AUDITORS AS GUARDIANS AGAINST FRAUD

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On

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MR CHAIRMAN

Thank you for inviting me to address the International Society for the Reform of Criminal Law.

Fraud has undergone a radical transformation and would today be hardly recognisable to the ancient Venetian merchants as a crime, except for its name and the element of trickery which is fundamental. Credit card fraud, securities fraud and insurance fraud are but some of the new forms of fraud which this millennium has witnessed.

In times gone by, auditing was concerned exclusively with the prevention and detection of commercial fraud. In 1878 the collapse of the City of Glasgow Bank prompted calls for greater controls. False accounting had been used to cover a deteriorating position which eventually brought about the Bank's collapse. A year after the crash, in 1879, a Companies Act introduced limited liability to the whole banking sector and required an audit of the 'full and fair' balance sheets of banks. Insolvency work started to dwindle and the accountancy profession started looking for pastures new. These it found in auditing.

What the first auditors were concerned with was the attestation of fairness and truth to the accounts of merchants. A lot of water has flowed beneath the bridges since the collapse of the City of Glasgow Bank, and today the auditing profession is faced with companies and undertakings, both national and international, parent companies and subsidiaries as well as associated undertakings, the likes of which had never been seen before.

Auditing firms are themselves large entities. Mergers have taken place between different auditing firms, and the formation of large auditing 'blocks' with offices worldwide has converted these auditing firms into veritable giants.

Within the auditing profession itself there is no general agreement on whether the detection of fraud is one of the aims of the audit. Prior to the beginning of this century, the detection of fraud and error was widely accepted as being the primary audit objective (vide **Nichol's Case, 1959**). After the Companies Act 1948 the emphasis was shifted on to lending credibility to financial statements. So far the auditing profession has only shown its preparedness to certify that the financial statements of a company 'give a true and fair view'.

It has been said that 'true' and 'fair' is what you make it. Many within the auditing profession refuse to accept that detection of fraud is their responsibility. Auditors say that they have developed modern techniques of verification which they consider as most reliable instruments of auditing. Nevertheless, they refuse to certify in their audit that the business of the company whose accounts they have audited is free from fraud. They provide a ritual of verification, but go no further than that. This is the problem that I would like to set and discuss before this Conference.

When this distinguished gathering will on Sunday discuss National and International Responses, it is in effect professing its belief that the aim of our operations is principally to protect businesses, investors and other potential victims from fraud. It is my firm belief that a very effective way to counter fraud is through company auditors. Law enforcement agencies usually enter the scene 'ex post facto', whereas the company auditors' vantage point as overseers puts them in a good position to prevent and detect fraudulent conduct by senior management and deliberate misstatement.

Holding directors and officers of companies responsible for fraud committed by their companies goes a long way towards achieving the aim of combating fraud. However, the task of 'policing' corporate business ought to be assigned to the company's auditors.

Auditors are usually very fast to react and protest that this is too grave a responsibility for them to shoulder and that constraints stemming from confidentiality obligations prevent them from assuming this role. The more I think about these protestations, the more I feel convinced that there is little valid justification for auditors to refute this responsibility.

Attesting that a company's financial statements give a true and fair view implies a responsibility for detection of fraud. The two are undoubtedly closely allied. If the audited financial statements contain material omissions and conceal the true state of a company's financial affairs, one is inclined to ask: What is the purpose of having auditors and audited accounts? If a material fraud or breach of law effecting the true and fair view were to pass undetected by the auditor, then truly this is proof of gross negligence. This is like saying that a police investigator, given access to all the suspect's documents and granted all the powers which are normally granted to an auditor, is

unable to make up his mind at all whether or not a fraud was perpetrated or, worse still, is unable to detect a completed offence of fraud.

In the English case **Re Thomas Gerrard & Sons Ltd, 1968**, investigations revealed that the managing director (who was later convicted and imprisoned on fraud charges) had at least since 1957 made it a regular practice to falsify the company's accounts, thereby concealing the fact that after 1957 the company had made heavy losses, and presented a picture of profit. Where were the auditors throughout these years? An action for damages against the auditors succeeded. Would not a penal sanction have been appropriate?

Ken McGuire criticised the stance taken by the profession in a chapter on 'The role of auditors in protecting against bank fraud' which features in **'Banks: Fraud and Crime'**, edited by Joseph J. Norton.

> "…(T)he accountancy profession has for much of the 20th Century been engaged in a campaign to counter the assertion that the detection of fraud is a major objective of the contemporary audit process. As the modern audit function has developed, the accountancy profession has perceived the detection of fraud as being subsidiary to the more general responsibility to serve the public's interest by reporting on the quality of an institution's financial statements. Others have argued that the reason for this change of attitude are less gallant, and that the accountancy profession has been more concerned with advancing its own self-interest than that of the public … A survey carried out by a leading accountancy firm in 1990 found that 75% of the respondents thought that it was the auditor's responsibility to detect frauds of all kinds, and that 61% reckoned that it was their responsibility to search actively for fraud."

The paradox is that whilst denying responsibility for the detection of fraud, the auditing profession in England has issued Statement of Auditing Standard (SAS) 110 regarding fraud and error, which provides 'inter alia':

> *110.9 Where the auditors conclude that a suspected or actual instance of fraud or error has a material effect on the financial statements and they disagree with the accounting treatment or with the extent, or the lack of disclosure in the financial statements, of the instance or of its consequences, they should issue an adverse or qualified opinion …'*
>
> *110.10 Where the auditors become aware of a suspected or actual instance of fraud they should:*
> *(a) consider whether the matter may be one that ought to be reported to a proper authority in the public interest, and where this is the case*
> *(b) except in the circumstances covered in SAS 110.12 discuss the matter with the board of directors, including any audit committee.'*

110.11 *Where having considered any views expressed on behalf of the entity and in the light of any legal advice obtained, the auditors conclude that the matter ought to be reported to an appropriate authority in the public interest, they should notify the directors in writing of their view and, if the entity does not voluntarily do so itself or is unable to provide evidence that the matter has been reported, they should report is themselves.*

110.12 *When a suspected or actual instance of fraud casts doubt on the integrity of the directors, the auditors should make a report directly to a proper authority in the public interest without delay and without informing the directors in advance.*

If the auditors are expected to discover fraud only in those instances where the directors have acted properly and honestly, are auditors really necessary?

Naturally, the responsibility of auditors for preventing and detecting fraud cannot be absolute, for that would be unfair on the auditing profession. Failure to detect fraud should only attract liability – as in most other areas of the law – if there is gross negligence or collusion.

(1) Instances where fraud stood glaring the auditor in the eye but was left undetected should attract liability.

(2) Instances where an auditor, using proper care, ought to have detected the fraud should similarly attract liability.

(3) Instances where there is evidence of 'wilful blindness' or outright collusion between the auditor and the directors or officers of the company should also give rise to criminal prosecution.

What sort of liability are we referring to? Does civil liability suffice, or is criminal liability a 'sine qua non' in order to provide the necessary protection? Auditors would require a period of time within which to adapt to the new principles and sanctions. During the period of transition, criminal liability should only result in cases of clear evidence of collusion in cooking the books. In all other cases, during the transition period auditors ought only to be exposed to civil liability. Eventually, however, when the notion of liability for fraud detection will be clearly understood by auditors, in theory and in practice, criminal liability should be extended to instances of gross negligence as well as complicity and 'wilful blindness'. In all the above cases, specific legislation would be required.

Auditors would be able to avail themselves of the defences normally available in the context of criminal law, for instance, absence of malicious intent.

If we wish the role of auditors in the detection of fraud to be meaningful, resort to criminal sanctions must be had. In an area where even civil liability for damages is contested by the auditing profession, specific legislation is necessary. These matters should no longer be treated as exclusively private law matters, and therefore penal sanctions should be introduced to give the auditor the role of guardian against fraud and guarantor of the audited financial statements. If an auditing firm is not held responsible at law for the correctness of the financial statements it has effectively audited, the audit might as well be abolished. It is only by attracting some form of criminal liability that an audit can be meaningful.

It has been stated that the purpose of having the financial statements of a company audited is "to provide a mechanism to enable those having a proprietary interest in the company or being concerned with its management or control to have access to accurate financial information about the company." (Hobhouse, J.).

How accurate is 'accurate'? Does 'accurate' exclude fraud? Company legislation and investment services legislation penalise such acts as defrauding creditors, fraudulently removing company assets, fraudulently obtaining credit and making false entries in the company's books. How accurate are the audited financial statements of a company which fail to detect fraud? Auditors brag about the reliability of their audit, vaunting new 'watertight' procedures made available through information technology; yet they stop short of assuming responsibility for a fraud-free audit.

In 1994, the Maltese legislator introduced a package of financial services legislation. Provisions were inserted in some of these laws making the auditor accountable to the regulatory authorities. A duty to report was imposed on the auditor in The Banking Act 1994, The Financial Institutions Act 1994, The Investment Services Act 1994, The Insurance Business Act 1998 and The Insurance Brokers and Other Intermediaries Act 1998, as well as an earlier law, The Co-operative Societies Act 1978.

For instance, section 31 of The Banking Act 1994 provides:

> *"An auditor shall immediately advise the Competent Authority if:*
> *...*
> *(c) he decides to qualify the audit report.*
>
> *(9) If, in his capacity as an auditor of a bank or due to a direct request by the Competent Authority under section 20 or under section 22 of this Act, an auditor becomes aware of any matter which relates to and may have a serious adverse effect upon the depositors of that bank, of the branches in Malta of a bank which is not incorporated in Malta, or of any connected person which is a bank, he shall immediately inform the Competent Authority through the bank's management or, if circumstances so warrant, directly to the Competent Authority."*

Similarly, section 18 of The Financial Institutions Act 1994 imposes an identical duty to report on any auditor if he –

> *"becomes aware of any matter which relates to and may have a serious effect upon the stability and soundness of the financial institution or of a branch in Malta of a financial institution not incorporated in Malta or the integrity of the financial system in Malta".*

Furthermore, The Financial Institutions Act (as well as several other laws) grant an exemption from liability to an auditor making a report to the competent authorities in good faith:

> *"No duty (including the duty of professional secrecy) to which –*
> *(a) an auditor of a financial institution may be subject, shall be regarded as contravened by reason of his communicating in good faith to the Competent Authority, whether or not in response to a request from it, any information or opinion on a matter of which the auditor has become aware in his capacity as auditor of that institution and which is relevant to the functions of the Competent Authority under the provisions of this Act or is required to be communicated by virtue of this Act."*

Determining in what circumstances this duty to report should apply is the crux of the matter. In the United Kingdom, Statements of Auditing Standards evolved by the Auditing Practices Board provide guidance on such reporting situations. SAS 620 issued in March 1994 provides useful guidelines:

> *When the auditors conclude, after appropriate discussion and investigations, that a matter which has come to their attention gives rise to a statutory duty to make a report, they should bring the matter to the attention of the regulator without undue delay in a form and manner which will facilitate appropriate action by the regulator …*
>
> *When the matter giving rise to a statutory duty to make a report direct to a regulator casts doubt on the integrity of the directors or their competence to conduct the business of the regulated entity, the auditors should make a report to their regulator without delay and without informing the directors in advance.*

The U.K. Criminal Justice Act 1993 states that when, in the course of their work, auditors become aware of evidence indicating the presence of laundering of money which either derives from drug trafficking or is related to terrorist offences, they are required to report their suspicions to the appropriate authority.

After examining these various aspects of the duty to report to regulators in the financial sector, a suggestion made by the U.K. Cadbury Committee on Financial Aspects of Corporate Governance (1992) readily comes to mind. The Committee suggested that legislation should be considered which would extend the statutory protection, already

available to auditors in the financial services sector, to the auditors of all companies so that they can report any suspicions of fraud or other misdemeanour to the appropriate authorities without breaching confidentiality obligations.

This suggestion is particularly apt in the light of the discovery of a devastating monumental fraud at the European Commission in Brussels. Paul van Buitenen, a lone assistant auditor, blew the whistle on corruption and mismanagement at the heart of the European Union. Admittedly, at first his infuriated superiors not only suspended him from work but also branded him as disloyal and 'unbalanced'. Yet later on he was fully vindicated. No fewer than eleven separate police teams investigated the EU staff in connection with alleged frauds. The fraud investigation will include the disappearance of up to £12 million of food aid sent to Russia six years ago. I ask: Where were the auditors?

My message today, Mr Chairman, is an invitation to you to support the introduction of criminal sanctions, in varying degrees, for auditors failing to report a fraud as a result of collusion, wilful blindness or gross negligence.