

A close-up photograph of a person's hand holding a single, ripe red and yellow apple. The hand is positioned above a tray filled with many other similar apples, which are slightly out of focus. The background is a blurred industrial or agricultural setting. A bright yellow banner is overlaid on the top left of the image, containing the title and subtitle.

# Preventing and detecting fraud

Strengthening the roles of companies, auditors and regulators

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# Introduction

In his recent report on audit quality and effectiveness in the UK, Sir Donald Brydon described the question of fraud as “the most complex and misunderstood in relation to the auditor’s duties.”<sup>1</sup>

While there have been a number of major corporate failures as a result of fraud over the past few decades, it is important to note that relative to the overall number of listed companies the figures are very small. These failures nevertheless reinforce the need for more to be done to discourage and prevent fraud and, where it cannot be prevented, to detect it as soon as possible.

We recognize that, as part of ongoing improvement efforts, we need to evolve how we perform our audits to address fraud. Further, we are committed to leading the profession more widely to address the questions that many stakeholders are asking about the role of the auditor in fraud detection.

We are already making progress. In fact, the actions we are taking – mandating the use of data analytics for fraud testing, using additional internal and external data and information, using electronic confirmations for audit evidence wherever possible, developing a proprietary fraud risk assessment framework, mandating annual fraud training and requiring the use of our forensic specialists in the audit on a targeted-risk basis – go beyond currently accepted professional standards.

Recognizing that auditors cannot succeed on their own, we set out a call to action to all members of the corporate governance ecosystem, including management, boards, audit committees and regulators, to work with auditors on these issues, to improve accountability and, where they do not exist already, to develop their own initiatives to improve the prevention and detection of fraud.

<sup>1</sup> [Assess, Assure and Inform: Improving Audit Quality and Effectiveness](#), December 2019, Report of the Independent Review into the Quality and Effectiveness of Audit.

# Who is responsible for preventing and detecting fraud?

The prevention and detection of fraud within a company is primarily the responsibility of management under the oversight of those charged with the governance. Along with other members of the corporate governance and reporting ecosystem, auditors also play an important role in detecting material fraud.

Currently, auditors are responsible for providing reasonable assurance to shareholders that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error. Public opinion in many places though indicates that auditors are expected to play a role that extends beyond providing this reasonable assurance.<sup>2</sup>



## Using data, forensic, behavioral analysis and training in the audit to detect fraud

New opportunities to catch fraudsters are presenting themselves. Companies have never been as data-rich as they are today, potentially providing entirely new opportunities to detect material frauds through data mining, analysis and interpretation. Auditors are ideally placed to do this.

Auditors are already increasingly using data analytics to identify unusual transactions and patterns of transactions that might indicate a material fraud. At the same time, auditors still face challenges when it comes to acquiring and analyzing the relevant data from companies, either due to systems infrastructure, formatting issues, or data privacy rules.

Technology is not a panacea: an important human element also comes into play. There is an opportunity for all involved, management and boards, auditors and regulators, to focus more on corporate culture and behaviors to support fraud detection. The fraud triangle,<sup>3</sup> a generally accepted model used to consider the likelihood of fraud risk, holds that three factors (opportunity, pressure and rationalization) provide the environment

for a fraud to occur. We believe that developments in technology and research on human behaviors could enhance an assessment of the pressure and rationalization elements. These results could feed into a fraud risk assessment process. For example, consideration of the fraud triangle could in the future be part of a company's risk management and compliance system, and audit firms could deploy professionals with different skills to look at all three factors (opportunity, pressure and rationalization) to enhance the ability to detect fraud. We would welcome a dialogue with all stakeholders to explore opportunities in this area.

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<sup>2</sup> Closing the expectation gap in audit, ACCA, May 2019, summarizing the results of survey of 11,000 people across 11 different countries.

<sup>3</sup> Donald R Cressey, Other People's Money, Montclair: Patterson Smith, 1973. Explains how fraud is more likely to take place when there is an opportunity to commit the fraud in a concealed way (e.g., where there is a flattened management structure or limited approval processes); there are pressures (e.g., to appear to meet earnings to sustain investor confidence or personal financial problems); rationalization where the perpetrator justifies their actions to feel they are acceptable (e.g., "I need it more than they do").

There are also opportunities to boost auditors' professional skepticism and moral courage through education and training in topics such as behavioral science, including the concepts of conscious and unconscious bias. These opportunities could have profound implications for auditor education and qualifications, as well as standards and audit regulation in the future.

The use of forensic specialists in the audits of public interest entities may become mandatory in the future. In the UK, Sir Donald Brydon's review of audit has suggested that forensic skills and fraud awareness should be part of the formal qualifications and continuing professional development for all auditors. EY supports that recommendation, and as noted, is already moving forward with enhanced procedures designed to detect fraud.



## How EY is evolving the audit to detect fraud

Where there is an incident of fraud, we seek to understand what we can learn from it to further enhance audit quality – regardless of whether the affected business has been audited by us or another firm. Drawing on both our skilled talent pool and our state-of-the-art technologies, we are developing our auditing process to systematically go beyond standard practice by:

- ▶ Mandating the use of data analytics for fraud testing in audits for all listed entities globally to enhance fraud detection capabilities and further develop professional skepticism. We are already rolling out an approach to use data analytics throughout the audit process which will further bolster our ability to detect fraud.

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**Where there is an incident of fraud, we seek to understand what we can learn from it to further enhance audit quality.**

- ▶ Using additional internal and external data and information to enable more nimble responses to external risk indicators, such as short sellers and whistleblowers. Improving access to news and social media information will also assist in deepening our independent and objective point of view, which is critical in serving the public interest.
- ▶ Using electronic confirmations for audit evidence wherever possible, moving in time to matching companies' records of banking transactions with those provided to EY directly by banks.
- ▶ Developing a proprietary fraud risk assessment framework for use with audit committees and those charged with governance.
- ▶ Mandating annual fraud training for all audit professionals that incorporates the experiences of our forensic professionals.
- ▶ Requiring the use of our forensic specialists in the audits on a targeted-risk basis to assess potential opportunities for fraud.

EY will also continue to work with boards, audit committees, standard setters, regulators and other parties in the corporate governance and reporting ecosystem to strengthen fraud detection. For example, in the US through the Center for Audit Quality, EY works with the Anti-Fraud Collaboration, a combined effort with Financial Executives International, the National Association of Corporate Directors and the Institute for Internal Auditors. The Anti-Fraud Collaboration takes collective action to improve financial fraud risk management.

Outside the US, EY is actively involved in efforts to determine how professional standards for auditors and others in the financial reporting ecosystem can be improved to aid fraud detection. For example, we are contributing to the International Auditing and Assurance Standards Board consultation, as well as a number of anti-fraud related debates in the EU, the UK, India, the Netherlands and South Africa, to name but a few.

## Promoting wider collaboration to effect change

When a fraud extends to a broad network across management and third parties, it can take more than a normal audit to find the evidence. So, what can be done to detect fraud as early as possible or even prevent it?

We firmly believe that this goes far beyond the auditing profession: we cannot succeed on our own. Large-scale fraud is mostly very well thought through and very difficult to detect. Auditing is an important check, but it is not the only one. Nor should it be, if we are to maximize the number of opportunities to prevent or detect fraud as efficiently as possible. In this regard, we believe adopting a “three lines of defense” approach as recently coined by the European Commission is useful: namely (1) corporate governance, (2) the auditor, and (3) capital markets supervision.

In this regard, we believe the following areas are ripe for exploration to drive better prevention or detection of frauds. It is important to state that in some cases these areas draw on best practices or requirements from different countries around the globe, but we believe the public interest would be better served if they were applied more generally to public interest entities.

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**To maximize the number of opportunities to prevent or detect fraud, we believe the “three lines of defense” approach will be useful.**



# Promoting wider collaboration to effect change (Continued)

## 1 Corporate governance

- 1.1. Public interest entities should have a system of strong internal controls over financial reporting that includes fraud risk specifically. Such a system would set out clear and specific roles for each stakeholder (e.g., management, board, audit committee and internal audit), including, where relevant, certification and reporting requirements. According to findings by the Association of Certified Fraud Examiners, a lack of internal controls could contribute to nearly one third of all frauds.<sup>4</sup>
- 1.2. For public interest entities, management and director certifications on the content of financial statements as well as the internal controls over financial reporting should be explored. There should be meaningful consequences for inappropriate certifications. In countries where certifications are already required, this has led to greater understanding by management and boards of the control environment and detailed work to ensure that appropriate internal controls are in place and operating effectively.
- 1.3. Systems and controls are not the only protections against fraud. Culture and incentives also play a role. Companies could do more to measure and oversee both these elements. Whether or not there is a role here for external auditors is open to debate – internal audit or other assurance providers may be better placed to give boards comfort about the corporate culture and influence of incentives. That said, as we explain above, there could be opportunities to enhance companies and their auditor's ability to assess both pressure and rationalization and feed the results into their fraud risk assessment processes. Audit firms could deploy professionals with different skills to look at the three sides of the fraud triangle (opportunity, pressure and rationalization) to enhance the ability to detect fraud.

- 1.4. All actors in the corporate governance chain, including auditors, should have strong whistleblower programs in place that both encourage and protect those who make reports.

Where we have seen similar measures implemented, for example, in the Sarbanes-Oxley Act in the USA, they have led to better accountability of management and those charged with governance over the financial reporting process, improvements in audit quality, decreased severity of restatements and increased investor confidence. It has also been observed by regulators and other key participants that the overall benefits of higher valuation premiums and a relatively lower cost of capital have outweighed the associated additional compliance cost.

## 2 The auditor

- 2.1. Auditing standards should be reviewed to provide auditors with a stronger framework to detect fraud. Such a review should examine matters like materiality, level of skepticism, use of forensic specialists, internal controls, access to and use of culture and incentives' assessments, discussions with audit committees, and public reporting.

It is helpful in this regard that the International Auditing and Assurance Standards Board<sup>5</sup> and the UK Financial Reporting Council<sup>6</sup> have both recently started a review of the auditor's role in fraud detection.

- 2.2. Separately to improve fraud prevention and detection, external auditors could be required under an accepted framework to assess and report on a public interest entity's internal controls and risk management processes (including how the company monitors and tests compliance) to boards, regulators and the public. This reporting would also give an opinion on the directors' statements referred to in 1.2 above. Over time, this feedback loop should lead to more effective controls and processes.

<sup>4</sup> Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, 2020.

<sup>5</sup> Fraud and going concern in an audit of financial statements, IAASB.

<sup>6</sup> Consultation on revised auditing standard for the auditor's responsibilities relating to fraud, FRC.

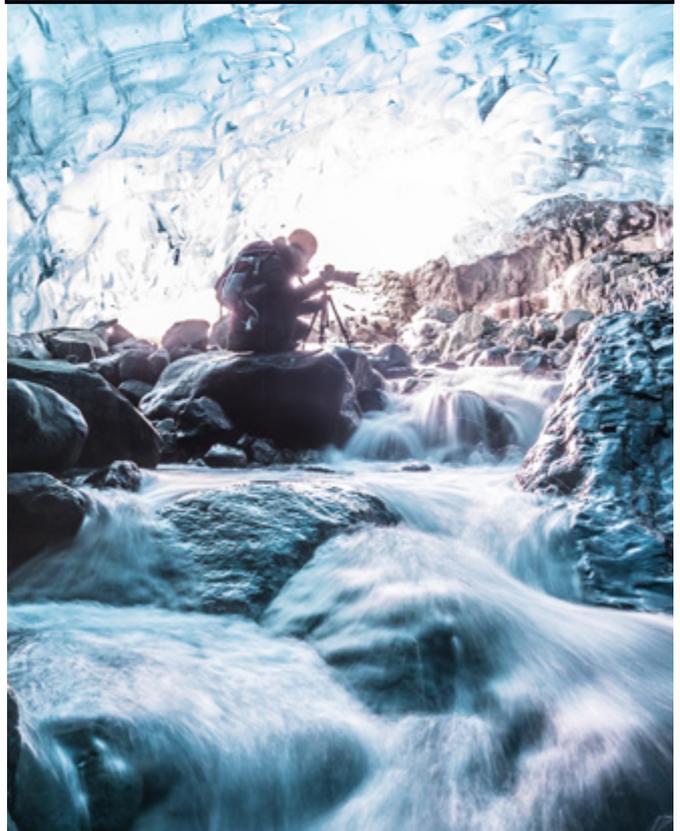
## 3 Capital markets supervision

- 3.1. Minimum corporate governance and reporting standards (including the proposals above) should be required as a precondition for a listing on a major stock market index.
- 3.2. In many places, auditors already have red-flag obligations to escalate, or determine whether to escalate, any concerns they have over potential breaches of laws and regulations that may impact the financial statements, to an appropriate authority. Under this approach in certain jurisdictions, auditors are required to escalate further to a nominated regulator if their concerns are not addressed by management or those charged with governance. Where these obligations already exist, they must be clearly enshrined in law or regulation – the circumstances in which auditors have to report should be clearly defined and the reporting channels should protect good faith disclosure. Importantly, the regulator receiving reports should have a corresponding obligation and the resources to act on the information they receive. This is an important element of, not a substitute for, the other robust lines of defense delivered by management, those charged with governance, auditors and regulators as set out in this paper.

We recognize that the maturity of local or regional corporate governance and regulatory systems needs to be considered when deciding how to progress the areas mentioned above. A full cost-benefit analysis would also need to be undertaken.

## Conclusion

The evolving external environment, increasingly complex business models and the sophistication of fraudsters requires a reexamination of how traditional audit procedures approach the risk of fraud. There are clear actions that we as auditors are already taking to evolve the audit to detect fraud. However, if we are to truly tackle the issue of corporate fraud, actors throughout the “three lines of defense” must work together. Collaboration is key to improving the prevention and detection of fraud, and ultimately protecting the victims of fraudsters.



# Contacts



**Marie-Laure Delarue**  
EY Global Vice Chair – Assurance  
marie-laure.delarue@fr.ey.com



**John King**  
EY Americas Assurance Leader  
john.king@ey.com



**Peter Wollmert**  
EY EMEA Assurance Leader  
peter.wollmert@de.ey.com



**Michael Wright**  
EY Asia-Pacific Assurance Leader  
michael.wright@au.ey.com

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