIAL REPORTING DIFFICULT TO DETECT?

The initial actions may not meet the definition of financial reporting fraud – it may start with taking an overly optimistic accounting position to meet a one off target. Principles-based accounting standards often require judgment; which, combined with increasingly complex operational practices, can inadvertently provide levers to inflate revenue to meet a target, or increase costs to smooth profits year on year. Formally determining what is and what is not a fraud is a matter of judgment ultimately for the courts. The dividing line between an 'aggressive' accounting policy and fraudulent financial reporting is rarely clear and, importantly, often only emerges over time as a situation deteriorates.

If pressure builds to continue to meet difficult or unrealistic targets, this behaviour could be repeated in each reporting cycle. An adjustment that was insignificant initially may build up to represent a significant value over time. Bias to accept a previously agreed treatment can exacerbate this, making it even more difficult for management and auditors to spot or respond. Like the proverbial frog in boiling water, both may only realise there is a problem with the treatment after it has crossed the line from aggressive accounting to fraud.

[5] ACFE, Report to the Nations (2018), https://go.aws/2RWiYZz
[6] Ibid

We summarise what auditors do on fraud below.

What do auditors do on fraud?

Auditors have a duty to ensure that financial statements are free from material error. This includes looking for material errors caused by fraud. The relevant audit standard, ISA 240[7], defines fraud as 'an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage'.

Auditors are concerned with finding material misstatements in the financial statements whether caused by fraud or error. ISA 240 identifies two types of misstatements caused by fraud: fraudulent financial reporting, and misstatements from the misappropriation of assets. Not all frauds will result in a misstatement of the financial statements, and when they do, it may not be material.

Auditors must remain professionally sceptical throughout the audit and be alert for inaccurate or misleading information from management. Auditors do not gather evidence to prove a case in a court of law, although they do have a duty to report fraud[8], and their findings might lead to an investigation by management or law enforcement authorities. The courts are the ultimate arbiters of what is, and what is not fraud, and there is extensive legislation and case law in the UK.

Auditors carry out a range of procedures aimed at detecting fraud, but an audit is not a guarantee against fraud. Testing is done on a sample basis. The cost of the work required by auditors to undertake substantive testing of 100% of balances would be regarded as prohibitive by most organisations. Instead, auditors test on a limited, but targeted basis, which takes into account risk assessments, materiality and sampling methodologies.

[7] International Standard on Auditing 240: The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

[8] Auditors may report to management or to those charged with governance when auditors suspect the fraud involves management, employees with significant roles in internal controls, or material misstatements of the financial statements. In some cases, the law, regulations or ethical requirements may require auditors to report to an appropriate authority, such as the Serious Fraud Office or the National Crime Agency in the UK.

Looking beyond the numbers

Financial reporting fraud is often hidden away in estimates and other judgmental balances. Perpetrators know how to justify positions and may produce detailed and complex evidence to support their view. While investigating some frauds may require specialist technology or forensic expertise, we believe that understanding human behaviours and culture are at the heart of tackling fraud. Auditors should be curious, investigating not only what makes the organisation tick, but the people, their personalities and the pressures under which they operate. They should hone their ability to look beyond the numbers, paying close attention to the individuals and culture that make up an organisation.

Organisational culture is about more than just values. It is the behaviour of the organisation as a whole, from directors and senior management, to employees. It is the tone that permeates the organisation and shapes the way it produces goods and supplies services, works with suppliers and respects its employees. Organisational culture has major implications for the risk of fraud, particularly financial reporting fraud.

Auditors' knowledge and experience builds a strong foundation for understanding human behaviours that lead to fraudulent financial reporting, as well as the steps to prevent it. Auditors can best use this by displaying curiosity and routinely going deeper to 'get under the skin' of an organisation. They should listen attentively to the stories being told and look at the indicators in the physical environment, understanding employees' behaviours and intent, and communicating to management these understandings and their significance. We will explore practical ways that auditors can do this.

FOCUSING AUDIT TEAM PLANNING ON ORGANISATIONAL CULTURE AND BEHAVIOUR

Auditors already undertake risk assessments when planning their audits. These assessments aim to identify areas at risk for material misstatement and ensure that they are addressed by the audit work plan. Their technical expertise should already highlight areas more susceptible to manipulation, for example, revenue recognition or accrual policies. The planning process should be augmented to consider more specifically whether the organisation's culture and behaviours may increase the likelihood of fraudulent financial reporting.

In general, the audit team as a whole, including the partner, specialist staff, and juniors will sit down together and consider the risk of fraud impacting the financial statements. This is important, and we believe that this practice should invariably involve 'brainstorming' how the behavioural and cultural aspects of the organisation could hypothetically facilitate manipulation of the financial results. For example, if management needed to achieve a certain target, then alongside the financial levers someone in the organisation might pull to reach that target, what cultural or behavioural aspects would make it easier for them? This exercise could help to identify not only the level of risk of fraudulent financial reporting, but also target the aspects of the organisation that may facilitate fraud.

It is important that auditors ensure that this is a holistic assessment by the team as a whole, rather than a top down risk assessment undertaken by senior staff in isolation. People behave differently towards senior and junior staff respectively. Junior auditors based at the organisation on a day-to-day basis may see and hear things that more senior members of the audit team would not. They may overhear 'water cooler' conversations, for example, that provide insights into office politics and unusually strained or overly familiar relationships. Partners should encourage the audit team to think about the people who produce the numbers and whether organisational dynamics could, for example, impact the effectiveness of certain financial controls such as segregation of duties.

The audit team should discuss their interactions and insights regularly throughout the audit process and factor them into their assessment of the organisational culture. We suggest that the following areas are considered, along with more organisation-specific questions. These are not meant to be a checklist, but additional considerations that might enhance auditors' existing processes through an early and more explicit look at behaviour and culture.

Audit planning: example behavioural and cultural considerations

How have management and staff behaved in the past?

- Have they been open and honest, or inaccurate and evasive? Do they provide excessively complex or difficult to understand evidence? *This could be an indication of a lack of understanding or an attempt to hide information.*
- How willing have management been to correct errors or ensure that staff provide information on a timely basis? *Leaving uncorrected errors could signal an organisational culture that encourages cumulative misstatements, eventually leading to material frauds.*
- Are there internal politics or relationships between staff and/or management, that could motivate or facilitate fraud? *Internal competition could motivate individuals to manipulate numbers to get ahead, while relationships between staff could facilitate collusion and make controls less effective.*

What management styles are common in the organisation?

- Do any managers adopt an authoritarian tone? *This could encourage employees to hide mistakes to avoid consequences.*
- Is the tone from the top focused on achieving high performance? *This could result in unrealistic targets, encouring excessively optimistic estimates.*
- Do any managers take an overly relaxed approach to their team's work? *This may foster a culture that lacks self-review mechanisms.*

What motivations or pressures exist?

- Is pay tied to achieving targets, such as revenue, profit or margin figures, or meeting a fundraising target? *This could result in staff manipulating personal performance numbers or colluding to achieve certain results.*
- Are senior staff and management rewarded in shares, which would increase in value if certain targets were met? *This could increase the risk of material manipulation of the financial statements.*
- Do directors and management face economic or personal pressures? *Lifestyle changes, bankruptcy or the sale of shares could indicate heightened risks.*
- What reputational risks could directors and management face? *Founders or other senior staff may tie personal worth to performance.*
- Are there additional family dynamics, such as power vacuums or handover considerations? *A desire to not disappoint say a parent or partner could increase this risk. ICAEW's film, Without Question, explores this dynamic. https://bit.ly/2RWMwpG*

What, if any, behavioural controls exist?

- Does the organisation have a Code of Conduct for employees? *A lack of controls or emphasis on ethical behaviour may help employees to rationalise fraudulent behaviour, particularly aggressive accounting, as they may not see it as out of line with the organisational culture.*
- What mechanisms exist for employees to proactively raise concerns? *Internal tips can help with discovering fraud earlier, as well as promote a culture of openess.*
- Do directors and management demonstrate through actions their support for it? *Management need to live the culture and set the tone from the top. If they don't behave ethically, it shouldn't come as a surprise if their employees fail to as well.*

UPDATING AND REVIEWING THE AUDIT APPROACH

Based on responses to these questions, auditors can flex their audit approach and targeted risk areas. They can consider whether the responses increase the risk of collusion, either among members of staff or at a management level. They could also prepare for more difficult or challenging conversations with roleplaying, and review more closely evidence provided by staff deemed as higher risk from this assessment.

Throughout the audit, auditors should stand back together and evaluate whether anything has changed from their initial assessment. Have staff acted as expected or have there been any unusual transactions or odd behaviours during the field work? Where something seems even a little unusual, this should spark the auditor's curiosity and prompt further investigations.

USING TECHNOLOGY TO SPOT OUTLIERS AND ODD BEHAVIOURS

Auditors should also consider the technology that is available to test for fraud as it can provide them with additional tools to analyse transactions and journals to identify unusual entries. For example, auditors could review for unusually late or weekend posting of journals. They could review information on working hours which could indicate which employees are under particular pressure if they frequently work weekends or holidays outside their normal contracted hours. These patterns of behaviour could shed light on whether the internal finance team or wider organisation could be motivated to present more optimistic numbers or whether controls around financial reporting may be under strain.

In addition to identifying unusual behaviours, technology is being developed which auditors could use to identify signals for when the first steps were taken on the slippery slope towards fraudulent financial reporting. Data mining in particular seeks to discover patterns in large data sets through machine learning. Academics have used computer science and statistics to show in a number of studies how fraud can be identified from financial statements[9]. These studies have found that published financial reports include valuable clues to the existence of fraud, for example, in financial ratios of debt to equity or net profit to total sales[10].

[9] Ravisankar, P., Ravi, V., Raghava Rao, G. and Bose, I. (2011), 'Detection of financial statement fraud and feature selection using data mining techniques', *Decision Support Systems*, vol 50, pp491-500.

[10] Kirkos, E., Spathis, C. and Manolopoulos, Y. (2007), 'Data Mining techniques for the detection of fraudulent financial statements', *Expert Systems with Applications*, vol 32, pp995-1003.

Academics tend to rely in this research on limited, publically-available information. Auditors in contrast, have access to full data sets of corporate financial transactions. Future technologies could allow for mapping out process flows on all transactions, for example following a purchase from requisition request and purchase orders, to goods received and invoicing. This would allow for the identification of unusual, possibly fraudulent transactions.

While advanced technologies are already being used by some large firms on more complex audits, these capabilities require further development. Combined with auditor insights on organisational culture and behaviour, as well as external data such as media stories or share price performance, auditors could in the future potentially develop robust data models for identifying potentially fraudulent financial reporting. Where the data demonstrates a heightened risk of financial reporting fraud, assurance procedures could be focused on the areas of the accounts more open to manipulation.

Building a strong organisational culture

Negative organisational cultures facilitate fraudulent financial reporting. To prevent this, organisational culture needs to be grounded in openness and honesty. Directors and management set the culture and ultimately are responsible for preventing fraud. Auditors may after all only be on site once a year for a short period. Despite their limited role, auditors can – and often do – contribute to the building of this foundation in the following ways.

PROMOTE A CULTURE THAT ACKNOWLEDGES AND CORRECTS MISTAKES

An organisation should not be afraid to acknowledge and learn from identified errors or mistakes. Auditors can encourage organisations to make corrections and learn from errors, whether or not they are material. They should be part of an open dialogue on how to improve and learn from the past.

As fraudulent financial reporting sometimes starts from immaterial errors or optimistic, but still appropriate treatments, it can be difficult to spot. Employees and management should feel safe enough to report issues or correct errors without negative repercussions. Auditors can help build an atmosphere of openness by stressing the normality of continual review and challenge of past judgments. Making corrections should be viewed as a learning opportunity, rather than a failing.

Auditors can lead by example, in reviewing and challenging not only management's prior judgments, but the previous year's audit file. Professionalism means auditors should not only call out errors or issues in others' work, but also in their own.

CHAMPION WHISTLEBLOWING

Employees play a key part in detecting fraud. ACFE finds that most frauds are detected by tips[11], rather than internal audit or management review. These come not only from employees, but also customers and vendors. The organisation should strive to build a culture that encourages employees to speak up, whether by raising concerns internally or through external whistleblowing. It is important that the organisational culture ensures whistleblowers feel confident that reports will receive attention and that confidentiality is respected as appropriate[12].

In addition, auditors can play a part in the support of raising concerns and formal whistleblowing by, for example, reviewing the effectiveness of internal concern raising systems in the organisation and providing recommendations for improvements to management. Their reviews should not be limited to looking at the number of complaints, as low numbers might indicate that employees do not feel comfortable or protected when raising an issue. Auditors should aim to understand whether employees are aware of how to make use of whistleblowing mechanisms and when they should speak up. Auditors can then use their findings to identify areas of improvement, with particular focus on whether additional protections are required for companies with highly results-focused styles of management.

[11] ACFE, Report to the Nations (2018), https://go.aws/2RWiYZz

[12] ICAEW's 2019 report *How whistleblowing helps companies* explores this topic in more detail. Sir Donald Brydon's recommendation in section 22.7 of his report that whistleblowing protections should be extended to cover reporting to statutory auditors would create an additional stimulus to transparency in organisations.

HAVE THE COURAGE TO SPEAK UP

Auditors can provide trusted insights to audit committees and senior management about the organisation's culture and people. When auditors see something that appears wrong, they should speak up. It is not always easy to call out questionable or unethical behaviour, but it is necessary.

If management does not respond, then auditors should consider escalating matters by reporting to audit committees or shareholders directly. Auditors should be prepared and willing to risk the loss of an audit engagement where the organisational culture facilitates behaviours that encourage fraud or other unethical activities. Employees and management need to see auditors as unafraid and relentless in supporting strong, ethical behaviours.

Conclusions and next steps

Ensuring that fraud is kept to a minimum is crucial for a strong economy and trust in business. While fraud will never be eliminated, we can strive to continually get better at both deterring and identifying it. The tools and techniques used by those committing fraud do not stand still, so neither should those of parties responsible for preventing and detecting it.

We believe that auditors should look beyond the numbers. They can build on and fully utilise their behavioural and cultural experience to help detect and prevent financial reporting fraud. To achieve this fully may require the further development of audit training and programmes to help auditors better understand and target the behaviours that can facilitate fraudulent reporting.

We have set out a number of ways auditors might plan and review for fraudulent financial reporting as part of the statutory audit. They focus on one important way in which auditors can consider this, focusing on behaviour and organisational culture. We recognise that some firms do this well. But there is no doubt room for improvement. We also recognise that policymakers may use other routes to drive improvements, including those suggested in the UK by Sir Donald Brydon, and that enhanced use of audit technology and assurance outside of the statutory audit will be key to discouraging and detecting fraud, including fraudulent reporting.

Our extensive discussions with stakeholders in the preparation of this essay have revealed that thinking and practice in this area is evolving rapidly. We have the opportunity to make the clear and decisive progress that has eluded those who have previously sought to effect change. **We invite individuals and organisations to share with us not only their comments on the analysis and suggestions in this essay but on their own experiences and ideas in relation to the problem of fraudulent financial reporting.**

Please email your comments to Nigel.Sleigh-Johnson@icaew.com. These will help us to develop our contribution to the coming period of intense consultation and reflection that will determine the future of audit in the UK, and beyond.

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