ACCOUNTANCY EUROPE.

AUDIT COMMITTEES' ROLE IN FIGHTING FRAUD

Recommendations

Position paper

VIEWS.

CORPORATE GOVERNANCE
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HIGHLIGHTS

Fraud can deteriorate investors' trust, weaken the public's confidence in markets and have long lasting damaging effects on society. A strong internal corporate governance structure is instrumental in preventing and detecting fraud.

Mitigating fraud risks requires the full collaboration of the whole corporate governance ecosystem. This publication examines how audit committees, with other key corporate governance and reporting actors such as the board, management, auditors and policymakers can help tackle corporate reporting fraud.

We propose several recommendations for an audit committee's future-oriented and evolving role. This paper aims to inform policymakers in the context of the European Commission's ongoing initiative on corporate reporting.

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INTRODUCTION

Fraud[1] that deteriorates investors' trust in the company and can lead to corporate failure weakens the public's confidence in markets, undermines the entity's reputation and has long lasting damaging effects on society. Mitigating fraud and corruption risks within companies is vital to achieve a company's operational, reporting and compliance objectives. It is also key to shareholder protection.

A company's internal corporate governance structure is instrumental in preventing and detecting fraud. It establishes systems and structures to manage fraud risks. The audit committee (AC) is a subcommittee that supports the board in executing their supervisory responsibilities. There may be differences in board structures i.e. one-tier (unitary) and two-tier board, depending on the national jurisdiction and applicable corporate governance system. In this publication, we use 'board' as a general term.

AC plays an important role in overseeing the risk of fraud and shortcomings in internal controls. With the board, AC contributes to providing confidence to investors, creditors, business partners, public authorities and the broader public.[2]

OBJECTIVE

This publication considers how ACs together with other key corporate governance and reporting actors such as the board, management, internal auditors as well as external auditors and policymakers can help tackle corporate reporting fraud. It proposes several recommendations for an AC's future-oriented and evolving role. This continues our work on exploring ACs' future role and responsibilities; see our paper *ESG Governance – Recommendations for Audit Committees*.

This paper and its recommendations are targeted at Public Interest Entities (PIEs) and large unlisted companies that usually have an AC.

AUDIT COMMITTEE'S EVOLVING RESPONSIBILITIES

Economies and global supply chains are highly interlinked and complex. This is further exacerbated by crises such as the Ukraine war, Covid pandemic impacts, climate change and the ESG implications of these. These crises coupled with the impact that digitalisation and related cyber risks can have in terms of expanding companies' fraud risks. Mitigating these risks and uncertainties requires the full collaboration of all key corporate governance ecosystem actors – including ACs.

The board is at the forefront in the fight against different forms of corporate fraud, from misappropriation of assets and transactions to fraudulent reporting or greenwashing. It has the primary responsibility for corporate reporting and is accountable to shareholders and stakeholders. The board relies in part on ACs for this task, specifically to safeguard the corporate reporting process' integrity and to oversee statutory audits.

ACs often together with the board oversee business risks, risk management systems, internal controls, corporate reporting and audits. Their responsibilities are further expanded by new EU legislation[3]. It requires them to monitor the quality of the corporate (including and integrating financial and sustainability) reporting process as well as the quality of financial statements audit and sustainability assurance.

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[1] Fraud - 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. See https://www.ifac.org/system/files/downloads/a012-2010-iaasb-handbook-isa-240.pdf

[2] Tapestry Networks, 2020, *Audit Committee Realities: Insights from Europe's leading boards*

[3] The EC *Corporate Sustainability Reporting* Directive expands the AC's mandate and responsibilities to include company sustainability reporting to enable them to support company boards.

RECOMMENDATIONS TO MITIGATE FRAUD THROUGH AN EFFECTIVE CORPORATE GOVERNANCE SYSTEM[4]

An appropriate and effective corporate governance system is key to prevent and detect fraud and corruption risks. We outline below recommendations for a future-proof and effective corporate governance ecosystem.

BOARDS

ESTABLISH ROBUST INTERNAL CONTROLS AND RISK MANAGEMENT

Boards are responsible for ensuring that management has designed and put in place appropriate internal controls and for managing risks such as fraud, going concern and non-compliance with laws and regulations. The effective use of technology should be considered to facilitate these processes.

The board should also ensure that management conducts a proper fraud risk assessment in collaboration with relevant functions within the company such as the risk officer and internal audit. ACs have a key role in supporting boards in these responsibilities.

Companies should issue a public statement about the internal controls' effectiveness over financial reporting with a focus on fraud and going concern. Such a public statement would help ensure that management and the board are discharging their responsibilities on this matter (more details under recommendations to policymakers, p. 7).[5]

DEFINE CLEAR RESPONSIBILITIES FOR RISK MANAGEMENT AND INTERNAL CONTROLS

Boards and ACs should agree on clear responsibilities for risk management and internal controls oversight over corporate reporting of both financial and non-financial information. These controls are crucial to identify areas with deficiencies. It is the board's responsibility to remedy weaknesses in internal controls including those related to fraudulent activities.

This requires having adequate competences, expertise and a sufficient number of AC members that are independent from the audited entity. The board should strengthen ACs' functioning and ensure their independence.

BUILD A RESILIENT CULTURE

The board sets the tone at the top that must cascade across the organisational structure in an effective and collaborative way. This means making sure that everyone is speaking the same language and adhering to the same values. The AC plays a principal role in the culture building making sure the organisation's culture is in line with its values, purpose and risk appetite.

A healthy culture is one that helps drive strategy and ensures objectives can be met. Taking appropriate measures to assess and audit culture is the AC's job e.g. the creation of code of conduct, setting up whistleblowing policies and procedures. The AC is responsible for ensuring that the whistleblowing policy is understood by stakeholders and effective in terms of getting them to speak up if they see a wrongdoing. It also must ensure that investigations are followed through and resolved.

In addition, the board should evaluate whether their own actions, and this includes those of the board committees, encourage or pressure management and others to commit fraud or corruption. ACs can play an important role

[4] Points raised in this section derive from our papers/consultation responses:

- Response to the EC consultation *Strengthening of the Quality of Corporate Reporting and its Enforcement*
- Fraud: recommendations to strengthen the financial reporting ecosystem
- Going concern: recommendations to strengthen the financial reporting ecosystem
- Stronger internal controls to reduce corporate risks

[5] See also Accountancy Europe position paper *Stronger internal controls to reduce corporate risks*

by ensuring the processes and controls are in place and constantly monitored for effectiveness and ways of improving and modernising.

AUDIT COMMITTEES

DEVELOP THE NECESSARY COMPETENCIES AND EXPERTISE

An AC should have the skills and attitude to proactively detect potential issues in corporate reporting and challenge management where necessary. To this end, they should collectively have the competence in areas such as financial, climate and other environmental matters, digitalisation, cyber and industry risks. This includes awareness about fraud risk factors and conditions that may lead to fraud, e.g. incentives, pressures, opportunities and rationalisations. Calling on internal and/or external experts may help enhancing the required expertise.

Diversity in AC composition will also play an important role. Factors such as diverse skillset, backgrounds, intergenerational diversity, diversity of stakeholder representation could be considered.

LOOK OUT FOR SENIOR MANAGEMENT FRAUD

The board and AC should include fraud risks as a recurring item on their agenda. Discussions around (potential) fraud by senior management can often be misinterpreted as mistrust. Having a trustful relationship, however, should not stop board and AC members from asking management controversial questions or making enquiries.

This will require ACs to nurture and leverage their soft skills such as critical thinking, an investigative mindset, scepticism, an ability to challenge the status quo and moral courage to raise uncomfortable questions.

COLLABORATE WITH INTERNAL AUDITORS

The internal audit function is also important in a company’s governance structure. Internal auditors usually report directly to the AC. Their main role is to assess the efficiency and effectiveness of the company’s internal controls, including fraud risk management systems, which help produce reliable corporate reporting.

ACs will need to work closely with internal auditors to identify fraud risks. For example, ACs should review and approve the company’s annual internal audit plan to ascertain that it is aligned with audit committee’s expectations and addresses management fraud risk appropriately.

COMMUNICATE WITH EXTERNAL AUDITORS

ACs cooperate with the external auditors through their monitoring responsibilities. This allows for the AC to exchange information on company risks with the external auditor. Such an exchange is useful for the auditor in planning, risk assessment, progressing and finalising the audit engagement.

Auditors benefit from ACs’ commitment and cooperation, based on openness and honesty. ACs should also ensure that external auditors have sufficient resources to perform their engagements to a high standard. An effective working relationship between the auditor and the AC, while maintaining independence, is beneficial not only for the two parties but also for the company, investors and the general public.

Sustainability assurance

Sustainability reporting is growing in importance. This means ACs will also need to reflect on the interconnection between their sustainability and financial reporting responsibilities when deciding on assurance needs.

For sustainability reporting assurance, the AC needs to be involved in the assurance provider selection, monitoring their independence and work. The AC should also exchange with the external assurance provider information about company risks, including ESG related fraud risks. All this will be pivotal to ensure that the sustainability reporting is robust, accurate and mitigates greenwashing risks.

MONITOR HOW AUDITORS DISCHARGE THEIR RESPONSIBILITIES

ACs should monitor how auditors discharge their responsibilities in relation to fraud. Developing fraud related audit quality indicators (AQIs) can help monitoring the auditor's performance on this matter. For specific examples of possible AQIs, see Accountancy Europe's publication - *Audit Quality Indicators: A global overview of initiatives*.

These indicators can also enrich discussions among stakeholders. Indicators should consider the company's operating environment, audit procedures and communications during the audit. They can be part of firms' quality management systems.

AUDITORS

CLEARLY COMMUNICATE ON WORK AND CONCLUSIONS

The auditor is already required to report their work on fraud and deficiencies found in internal controls to the board and AC. If the auditor suspects fraud involving management, they have to communicate these suspicions to the board and AC. Such communications need to be clear and ideally lead to a valuable exchange on the specific issue.

Auditors should also describe specific procedures performed rather than having boilerplate explanations when communicating with boards and ACs. For instance, if a forensic expert is involved for the first time, the reasons behind this could be explained to the AC in a more detailed manner.

POLICYMAKERS

ENHANCE THE EU CORPORATE GOVERNANCE FRAMEWORKS' CONSISTENCY

Strong corporate governance is indispensable to identify, mitigate and prevent fraud and corruption risks. It is therefore important policymakers enhance consistency in corporate governance structures and practices in EU Member States (MS). This will be key to the corporate governance framework's overall effectiveness and fraud prevention.

MANDATE A SEPARATE AUDIT COMMITTEE FOR ALL PUBLIC INTEREST ENTITIES

According to the EU audit legislation, MS may allow a PIE not to have an AC in circumstances where it has a body that performs equivalent functions. Given the critical role of ACs in mitigating fraud risk, it should be mandatory for all PIEs to have:

- a separate audit committee independent from management
- a sufficient number of members in the audit committee with competence in accounting and/or auditing as well as sustainability and risk management
- an independent internal audit function supervised by the audit committee

Legislators should abolish provisions that allow MS to derogate from the requirements above.

MANDATE PUBLIC REPORT ON A FRAUD RISK MANAGEMENT SYSTEM

EU (and national) legislation should ensure that companies' risk management and compliance management systems include anti-fraud mechanisms. These mechanisms should set out specific procedures, and clear responsibilities for boards, ACs and management.

As part of these systems and based on a well-defined framework, companies' management should be required to operate a fraud risk management program. It should cover the fraud risk assessment, internal controls and responses to allegations and incidents of fraud and corruption.

Legislation should require companies to publicly disclose a statement about the effectiveness of this program and relevant controls. This disclosure could be made as part of a corporate governance statement included in a company's management report.

ENHANCE TRANSPARENCY ON HOW BOARDS AND AUDIT COMMITTEES DISCHARGE THEIR RESPONSIBILITIES

Lack of transparency on how boards and ACs discharge their responsibilities and corporate governance statements should be improved. Companies should be specific when reporting on the effectiveness of their internal controls, also related to fraud, instead of providing descriptive and boilerplate information. We refer to the above recommendation for companies to issue a public statement about the effectiveness of internal controls and fraud risk management systems.

PROMOTE EXCHANGE OF BEST PRACTICES

Collecting and sharing of good practices at EU level could contribute to better corporate governance in listed companies. In this regard, the CEAOB surveys and analyses on ACs could be expanded. They should cover ACs' interactions with internal and external auditors as well as the AC's reaction to findings communicated by the auditors including in relation to fraud.

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