AGENDA

Who Is Stopping Corporate Fraud?

By Jennifer Williams-Alvarez October 5, 2020

With each audit firm scandal, board members are confronted with the question of whether to undertake the arduous and costly process of changing auditors. The **Wirecard** scandal, in which **EY** failed for a time to uncover a roughly $2 billion fraud, has also revived another question: Who in the audit process — from outside auditors to internal audit or audit committee directors — ultimately bears the responsibility if a company suffers an accounting mishap?

For some, the extent of auditors' responsibility in rooting out fraud is up for debate.

Still reeling from the Wirecard circumstances, EY global chair **Carmine Di Sibio** lamented recently in a letter to clients, a copy of which was viewed by *Agenda*, that the firm had not identified the fraud sooner. He also suggested that, while ultimately it's the responsibility of management and directors, auditors should take on more of a role in detecting fraud.

Di Sibio's letter, which was first reported on by the *Financial Times*, speaks to a larger, ongoing debate about whether auditors ought to be expected to detect fraud. Current and former audit committee directors and attorneys underscore the uncertainty. Some are emphatic that auditors are the board's "primary protection" against fraud, while others proffer a more moderate view that auditors are part of collective detection efforts.

Nevertheless, no matter what the assumption is about who is meant to catch fraud, scrutiny will ultimately fall back to the board, says **Irvine Hockaday Jr.**, director at **The Estée Lauder Companies**, who previously chaired the audit committee. The outside auditor is selected, evaluated by and reports to the audit committee, in his experience, which makes it next to impossible for directors to "escape responsibility" if there are accounting issues, says Hockaday, former CEO of **Hallmark Cards**.

"Maybe it's not legal liability," he says, but audit committee directors have "responsibility for ensuring that they are assessing the adequacy of the outside auditor's scope, including looking for fraud."

The Four Percent

Just 4% of fraud is initially caught by outside auditors, research shows. Tips are by far the most likely source of fraud detection at 43%, according to a report released this year from the **Association of Certified Fraud Examiners**. The review of more than 2,500 cases of fraud that occurred between January 2018 and September 2019 revealed that a number of sources, from internal audit to accidental discovery, more frequently lead to fraud detection than do outside auditors.

Over the years, auditors have expressed where they see themselves in fraud detection. When **Colonial Bank** collapsed in 2009 because of accounting malfeasance, at the time the sixth-largest bank to fail in the United States, much of the scrutiny was directed at auditor **PwC**'s failure to detect the fraud. One such source of criticism came from the **Federal Deposit Insurance Corporation** (FDIC), which became the failed bank's receiver.

PwC's missteps, the FDIC claimed in a 2012 lawsuit, had cost the insurer billions of dollars. The case ultimately resulted in a $335 million settlement but not before a federal judge ruled that PwC had failed to design its audits to detect fraud, in violation of auditing standards.

Colonial's demise and the resulting litigation also brought focus to varying opinions about whether the Big Four firms' audits were meant to catch fraud. A PwC audit partner testified in one of the lawsuits that PwC "audits are not designed to detect fraud." That same partner, **Gary Westbrook**, later changed course, testifying that the firm had a duty to design audit processes to find fraud, court records indicate.

Some auditors today maintain that they are not looking for fraud. Early this year, faced with questions about the collapse of **Patisserie Valerie**, the United Kingdom bakery chain's auditor, **Grant Thornton**, clung to the view.

"We are not doing what the market thinks. We are not looking for fraud and we are not looking at the future and we are not giving a statement that the accounts are correct," Grant Thornton chief executive **David Dunckley** said at a hearing this year before a U.K. Parliament committee, the *FT* reported. "We are saying they are reasonable, we are looking at the past, and we are not set up to look for fraud," he added, a view not supported by other accounting executives at the hearing.

The lack of clarity has become a central aspect of a potential overhaul of the audit profession in the United Kingdom, with **London Stock Exchange** chair **Donald Brydon** emphasizing both before and after Wirecard collapsed that there should be no question about whether auditors are expected to find fraud.

In the U.S., current and former board members and advisors draw a distinction between an auditor and a forensic accountant, with the latter often explicitly tasked with examining for fraud. Still, directors expect that external auditors are board members' "primary protection against accounting fraud," says **Boris Feldman**, partner at law firm **Freshfields**.

Feldman has represented companies in the midst of accounting fraud, and inevitably, the question from audit committee members is, "Where were our outside auditors," he says. "If you ask a hundred public company directors in the U.S., 'Do you believe that part of the reason you are paying auditors these fees is in part to detect fraud?' I think the answer would be, 'Damn straight.'"

Hockaday, who has chaired the audit committees at Estée Lauder and **Ford Motor Company**, described fraud detection as a “mosaic.” The audit committee is central, but rather than the board shouldering sole responsibility, management, internal audit and outside auditors are right there in the mix, he says.

Audit committee chair **Jonathan Foster** points to accounting standards to explain his understanding of whether auditors are on the hook for detecting fraud. Auditing standards from the **Public Company Accounting Oversight Board** (PCAOB), for one, require an auditor to give reasonable assurance about whether financial statements are free of material misstatements, he points out.

“So, by definition, they have to look for anything that would cause a material misstatement, and that includes fraud,” says Foster, who chairs the audit committees at manufacturers **Lear Corporation** and **Masonite International Corporation**.

There is no doubt that primary responsibility rests with the company, Foster says, which includes ensuring strong internal controls, a clear segregation of duties, and a culture of transparency and ethics.

At the same time, though, “you want your auditors to be searching for it, too,” Foster says.

Foster and **Robert Cox**, a former assistant director in the PCAOB’s division of enforcement and investigations, agree that the accounting standards do not specifically task one individual with looking for fraud. But with new auditing standards adopted in 2017, the PCAOB made it clear that detecting fraud was within the scope of auditors’ responsibilities, says Cox, now a partner at law firm **Briglia Hundley**.

EY shared Di Sibio’s letter in response to questions for this article, which notes a fraud risk assessment framework the firm has developed to “strengthen the focus on fraud.” The pressure for EY has mounted since Di Sibio wrote to clients in September with the revelation by the *FT* that the firm was warned by an employee about potential Wirecard fraud in 2016.

A **KPMG** spokesperson tells *Agenda* that the firm’s “responsibility is to provide reasonable assurance that material misstatements are detected, whether caused by error or fraud[.]” PwC declined to comment. The last of the Big Four firms, **Deloitte**, did not comment for this article.

‘The Next War’

An accounting scandal brings with it not only the prospect of a company’s ruin, as with Wirecard, but also significant reputational risk, says Hockaday. Limiting the risk involves clearly defining the roles of those involved in the collective audit effort, he says.

However, even the best-laid processes can fall short. Hockaday recalls, for example, his involvement at a company that he said had “pristine” role definitions. And still, rogue employees ignored protocols and failed to properly escalate bad behaviors once discovered.

Moreover, the reputational hit of an accounting scandal can extend to other companies and board members that continue to use an embattled auditor, says Hockaday. Take the test cheating scandal involving KPMG, he suggests. Such circumstances should cause any company using the firm to press about tone at the top, risk management processes that allowed for the behavior, and what changes were made to prevent a recurrence.

Directors must be sensitive to the fact that some may wonder about the continued use of an audit firm that has been tarnished by issues that betray some level of unprofessionalism, Hockaday says. “You could have a situation where companies don’t have any liability but they have reputational damage.”

Estée Lauder, which had used KPMG as its auditor for more than 15 years, revealed the dismissal of the audit firm in February of this year, according to regulatory filings.

Aside from a potential reassessment of a relationship with an auditor, closely watched accounting scandals sometimes inspire progress. The Sarbanes-Oxley Act was, for instance, in reaction to financial improprieties at Enron and WorldCom.

The same may be true of the fall of Wirecard.

One progression could be a formal mandate outlining the role auditors have to play in identifying fraud, says Feldman. The pressure that follows this and other accounting scandals may also drive improvement in audit quality, says Cox.

Such developments in the wake of accounting issues, like Sarbanes-Oxley, can go a long way in thwarting specific types of fraud, says former Enron director **Herbert Winokur Jr.**, who in his more than 15 years on the Enron board, served as chairman of the finance committee. Fraud risks that board members and auditors need to be attuned to persist, though, he says.

“You can count on the capitalist system to produce clever people doing things that are slightly wrong or more than slightly wrong,” says Winokur, CEO at private investment firm **Capricorn Holdings**. “And so the auditor’s job is not to fight the last war. It’s to try to guess about the next war.”