GPPC

Fraudulent Financial Reporting: A view from the Global Public Policy Committee[1] (GPPC)

Fraud has a significant effect on investors' and society's confidence in financial markets / capital markets. As auditors we recognise our role in addressing the risk of fraud. Along with regulators, management, boards and audit committees, we have an important role to play in instilling confidence in a well-functioning market. All parties must play their part in order for financial reporting to provide the insight investors and society need – we are ready to play ours.

I. Why is this an important topic?

a. Financial reporting fraud, while representing a small percentage of fraud cases, is nevertheless the costliest form of fraud.[2] It is, therefore, important to take appropriate steps to mitigate the risk to the marketplace.

b. Unfortunately, there will always be bad actors who are willing and able to commit fraud; and those bad actors have a natural advantage over others who are charged with preventing and/or detecting fraud. They have the time to plan the fraud and related coverup. They usually have very detailed knowledge of the system; and often have help from others with whom they are in collusion. Accordingly, it is not possible to prevent or detect all fraud; but it is possible, and necessary, to improve the functioning of all relevant market participants who have responsibilities related to the prevention and/or detection of fraud.

II. Who has responsibilities related to fraud?

a. While it is possible for effectively designed financial reporting frauds to go undetected in the best of financial reporting ecosystems, fraud that is material to a company's financial statements nearly always involves a breakdown in one or more key areas:

   i. The **company's management**, through its system of internal control, is the first line of defense against fraudulent financial reporting. Good corporate governance requires an appropriate consideration of fraud risk and appropriate controls to prevent and detect it.[3]

   ii. The **board and/or audit committee** (including the **internal audit function**), through its oversight role related to the company's response to fraud risk, is in the unique position to hold management accountable for effective fraud control and to interact objectively with the external auditor to understand and help direct their detective fraud procedures.

   iii. The **external auditor's** responsibility is to obtain reasonable assurance that the financial statements are free from material misstatement, whether due to fraud or error. The auditor's consideration of fraud risk, its evaluation of fraud risk controls, and reasonable audit procedures designed to address fraud risk – helps the audit committee understand the related strengths and weaknesses in the internal control system and may detect frauds that have bypassed the company's and internal audit's fraud prevention and detection measures.

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[1] The Global Public Policy Committee (GPPC) is the global forum of representatives from the six largest accounting networks: BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC, which has as its public interest objective the enhancement of quality in auditing and financial reporting.

[2] See the Association of Certified Fraud Examiners' (ACFE) *2010 Report to the Nations on Occupational Fraud and Abuse.*

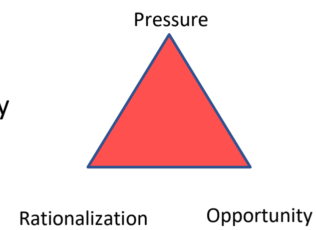
[3] See COSO's 2016 Fraud Risk Management Guide at *COSO-Fraud Risk Management Guide-E Summary_8 5x10 875_r1 (3).pdf*

Importantly, however, it is not possible for the external auditor todesign procedures that will detect all fraud in a company.

b. Regulators also play a pivotal role in establishing a regulatory framework that is clear and reasonable and has robust enforcement to act as a deterrent.

III. How can fraud be prevented and/or detected in a timely manner?

a. Addressing the source: In order to reduce the risk of financial reporting fraud to the marketplace, we must address the governance, risk and compliance roles of all three market participants. Further, all three participants must address the three conditions that are present in every fraud. Commonly called the ***Fraud Triangle***, these conditions include:



   i. The presence of **pressure** for fraudsters to commit fraud
   ii. The **opportunity** for fraudsters to commit fraud, and
   iii. The **rationalization** that fraudsters always have as their reason(s) to commit fraud

b. Preventing and detecting by the Company: Controls designed to **prevent** fraud from occurring in the first place are, of course, most important. However, it is not possible to prevent every fraud without incurring a cost that is even greater to the marketplace than the cost of the fraud. Accordingly, it is also important for the Company to establish controls that could **detect** and address financial reporting frauds that have occurred before they become material.

c. Preventing and detecting by the board/audit committee/internal audit: The first step is understanding the nature and significance of fraud risk. The next step is setting an appropriate tone and asking reasonable questions about management's controls. How does management assess fraud risk? Where might fraud be committed? What preventive and detective controls has management put in place? How does management verify that the controls are effective?

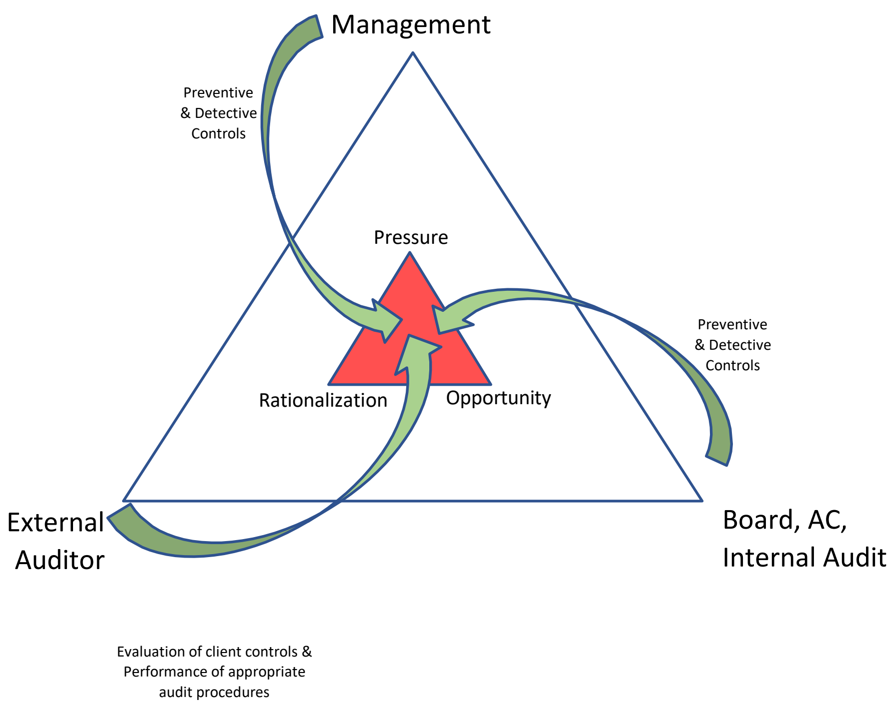
d. Detecting by the external auditor: The external auditor has a responsibility in the standards to consider fraud risk in the design and execution of the audit. The auditor cannot prevent fraud, but audit procedures may identify potentially ineffective fraud controls, or detect a fraud that was not prevented or detected by the company's controls.

IV. What might be needed to improve fraud prevention and detection?

a. For management: Strong tone from the top and appropriate guidance, examples, and reinforcement of the inherent requirement for effective fraud risk assessment and control.[4] For boards, audit committees and internal auditors: The same needs as management, plus healthy dialogue with the external auditors about fraud risk.

b. For auditors: Although continuous improvement should always be a goal, the existing auditing standards (e.g. ISA 240, AS 2401) are largely fit for purpose as it relates to fraud. It is noteworthy, however, that environments that have a greater focus on management's responsibilities for maintaining a robust control environment combined with good execution of audit procedures are a strong combination in the prevention and detection of fraud.

   In countries with strong corporate regulatory environments, what is most needed to continually improve audit quality as it relates to fraud risk is ongoing training with examples of fraud and reinforcement of the need for professional skepticism.[5]



[4] For example, see COSO's *Guidance on Fraudulent Financial Reporting*, [Guidance on Fraudulent Financial Reporting (coso.org)]

[5] For example, see the Center for Audit Quality's resources at [Anti-Fraud | The Center for Audit Quality (thecaq.org)]