

## Serving the public interest: a brief examination into fraud

*Keynote by Hanzo van Beusekom, board member of the Dutch Authority for the Financial Markets (AFM)*

*FAR Conference 2022: Inside out and outside in, 20 June 2022*

### Opening

Ladies and gentlemen,

First, I'd like to thank the Foundation for Auditing Research for inviting me to speak today, and to address a highly topical theme. 'Inside out and outside in', and how external factors, like societal expectations, affect the organization of the audit.

Few topics relate as closely to this theme as the one I'd like to focus on today: the audit firm's approach to fraud and fraud risks at audited companies.

Fraud, as we all know, remains a broad social issue, and can have a serious impact. Fraud can cause sizeable losses for investors, loss of jobs, and can cause serious harm to confidence in the financial system as well as in audit firms. We all know these cases well, don't we?

While the responsibility for fighting and preventing fraud rests primarily with the audited company, identifying and following up on fraud and fraud risks is a vital responsibility of auditors. As gatekeepers, they have a duty to serve and protect the public interest.

Admittedly, this task is becoming more and more difficult. The problem of fraud is expected to become even more widespread, due to developments like:

- **Sustainability** – think of issues with greenwashing
- **Technological developments** – where companies are vulnerable to IT-risks or cybercrime, and where those technical innovation creates more room for fraudulent behaviour
- And the **internationalisation of business** – which has led to major and complex fraud cases

A tough job, then, for any auditor. And this is not even taking into account any other internal or external thresholds an auditor faces when coming across possible fraud.

Now, think for a second, about such an auditor. A junior auditor, in this case.  
(Perhaps the person you see here, on this slide.)

During the audit, she's encountered an invoice that raises some alarm bells. It's for a large, round amount, with a vague, circumspect description. Something like 'For services delivered'. And it's to a private person with a foreign bank account.

Now, this junior auditor is new at the firm, just out of school, highly critical, very aware of her important societal gatekeeping role. Furthermore, she finds this very exciting. A possible fraud case! Corruption, maybe, or evidence of a bribe?

Naturally, she mentions her finding to her fellow, perhaps more experienced, team members. Except, they're not as excited as she is. They think she's overreacting. They tell her they've been auditing this company for years, and they can surely be trusted. Some simply tell her to forget it. They're busy enough as it is: their audit report is due in two weeks, and they don't have the time to do extra research.

Still, she goes to her team lead, to address the issue. He's also not very excited. He can already picture the hassle this would cause. As team lead, he would have to approach the client, a trusted, well-paying client, and start asking some difficult questions. He really doesn't want that confrontation.

Also, our audit report is due shortly. What if we cannot finish it in time? Especially when they do investigate, but her suspicion proves unfounded. The company will be mad. Investors will start asking questions about why there's no auditor's report in time.

And what repercussions will this have for the firm? Will we lose the client? And what if there is fraud, but we're accused of not detecting it sooner, in previous years? Our team lead is feeling the pressure.

Eventually, he asks our junior auditor to forget about the invoice, and to find a different one to include in the file.

This might be a slightly exaggerated example, of course, but it's drawn from our supervisory experiences, and I think we can all recognise such situations.

## **So how does the AFM view the approach by audit firms to fraud and fraud risks by audited companies?**

We recently published a paper in which we set out our position.

Our position in a nutshell:

- 1) Identifying and following up on fraud and fraud risks in the statutory audit of audited companies is a vital responsibility of the statutory auditor. The auditor serves the public interest.
- 2) Although there is no objectified picture, the audit sector as a whole seems to be insufficiently developed in detecting and following up on fraud risks.

Similarly, the Dutch professional body for auditors, the NBA, recently published an insightful report along similar lines. Naturally, we very much welcome their contribution.

Why have we come to this conclusion? We've identified three potential root causes:

### **1. Knowledge, competence, and expertise are not always sufficiently available.**

Specific bottlenecks include inadequate fraud risk analyses, insufficient knowledge of the client, the sector and environment the client operates in, and a lack of experience with fraud cases, sometimes specifically regarding group audits of internationally operating companies.

### **2. The auditor's role perception, attitude, and mindset may be inadequate when it comes to the detection of fraud and fraud risks.**

In general, the auditor's default position is to trust the company, rather than having a healthy distrust, and may be inattentive to signs of bad behaviour. Confirmation bias can come into play here: the auditor unconsciously looks for confirmation of what he or she expects.

### **3. The internal culture at audit firms may be an impediment.**

Specific bottlenecks here include internal disincentives, like time pressure, capacity, a tendency to 'minimise' cases, lack of a safe space to address possible fraud, and compliance pressure.

In short, we feel and expect auditors to better fulfil their gatekeeping role with regard to fraud and fraud risks. And at the AFM, we will make this a key theme in our activities in the coming years when it comes to our supervision of audit firms.

### **A key question here is: what should auditors do to better fulfil their role as gatekeepers?**

Because that's the million-dollar question: how do auditors and audit firms translate this crucial responsibility into their daily professional activities?

Clearly, that is not easy, and it makes for a challenging journey.

Let me elaborate on that in three points.

**First.** It's important that the audit sector applies a broad perspective and maintains a broad gatekeeping role. So not only focus on fraudulent financial reporting, but also focus on risks such as corruption, tax evasion, money laundering.

That broad role does justice to enhanced public expectations, and to the fact that the issue of fraud will extend to a wide range of areas in the future.

Clearly, this requires a lot from auditors, in terms of knowledge, skills, and diversified teams. Allow me to make a comparison with my own profession, the supervisory community. We travelled a similar route.

In the 'old days', a supervisor was an economist, lawyer, or auditor. Period.

Then came the financial crisis in 2008. It revealed serious weaknesses within the supervisory profession.

The IMF summarized it nicely: 'Supervisor did not adapt to the changing environment. And supervisors did not focus on the risks building outside their regular areas of focus.'

The message was clear, we needed to broaden our scope, and look beyond our safe and standard perimeters. This considerably changed our profession. Corresponding to our broadened role, we are now more than economists, lawyers, and auditors. We are also data scientists, behavioural scientists, and psychologists.

The audit sector and audit firms should accept their broad gatekeeping role, and act accordingly.

**Second.** Audit firms need to invest in hard skills: in knowledge, competence, and expertise.

This means: improve the quality of fraud risk analyses. Create detailed knowledge of your client, their sector and environment, as well as more awareness of behavioural and cultural signals within audited companies.

But also acquire more in-depth knowledge of regulations and standards with regards to fraud.

And, equally important, make sure audit teams contain sufficient diverse experience, including with forensic auditing.

**Third.** Audit firms also need to invest in soft skills. Auditors need to improve on their role perception, attitude, and mindset when it comes to the detection of fraud.

This entails, among other things, the issue of confirmation bias. A tendency to overestimate your own abilities can also play a part. 'I know my client, I am bound to notice fraud.'

However, targeted fraud risk detection and follow-up requires an attitude and mindset on the auditor's part that is fundamentally different.

There are ways to improve that. This might include the creation of more debate and checks and balances in the audit in case of fraud signals.

There could be increased attention for contra-indications and contradictory audit information. A specification of risks, in particular with regard to management override of controls – where can company management commit fraud?

And there can be an even greater emphasis on quality control reviews within audit firms.

Now, such behavioural challenges are not unique to auditors. In fact, supervisors have also been known to have their fair share of biases.

Over the years, there has been ample academic and – unfortunately – practical evidence that supervisors are, like most human beings, prone to confirmation, anchoring, over-confidence, availability biases.

To this end, at the AFM we have developed and implemented various de-biasing strategies.

This includes a formal 'contradiction team'. This is a group of people from different teams who engage with colleagues on difficult cases, ask tough questions, and pose challenging hypotheticals. The aim is to prevent tunnel vision, and to make sure that every consideration, opinion, and dilemma is adequately addressed.

Despite having them internally, with colleagues, these sessions are usually not 'fun' talks, of course. They can be uncomfortable or even a little painful. But then, that's often the point.

Ideally, the structure of the audit sector and individual audit firms should be such that it gives a positive impetus to detecting and addressing fraud risks.

Unfortunately, this is not yet the case in the current structure.

For instance, the auditor is being paid by the entity he or she is auditing. This entails the risk that the auditor will operate too much on autopilot, and that the financial and personal relationship with the company makes it inherently more difficult to discuss fraud signals.

There are currently various trials underway with alternative structure models. This includes the intermediary model, where an expert third-party, the intermediary, is directly involved in selecting and monitoring the auditor. This would contribute to the independence of the auditor with regard to the audited company.

We await the result of these trials with great anticipation.

Next to that, there should be strong and independent countervailing powers within audit firms themselves – such as the supervisory committee and the internal quality system. These remain of utmost importance to ensure that the public interest is placed above the client interest.

With these three points, we believe that auditors and audit firms can improve their gatekeeping role with regard to fraud and fraud risks.

Hopefully, we'll see improvement on their part in the analysis of fraud and fraud risks, and in the audit procedures they perform in this respect.

Now, this conference isn't merely attended by auditors. There are also a lot of academics in this room. And we have a call to action for you as well.

## How can further research help auditors better fulfil their gatekeeping role?

We propose possible avenues for further research that can help the audit sector and audit firms better fulfil their gatekeeping role. I will name three.

**One.** A recurring question we get is: what is the target on the horizon? What is the long-term aim, and when will the audit sector and the AFM be satisfied with the auditor's role in respect of fraud?

In other words, what does good fraud detection look like?

While this may be impossible to answer in any definitive form, it's useful to develop some key fraud metrics. That will allow us to discuss this matter with a certain degree of objectivity.

Now, many metrics are inherently flawed. Think of the number of frauds that are reported. Is a high number a good sign? Impossible to answer, because you don't know how many frauds go undetected.

Similarly, is a low number a good sign? This might simply be the result of an auditor having cleaned up his client portfolio, getting rid of all clients with a potentially high fraud risk.

So there lies an interesting research question.

**Two.** A second research question lies in the behavioural field.

What can be effective de-biasing strategies within audit firms? How can you create adequate countervailing powers within an audit firm or an engagement team?

And **three.** In the Netherlands, there is a lot of discussion on transparency. What should auditors report on fraud risks? Their activities or their findings?

An interesting research question would be: what would be the effect on the quality of fraud risk analyses by auditors if they had to report on their findings in their audit statement?

These, and surely other lines of research would help the audit sector and audit firms in their approach to fraud and fraud risks. And it would give us, as supervisor, an even greater understanding of the challenges in dealing with this issue.

## Closing statement

That might be a good point to close on: while we have different responsibilities, we can all contribute to combatting fraud.

As supervisor, the AFM is committed to promoting fair and transparent financial markets. Fraud is, by definition, unfair and non-transparent.

It's a significant social issue, which is expected to get worse, and potentially disastrous to many people, as well as to the integrity of our financial system.

It is therefore incredibly important to deal with it appropriately. For us, this is a key issue. And it should also be one for the auditing sector. There haven't been many large accounting scandals in recent years, but the risk of fraud is increasing.

So now is the time for audit firms to invest time and energy into an effective approach. After all, it's better to prevent a fire than having to put one out.

Think about our junior auditor again.

Instead of working in a system that works against her, she should be able to access the proper tools, and be able to speak openly, about her suspicions.

Instead of succumbing to tunnel vision and biases, she should be challenged to look at it her case from all directions.

Instead of having to find a different invoice, she should get the help and support she needs to investigate properly.

How will you react when she turns up with difficult questions at your desk? I wish you much wisdom and many hard questions.

Thank you.