Audit chairs in dialogue with the IAASB

The International Auditing and Assurance Standards Board (IAASB) develops auditing standards that can be adopted by audit regulators around the globe. It is a key player in determining how audit firms do their work, and it is continually trying to improve their performance by issuing new proposed standards or adjusting existing ones. These improvements are undertaken in response to shifting demands and evolving practices and technologies, using a process that maximizes stakeholder input.

On 5 February 2021, members of the European Audit Committee Leadership Network (EACLN) met virtually with Tom Seidenstein, the current chair of the IAASB, and Beverley Bahlmann, a deputy director at the IAASB whose work covers, among other issues, standards related to fraud identification and detection.[1] *For biographies of the guests, see Appendix 1, on page 9, and for a list of network members and other participants, see Appendix 2, on page 10.*

Executive summary

Much of the dialogue with the two guests was devoted to the issue of fraud—a current priority at the IAASB—and the role that audit firms and audit committees can play in preventing and detecting fraud. The discussion also touched on the IAASB itself and on several projects underway there.

- **Background on the IAASB** *(page 2)*

  Though the IAASB is not a regulator, it promulgates global standards on how independent audits are performed. Approximately 130 jurisdictions, including nearly all of the European Union member states, are using, adopting, or incorporating IAASB standards or are drawing on them in preparing national auditing standards. The IAASB has a rigorous process for selecting its board members, striving for a mix of perspectives and experience. As it develops its standards, the IAASB conducts extensive outreach, spending considerable time interacting with a variety of stakeholders.

- **The consultation on fraud detection and prevention** *(page 3)*

  The IAASB is assessing whether its standard on fraud detection should be enhanced. The general view among stakeholders, including EACLN members, appears to be that fundamentals of the existing standard are largely fit for purpose. However, some refinements of auditing practices might help, such as improved engagement between auditors and audit committees, better integration of fraud detection with the overall audit, and improved used of technology. EACLN members emphasized that auditors are only part of the solution, and they recommended that audit committees deepen their understanding of companies' defenses against fraud, including the ways in which the company culture either encourages or discourages fraud.

- **Projects on technology, nonfinancial reporting, and group audits** *(page 5)*

  Members and guests touched briefly on three other IAASB projects. The IAASB is trying to promote the use of new capabilities like machine learning without impeding innovation or inhibiting long-term evolution in the market for audit services. Continued development of specific auditing standards for nonfinancial reporting is difficult because of the absence of a universal framework, so the IAASB's approach for now will rely on new guidance combined with existing standards on assurance engagements. For group audits, the IAASB is emphasizing the responsibility for the group audit of the primary team and the importance of two-directional communication between the primary team and component auditors. In all these areas, the guests explained, a principles-based approach to standards is key.

For a list of discussion questions for audit committees, see Appendix 3, on page 11.

Background on the IAASB

The IAASB explains its basic objective in its online fact sheet:

> To serve the public interest by setting high-quality international standards for auditing, quality control, review, other assurance, and related services, and by facilitating the convergence of international and national standards. In doing so, the IAASB enhances the quality and uniformity of practice throughout the world and strengthens public confidence in the global auditing and assurance profession.[2]

Similar to the International Accounting Standards Board (IASB), the IAASB is a private—not a regulatory or intergovernmental—organization. It is the chief architect of global standards for audit and assurance in approximately 130 jurisdictions and achieves its legitimacy and influence through its structure, oversight, and due process. It is one of three standards bodies formally housed under but independent from the auspices of the International Federation of Accountants, the global organization for the accountancy profession.

With the large majority of its staff based in New York, the IAASB has 18 board members who, along with technical advisers and staff, develop standards according to a process approved by the IAASB's oversight body, the Public Interest Oversight Board.[3] The board members consist of both practitioners with significant auditing experience and nonpractitioners, including individuals who reflect the wider public interest. The standard-setting process involves input from a range of stakeholders, such as user groups, regulators, financial executives, and others, including the IAASB's Consultative Advisory Group.[4]

Though the EU has not formally adopted the IAASB's International Standards on Auditing (ISAs), they are referenced by EU legislation, including the Audit Regulation and Directive,[5] and most European national audit standards bodies have adopted them, either as is or with small modifications. The United States has not adopted ISAs for listed companies, but the Public Company Accounting Oversight Board conducts ongoing dialogue with the IAASB and there is an effort to ensure some form of convergence on topics, including quality management. Audit standards for private companies in the United States are largely converged with ISAs.

The consultation on fraud detection and prevention

EACLN members' discussions with Mr. Seidenstein and Ms. Bahlmann focused closely on the IAASB's consultation on fraud[6] and the comments received, including a report submitted by Tapestry Networks (see Appendix 4 on page 12). Several observations emerged about the problem of fraud and the role of auditors and audit committees in preventing and detecting it.

Revisions to standards on fraud need to be evidence based

Mr. Seidenstein began by noting that fraud has become a prominent topic in the last several years; he warned that if the debate on any standard-setting topic becomes too political*, "the solution could be political."* He said that the IAASB's goal is to stick firmly to an evidence-based approach in considering changes to the current standard. Being clear about what kind of fraud is being addressed is important, an EACLN member noted, and Mr. Seidenstein agreed: *"Our standards focus on material misstatements, but we are trying to be responsive. Clearly defining fraud and making clear what the auditor's responsibilities are will determine where we go. We need to meet expectations on this."*

Current standards are largely fit for purpose but need refinement

Mr. Seidenstein and Ms. Bahlmann said that a wide range of stakeholders had commented on the consultation document and that their views often echoed those of EACLN members. Though the analysis of comments was not complete, there appeared to be little appetite for major changes to standards, such as a shift to a so-called "suspicious mindset" or more forensic work in all audits. An EACLN member explained, *"I don't like the idea of a suspicious mindset; I would prefer a curious mindset. That builds stronger relationships so you can work through the issues."*

However, stakeholders did see ways in which auditing for fraud could be improved. One suggestion was to improve cooperation between auditors and audit committees. *"What would be a more effective engagement between auditors and those charged with governance?"* Mr. Seidenstein asked. Among other things, Ms. Bahlmann noted, interactions could be more frequent: *"A lot happens at the end of an audit, but it should be more ongoing throughout the audit."* An EACLN member agreed: *"Knowing who is doing what is important early in the process. Getting clear on what the auditor will do versus the internal auditor and the first and second lines of defense is really challenging."* The member also noted a benefit of increased engagement: the auditor can offer tips to the audit committee based on their experiences at other companies.

Many stakeholders also want fraud detection to be more integrated with the overall audit, Ms. Bahlmann said: *"There's a big appetite for linking fraud to the rest of audit. Today it is isolated, and many want a stronger link, not just fraud detection as an add-on."* The idea is to enhance the focus on root causes of fraud by assessing the risks of fraud across the organization more effectively.

Mr. Seidenstein mentioned fraud-detection technology as another issue raised in the comments. *"We are hearing that there are areas that we need to update,"* he said. *"Have our standards evolved to keep up with technology? Fraud detection is one of the top use cases for* *machine learning. To what extent are our standards robust enough to deal with emerging technology?"* At the same time, he added, the IAASB sets standards for a range of firms, so it needs to avoid setting the bar too high, an issue that emerges for technology more generally. *For more on this topic, see the following section on technology.*

There have also been calls for more transparency on fraud in the auditor's report. *"Something along the lines of a KAM [key audit matter] but not a KAM—such as adding a bespoke paragraph on what they did on fraud detection,"* Ms. Bahlmann explained. One EACLN member expressed concerns about offering more public information: *"I'm very happy for more information to come to the audit committee, but I'm wary of information going to outside people. I just worry about the misinterpretation of information in the marketplace."*

A member urged the IAASB to be forthcoming with guidance on how to implement standards: *"I also hope you include some guidance notes—not binding, but guidance on how to play this out."* Mr. Seidenstein was happy to accommodate both auditors and others involved: *"We are very in tune to providing guidance and considering what guidance we should provide to governance leaders."*

Audit committees have an important role to play

"Auditors are only part of the solution," Ms. Bahlmann noted, and EACLN members agreed. *"It's about how the company itself is being governed,"* one member said, and several recommended that the audit committee develop a deeper understanding of all three lines of defense within the company, including the whistleblower system. *"You need direct access to people in the company who are part of the first or second lines of defense,"* a member said, specifically citing the chief risk officer and the heads of audit and compliance: *"We should invite these people to join us two to three times a year without the presence of the CFO, so they can speak freely. I think that is critical."*

Several members noted that the access enjoyed by audit committees could extend beyond the company if, for example, circumstances required independent confirmations. *"Do they have the ability to get in contact with third parties? You can't rely on just the numbers if there is an indication of fraud,"* one member said. Another member noted that the control over information exercised by management boards in some jurisdictions needs to be relaxed: *"There needs to be a removal of fear around internal hierarchy."*

Culture is another element that deserves significant attention from the audit committee, a member noted: *"At the companies where I'm on the board, we study culture in the audit committee and from a board perspective, making sure things are structured to avoid fraud. I believe there is a much bigger role for the audit committee to play here."* A member highlighted the importance of a culture in which speaking up is an obligation: *"It makes a difference if that's the expectation."* Another added that it is essential that speaking up is not seen as an action that could harm a person's career. *"Senior employees find it very difficult to address issues without fearing job loss. Anonymity is very hard sometimes,"* the member said.

To ensure that their capabilities are sufficient, members said, audit committees and management need the right experience and ongoing education, especially in areas such as technology. *"The nature of fraud is changing, and it's important to stay up to date on this,"* a member noted.

Projects on technology, nonfinancial reporting, and group audits

The IAASB is currently working on several other standards and research projects of relevance to audits of large companies. These reflect the strategic drivers laid out in the IAASB's strategy document for 2020 to 2023, which include the advancement of technology, an increasingly complex business environment, changing reporting needs of stakeholders, and changing public confidence in audits.[7] Members and their guests touched on three current projects, described below.

Impact of evolving technology

The IAASB's ongoing work on the impact of technology is spearheaded by its Technology Working Group, which is exploring how technology is enhancing audit quality and how the IAASB can respond via standards or guidance.[8]

The guests noted that the increasing use of technology in auditing presents two challenges for the IAASB. The first is how to create standards and guidance in a way that supports effective use of technology without being overly prescriptive. In this area, the IAASB has decided to maintain a principles-based approach and to avoid references to specific technology. As Mr. Seidenstein put it, *"We want to modernize standards without hardwiring technology—as we did years ago by mentioning the fax machine in a standard!"*

The second challenge is to understand what technology might look like in the future and how it will impact audit markets. *"Standard-setters tend to be reactive,"* Mr. Seidenstein noted, *"but we are trying to be a little more predictive and think five years out."* This involves identifying key trends rather than thinking incrementally about technology. One objective is to avoid writing standards that inhibit the entry of new and disruptive companies into the market.

Mr. Seidenstein mentioned another concern: setting the bar too high in a way that has adverse market consequences for practitioners. What are the implications of technology potentially favoring the scale of large companies versus smaller ones? *"We have to be careful of market access and competitive playing field issues,"* he noted.

Assurance for nonfinancial reporting

With the rise in importance of nonfinancial reporting, especially on environmental, social, and governance issues, the issue of assurance for this kind of reporting has become more urgent. The IAASB has been exploring this issue as part of its Extended External Reporting Assurance Project, which has been developing nonauthoritative guidance to help auditors apply an existing standard on nonfinancial assurance engagements, ISAE 3000 (Revised).[9]

Specific standards for assurance are difficult to develop given the lack of a universal framework for nonfinancial reporting. *"There doesn't need to be one standard, but there are too many right now,"* Mr. Seidenstein noted. *"We are hoping some consolidation will take place, and then we can do a gap analysis against our current standards."* Again, standards or guidance will have to be principles based, and, for now, practitioners will combine existing standards on assurance for nonfinancial reporting with the Extended External Reporting guidance currently being finalized. Mr. Seidenstein underscored the importance of assurance for nonfinancial reporting*: "If things are reported externally and for the purposes of attracting capital, that information better be right."*

Audits of group financial statements

The IAASB is currently considering comments received on an exposure draft addressing the challenges of performing global audits. The draft proposes improvements to ISA 600 (Revised): *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors).*[10]

In the draft proposal, Ms. Seidenstein explained, *"the big point is to put more responsibility for the group audit on the group engagement team and partner."* The primary audit team needs to better understand, for example, the complexities of different group structures and how to make sure there is enough evidence to ensure quality of the group audit. Mr. Seidenstein noted that there is a need for more communication between the primary team and component auditors, including two-directional communication that enhances the primary team's awareness of the risks in each component audit.

Conclusion

With business practices and technology constantly evolving, standard setters in many domains face an ongoing battle to stay relevant. The guests confirmed that the IAASB is no exception, as it strives to develop auditing standards that will serve stakeholders all over the globe. Relying on extensive outreach, the IAASB develops principles-based standards designed to establish effective auditing processes without being overly prescriptive, especially around applications of new technologies. Mr. Seidenstein noted how glad he was to be engaging with audit chairs: *"I see our standards as a product, and you are front-line users."*

The IAASB is currently revising its standard for detecting fraud, but based on stakeholder input thus far, the guests believed that any changes would be incremental rather than transformative. EACLN members supported this, arguing that fraud is a broader governance issue in which each of the relevant players—management and the board, as well as the auditor—has an important role to play. Members and guests saw opportunities for all the players to improve their performance, with greater communication and transparency serving as the foundation for a joint effort against fraud.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisors as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, management, and advisors who become systematically engaged in this dialogue, the more value will be created for all.

Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from conversations with network members and other participants in connection with the meeting.

[2] International Auditing and Assurance Standards Board, *Fact Sheet* (New York: IAASB, January 2017).

[3] International Auditing and Assurance Standards Board, *Fact Sheet*.

[4] International Auditing and Assurance Standards Board, *Fact Sheet*.

[5] International Auditing and Assurance Standards Board, *Fact Sheet*.

[6] International Auditing and Assurance Standards Board, *Fraud and Going Concern in an Audit of Financial Statements: Exploring the Differences Between Public Perceptions About the Role of the Auditor and the Auditor's Responsibilities in a Financial Statement Audit* (New York: International Federation of Accountants, September 2020).

[7] International Auditing and Assurance Standards Board, *Strategy for 2020-2023* (New York: IAASB, April 2020), 6.

[8] "Technology," International Auditing and Assurance Standards Board, accessed January 4, 2021.

[9] International Auditing and Assurance Standards Board, "IAASB Consults on Extended External Reporting (EER) Assurance," news release, May 13, 2020.

[10] International Auditing and Assurance Standards Board, *Proposed International Standard on Auditing 600 (Revised): Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* (New York: IAASB, April 2020).

Appendix 1: Biographies of guests

Beverley Bahlmann, Deputy Director at the IAASB, is a member of the Australian and South African Institute of Chartered Accountants. Beverley has been with the IAASB in New York for the past nine and a half years.

Ms. Bahlmann has worked on a variety of projects, including the IAASB recent projects related to Enhancing Audit Quality, Auditing Disclosures, and the revision of ISA 315 related to the identification and assessment of risks. Ms. Bahlmann also leads the IAASB's efforts on developing a separate standard for less complex entities, the development of the IAASB's Strategy and Work Plan, and the IAASB's efforts on fraud and going concern.

Previously Ms. Bahlmann worked for 15 years in a technical and training role in audit firms in Australia, the UK, and South Africa.

Tom Seidenstein commenced his three-year appointment as chair of the IAASB on July 1, 2019. His career has spanned both the private sector and international standard-setting. Prior to joining the IAASB, Mr. Seidenstein held senior strategic leadership positions at the Federal National Mortgage Association, commonly known as Fannie Mae (Senior Vice President, Strategy, Innovation & Capital Management: 2012-19), and the IFRS Foundation (Chief Operating Officer: 2000-2011).

Additionally, Mr. Seidenstein has served at a consulting organization for not-for-profits, CCS Fundraising (Executive Director: 1999-2000), and the Center for Strategic and International Studies (Special Assistant to the Managing Director: 1995-1997). He has also served as a trustee of the International Valuation Standards Council (IVSC) and on XBRL International's Board of Advisors.

A strong believer in volunteer service, Mr. Seidenstein has held or holds volunteer leadership positions serving school education the USA and the Make-A-Wish Foundation (both UK and international boards). He holds a Masters in Public Policy from the Kennedy School of Government at Harvard University and an undergraduate degree (cum laude) from the Woodrow Wilson School of Public and International Affairs at Princeton University.

Appendix 2: Participants

The following EACLN members participated in part or all of the meeting:

- Jeremy Anderson, UBS
- Julie Brown, Roche
- Aldo Cardoso, Bureau Veritas
- Carolyn Dittmeier, Assicurazioni Generali
- Liz Doherty, Novartis and Philips
- Eric Elzvik, Ericsson
- Renato Fassbind, Nestlé and Swiss Re
- Byron Grote, Tesco, Akzo Nobel, and Anglo American
- Margarete Haase, ING
- Liz Hewitt, National Grid
- René Hooft Graafland, Ahold Delhaize
- Dagmar Kollmann, Deutsche Telekom
- Pilar Lopez, Inditex
- Benoît Maes, Bouygues
- Hanne de Mora, Volvo Group
- Stephen Pearce, BAE Systems
- Ana de Pro Gonzalo, STMicroelectronics
- Nathalie Rachou, Veolia
- Jon Erik Reinhardsen, Telenor Group
- John Rishton, Unilever
- Mariella Röhm-Kottmann, Zalando
- Sarah Russell, Nordea Bank
- Guylaine Saucier, Wendel
- Erhard Schipporeit, RWE
- Carla Smits-Nusteling, Nokia and ASML Holding
- Maximilian Zimmerer, Munich Re

The EY organization was represented in all or part of the meeting by the following:

- Marie-Laure Delarue, EY Global Vice Chair, Assurance
- Jean-Yves Jégourel, EY Global Assurance Vice Chair, Professional Practice
- Julie Teigland, EY EMEIA Area Managing Partner

Appendix 3: Discussion questions for audit committees

- How could auditing standards be improved to help detect fraud? In what areas could the auditor do more to uncover fraud?
- What can management—including all three lines of defense—do to prevent and detect fraud?
- What is the role of the board and, in particular, the audit committee regarding fraud? In what areas could the audit committee do more?
- How can all the key players work together more effectively to prevent and detect fraud?
- How should the IAASB approach the use of technology in the audit as it develops its standards?
- What are key considerations regarding the audit of nonfinancial reporting?
- What are key considerations regarding group audits?

Appendix 4:

This report was submitted as a comment for the IAASB's consultation on fraud, but the appendix included with the submission (and mentioned in the first paragraph below) is not included in this version of the report.

Fighting fraud: Conversations with leading European audit committee chairs

In late 2020, Tapestry Networks convened audit committee chairs from some of Europe's largest companies to discuss how the various stakeholders, including the external audit process can contribute to detecting and preventing corporate fraud. This report presents those audit chairs' perspectives based on their experiences with listed companies in Europe, as well as perspectives that Tapestry Networks has developed in reflecting on the situation and the audit chairs' comments. We believe that the report stands on its own; Tapestry is also submitting it in response to the International Auditing and Assurance Standards Board (IAASB) discussion paper *Fraud and Going Concern in an Audit of Financial Statements*. An appendix to this report provides responses to specific questions raised by the IAASB. These responses reflect Tapestry Networks' conclusions, rather than individual or collective statements of the audit chairs.

The audit chairs whom we interviewed serve on boards of listed European companies having at least US$10 billion/€8.2 billion in annual revenue and global operations. Such companies typically retain Big Four firms to conduct external audits and have sophisticated internal audit teams and robust internal-controls frameworks. Audit chairs of smaller or less complex companies may have different perspectives.

The following current and former audit chairs participated in interviews and meetings between November 2020 and January 2021:

- Carolyn Dittmeier, Chair, Board of Statutory Auditors, Assicurazioni Generali
- Eric Elzvik, Audit Committee Chair, Ericsson
- Byron Grote, Audit Committee Chair, Tesco, Akzo Nobel, and Anglo American
- Simon Henry, Audit Committee Chair, Rio Tinto
- Liz Hewitt, Audit Committee Chair, National Grid and Melrose
- Lou Hughes, former Audit Committee Chair, ABB
- Arne Karlsson, Audit Committee Chair, Mærsk
- John Rishton, Audit Committee Chair, Unilever
- Sarah Russell, Audit Committee Chair, Nordea Bank
- Guylaine Saucier, Audit Committee Chair, Wendel
- Alan Stewart, Audit Committee Chair, Diageo

The interviews and discussions were held under a modified form of the Chatham House Rule, which allows for quotation of any comment but not for its attribution to an individual or company. Audit chairs spoke on their own behalf rather than as representatives of their companies or boards. EY provided financial support for the research and writing of this report and had opportunities to comment on the research design and the final product but did not exercise any editorial control over this report, for which Tapestry Networks bears full responsibility.

Key observations about fraud

The audit chairs whom we interviewed agreed on the following:

- Stakeholders use the word "fraud" in many contexts. Fraud should be carefully defined in discussions among diverse stakeholders when considering whether any changes are necessary.
- Collusive fraud at high levels of management is extremely difficult to detect.
- Corporate culture and management's tone at the top are key factors that can create an environment that is conducive to fraudulent activity, as well as whether employees feel comfortable reporting such activity to management and the board.
- To prevent and detect fraud, audit committees and boards rely first on management, including compliance and internal audit. The external audit, leveraging capabilities such as data analytics, can provide meaningful insights to inform the board and audit committee's oversight. External auditors can supplement companies' fraud detection and prevention efforts with capabilities such as data analytics.
- While supportive of exploring ways to make auditors more effectively exercise professional skepticism, adopting a suspicious mindset in all cases may not be helpful.

The content in this report details the audit chairs' reactions to the IAASB discussion paper and the bases for their agreement on the observations listed above.

Tapestry's perspectives

Tapestry Networks, speaking on its behalf only, offers its perspectives based on its discussions with the participating audit chairs. We do not attribute these conclusions to the audit chairs we interviewed, individually or as a group:

- **Management teams, with the help of the internal audit function, could do more to prevent and detect fraud.** Line management and corporate functions such as compliance and risk management are, respectively, the first and second lines of defense against fraud, maintaining robust internal controls and nurturing a culture of compliance and whistleblowing. A strong and independent internal audit function is the third line, harnessing the risk management system and sophisticated analytics to assess how the first and second lines are performing.
- **Audit committees could do more in their oversight capacity to encourage the detection and prevention of fraud at their companies.** Audit committees review the internal control

and whistleblowing systems, as well as the company culture, and they can study specific instances of fraud to glean lessons and demonstrate the importance of fraud prevention. Through training and attention to the experience and skills of committee members, they can better overcome the inherent imbalances in knowledge between non-executive directors and management.

- **Current audit standards seem to strike the right balance, but enhancements to recognize advancements in the use of data analytics would be appropriate.** External auditors are already doing most of what can feasibly be done to prevent and detect fraud. While improvement is always possible and standards should evolve – to recommend, for example, expanded use of data analytics and forensics – fundamental changes in approaches and procedures (such as adopting a "suspicious mindset") are not necessary today.

Preliminary observations about the fraud "expectations gap"

The high public profile of recent corporate-fraud incidents has led to renewed calls for auditors and the audit process to assume greater responsibility for detecting and preventing fraud, and even for auditors to bear stronger liability in the event of fraud. But audit firms and corporate leaders responsible for the audit processes in listed companies often have different views from the public about the current scope of an audit and its ability to combat fraud. The difference has come to be known as the "expectations gap." Recent proposals for audit reform have aimed at closing the gap.

The European audit chairs we interviewed noted several broad observations, outlined below, about the fraud expectations gap.

Fraud comes in many forms

European audit chairs emphasized that when evaluating whether any changes are needed relative to stakeholders' responsibilities for the prevention and detection of fraud, "fraud" should be appropriately defined to effectively assess any changes and their potential impact. One chair elaborated on the concern: *"We need to explain what we mean by fraud. As audit chairs, we are worried about high-level corporate fraud creating misstatements of financial statements. Other types of fraud, like bribery and corruption, might not be reflected in financial statements. You could do any amount of analysis and not find it."*

Several audit chairs observed that many stakeholders tend to conflate all "bad" corporate behavior—whether illegal, unethical, or merely reputationally harmful—with fraud. They said that such a broad definition can complicate the effort to close the expectations gap. One audit chair noted, *"Any company that doesn't meet investors' expectations needs to strengthen its audits. But that failure to meet investors' expectations could be the result of weak management, not fraud."* Another audit chair called for a focus on frauds that not only were formally material but also had catastrophic consequences for a company.

Highly consequential fraud is rare

Fraud of the severity that reaches stakeholders' attention occurs infrequently. While audit chairs acknowledged that material fraud may occur more often at smaller companies with fewer resources to assess and mitigate fraud risk, they wondered about balancing the potential costs and benefits that might results from any potential changes to stakeholders' responsibilities. One chair said, *"There are big media splashes when a major fraud occurs, but you don't see that every day from every company. You cannot have all companies pay for a tiny percentage of companies' fraud. We have to put things in perspective."* Another audit chair agreed, noting that companies typically succeed in preventing and detecting fraud: *"In most cases, material fraud is caught by the company. One or two high-profile instances of fraud do not mean that the system is broken and requires substantially enhanced procedures."* At the same time, audit chairs acknowledged that, even though severe cases of fraud are rare, they can have broad and lasting consequences, undermining confidence in capital markets and the broader economic system.

Collusive fraud is very difficult to prevent and detect

Many of the major fraud incidents that elicit public outcry are the result of collusion among executives. The European audit chairs emphasized that collusion can often bypass the internal controls meant to prevent fraud. One noted that these types of fraud are *"very difficult to root out."* Another agreed, noting that while *"major collusive fraud eventually gets uncovered, if people collude it means the independence has broken down, and it's hard to promptly determine that."* Another audit chair observed that *"no amount of review will identify all cases of fraud."* Given that preventing and detecting all instances of collusive fraud may be effectively impossible, the imposition of heightened standards alone may not address the underlying challenges. *"If there is collusion at the top level, doing all that we can still won't eliminate it. We have to be careful about widening the expectations gap about prevention and detection."* Management, audit committee and the external audit will need to continue to explore cost effective ways to assess and respond to fraud risks.

Perspectives on management's responsibilities

European audit chairs said that primary responsibility for fraud detection and prevention rests with management and internal audit teams. The European audit chairs were reluctant to increase the external auditor's fraud detection and prevention responsibilities.

Effective internal audit can be a critical resource

Audit chairs were confident in the ability of management, supported by robust, independent internal audit functions, to prevent and detect fraud and generally believed that they should continue filling that role. *"Preventing and detecting fraud is management's job through the first and second lines of defense. You need robust controls, a framework, and a strong tone from the top to manage this kind of risk. That's the major starting point."* An audit chair emphasized that *"solid information-technology general controls are one of the cornerstones of fraud prevention and detection."* These audit chairs serve on the boards of some of Europe's largest companies. Not all internal audit organizations will have the same level of sophistication and available resources as found in these companies.

Some audit chairs thought that the work of sophisticated internal audit departments is not sufficiently understood: *"There are many areas of fraud that are not as well-known as what gets publicized, but world-class internal audit departments know about them."* Internal audit departments work with robust enterprise risk management systems that help combat fraud risk; external auditors can review these systems to ensure that they are effective. An audit chair added that there is a *"behavioral aspect to fraud to which internal audit has particular insight."* Another audit chair observed that internal auditors are benefiting from *"an increased use of data analytics by both the second and third lines of defense as systems evolve."* The chair added, however, that *"data analytics is more effective in identifying small-scale breakdowns in internal controls than the type of mega fraud that has driven the current debate."*

Internal audit plays an important role in preventing and detecting fraud, but some audit chairs emphasized that internal prevention and detection of fraud begins and ends with executives. One said, *"We hold people accountable for fraudulent activity and noncompliance with policies, but it shouldn't be just the individual actors; it should be their superiors, because it happened on their watch and they weren't paying attention."* While the European audit chairs consulted for this report agreed that internal audit is a critical resource for fraud detection and prevention, the companies on whose boards they sit typically have large, sophisticated internal audit functions. Smaller companies may struggle to rely on their internal audit teams in this way.

There are strong parallels between compliance oversight and fraud detection and prevention

Several audit chairs noted that overseeing fraud prevention and detection is closely related to overseeing a company's compliance function, an important component of its second line of defense. Many audit chairs agreed that whistleblower programs are critical to detecting fraud. One explained, *"Companies need whistleblowing systems that are managed with independence and proficiency. The audit committee and external auditor should have transparency into specific cases, and internal audit should be involved. We've strengthened that role recently in part because whistleblowing is less common in certain geographic regions."* The same audit chair said that one company created an ombudsman role to independently handle whistleblower matters, which would encourage more reporting of potential fraud concerns.

Another audit chair emphasized that, more than facilitating a so-called speak-up mentality, companies should foster a *"speak-up obligation, meaning that you are in trouble if you do not speak up when you see something wrong or get a strong indication that unethical activity is taking place. You should have an obligation to raise hands and voices, and not be permitted to look the other way."*

Perspectives on the role of the board and the audit committee

European chairs agreed that boards and specifically their audit committees play an important role in fraud prevention and detection. An audit chair explained the tasks that audit committees should undertake: *"In the audit committees I'm on, we review the processes that are in place to prevent fraud, including the controls that are in place and the mechanisms whereby individuals who see something wrong can raise them through whistleblowing."* The audit chair noted that these tasks are standard for many audit committees: *"They are nothing new. Setting those tasks as requirements would be no problem for many audit committees."*

In addition to reviewing processes and controls, audit committees and boards can also study specific instances of fraud. An audit chair said that audit committees should assess any cases of fraud that have occurred and the specific actions the company is taking in response. Another noted that this approach can be instrumental in making whistleblower programs effective: *"The 'speak-out' program can report back to the board through the audit committee. It sends a powerful signal that the process works if reports to the board get follow-ups. The audit committee can have a huge influence on this."*

Again, internal audit is a key ally in these efforts, audit chairs said, and the audit committee should be sure that it is adequately staffed. As one audit chair explained, *"The audit committee should use internal audit to receive independent assurance about the adequacy of controls around prevention and detection. I think this is the most important area. We've hired two more internal audit forensics experts at our company to strengthen this function. That's where the main audit function should be when it comes to fraud."*

Audit committee oversight could be improved

European audit chairs acknowledged that there is room for improvement in how audit committees handle their responsibilities. *"At the end of the day, I think many audit committees need to up their game,"* one chair said. One approach is through board composition. An audit chair said, *"It's about putting together diverse boards. By definition, you then have people of different backgrounds and you end up with just a few sector specialists. What you're trying to do is look at the company from many angles. You're looking for some dimension to the board that isn't related to the sector but that, for other reasons, the board views as important."*

Training is also critical, particularly in certain areas. *"We probably should have more mandatory education for audit committee members on things like data analytics. We need to decide on a core curriculum and mandate a certain number of hours of education per year,"* one audit chair said. Another added, *"Audit committees would benefit from an awareness and training piece on forensics. One company requires non-executives to do antibribery, anticorruption, and cyber training."* Ultimately, audit committees also need to cultivate a certain mindset, an audit chair suggested: *"It's not a bad thing for the audit committee to have a questioning mind—it's a collective duty. We are non-executives and independent; we should have a good nose for where risk is and what questions to ask."*

However, audit chairs also noted that, even with enhanced training and effort, there are inherent difficulties in overseeing fraud prevention and detection. One issue is the need to have a good relationship with management. As one audit chair put it, *"A challenge for boards is the difficulty of having a discussion with the management team that you're supposed to trust. When the news is bad, you naturally dig deeper. But when the news is good, you may be tempted not to question it."*

Another issue stems from the inevitable disparity in knowledge between board members and executives. An audit chair explained, *"CEOs spend 24 hours per day on the job; they live and breathe it. Boards spend a couple of weeks per year on the company, and it's all stage-managed. You are in meetings planned by executives; visits are preplanned. The shadow of the leader is very powerful. Many executives are hesitant to contradict the CEO, their boss."* That imbalance means that one of the most important tasks of the board is selecting the right executives, the audit chair noted: *"The board relies heavily on the CEO. Getting that choice right is 90%. If you get it wrong, they can easily deceive you."*

Should there be attestation by the board or audit committee?

Attestation along the lines of the US Sarbanes-Oxley legislation, which requires extensive management certification of the internal-control system, already exists or is under consideration in European countries, but the discussion also includes the possibility of attestation by boards or audit committees as well as management. Audit chairs noted that attestation by management has added accountability, consistency, and focus in implementing and maintaining the controls framework.

They had mixed views, however, on requiring such attestation by the board or audit committee. One audit chair tentatively supported the idea: *"So long as it's phrased appropriately, I wouldn't have problems signing off for the audit committee. It does push liability exposure to board members further, so that would have to be thought through. At the end of the day, the attestation is that the controls are in place but not that they're fail-safe."* Other audit chairs were opposed to attestation by boards. *"If the board also has to sign off, you mix up the supervisory role and the operational role. You have to draw the line somewhere. The signing of the annual report should be sufficient,"* one audit chair noted.

Challenges in assessing corporate culture

Many audit chairs observed that corporate culture plays a central role in both fostering and discouraging fraudulent behavior. Culture can provide guide rails and cues for ethical behavior; it can strengthen the whistleblowing system by encouraging people to speak up if they believe something is wrong. But culture can also impose strong pressures on people to test the boundaries of ethical behavior. One audit chair noted, *"It boils down to the culture of the organization and its values, and how people are rewarded."* Despite its importance, however, culture is challenging for boards to assess and influence, and it may be even more challenging for both internal and external auditors to audit.

An audit chair mentioned the dilemma for boards, bringing up the difference in knowledge of the company enjoyed by executives versus non-executives: *"Boards should do more on* *culture, but it's very difficult. After six months as an executive at a company, I knew more about the culture than after two years as a non-executive at the same company."* The same audit chair elaborated on another challenge of assessing culture: *"The board most often interacts with senior executives. It can be challenging for board members to get a sense of the people lower down in the organization. And whenever people are talking to the board, they are on their best behavior."*

Nevertheless, boards should try to assess company culture, audit chairs said, and many boards are doing so. An audit chair recommended that boards *"spend more time acknowledging corporate culture, not just with a bullet about oversight and incentives, but by talking more about raising hands, voices, and whistleblowing. Understand the four-eyes principle [requiring two people to approve an action] and the separation of duties."* Companies often conduct company-wide surveys that include questions about culture, and the results are reviewed by boards. Vulnerabilities to fraud risk can be exposed, allowing the board to react.

An audit chair emphasized that the audit committee plays an important role in this oversight through its responsibility for ensuring that the whistleblowing system is functioning effectively and that an effective internal-control system is in place. Sometimes an audit committee or board may decide to follow up on a hunch: *"We have all been in meetings where we feel that something is wrong,"* one audit chair said. Another called for special attention to areas where senior managers may be exerting pressure on more junior staff, increasing the likelihood of fraud: *"profit pressure, bonus pressure, market-share pressure."* Other audit chairs agreed that aggressive bonus schemes and budgetary pressures have contributed to major frauds, and one highlighted the importance of understanding the connections between remuneration schemes and culture.

Assessments of corporate culture are critical to informing management, internal audit, the audit committee, and the external auditor in their assessments of fraud risk, but the subtler aspects of culture make it hard to audit in a more formal way, several audit chairs said. They mentioned assessing—both directly and indirectly—elements of culture such as comfort with escalating issues, confidence in working with others, and leadership. An additional complication emerges in companies that have a variety of subcultures, in which different types of activities lead to different norms and values. One audit chair suggested that it may be particularly difficult for the people who traditionally make good auditors to assess these kinds of variables: *"They struggle with it; they tend to be analytical as opposed to emotional."*

Given the internal audit function's role in fraud detection more generally, as well as its deep understanding of company processes, assessing culture should be a key consideration as part of its responsibilities, according to some audit chairs. *"The internal audit plan should include culture and behavior. It makes sense there,"* one audit chair noted. Another added, *"Internal audit can do it for you, with a line of sight directly to the board."* The goal is to *"create a bigger dialogue around things like culture and what prevents people from whistleblowing or acting earlier. There's not enough discussion about these soft issues. All they're doing is putting rules and frameworks on it."* Regarding more informal reviews of culture, one member noted that both internal and external audit are the eyes and ears of the audit committee, and another mentioned assistance from the human resources function.

Perspectives on the responsibilities of the external auditor

While European audit chairs saw opportunities to adjust the function of the external auditor in detecting and preventing fraud, most did not endorse large-scale role redefinitions.

The external auditor provides an adequate and appropriately limited role in preventing and detecting fraud

Most European audit chairs were not inclined to increase the auditor's existing role in fraud detection and prevention. Several noted that external auditors already play a role in preventing and detecting fraud within the confines of their assurance responsibilities. *"The auditors do a lot for my companies. They start with key risks. But there is a finite number of accounting standards, and only a subset of those creates risks,"* one audit chair observed. Another said, *"Auditors review the processes management has in place to detect fraud. They always assess internal controls for the management letter. There are many opportunities to find gaps in the system. I'm not sure what advantage more thoroughness would provide."* The auditor is invaluable in providing the audit committee with independent perspectives on transactions and balances, one member added, and others noted that the external auditor can provide valuable perspective to the audit committee on the company's culture.

Others questioned the value of broadening external audit's scope and saw the potential for it to detract from the auditor's other work. *"Expanding the auditor's scope with respect to detecting fraud would increase work and fees without delivering proportional value,"* one audit chair said. Another noted, *"I struggle to imagine what more the auditors could do. Reduce materiality to naught? If the CEO and CFO are colluding, the external auditor would struggle to uncover that as much as anyone."* Another, asserting that fraud prevention and detection is better addressed by internal audit, said, *"Fraud risk should not be viewed differently from other enterprise risks. The external auditor is not the main tool for working with that. If the external auditor looks more into this, it will devalue its work in other important specialties, of which they have many."*

Yet there may be room for external auditors to do more

Despite general agreement against large-scale expansion of external audit's role, some European audit chairs said that external auditors can and should do more to prevent and detect fraud. One said, *"The auditor should do more … Fraud is one of the most detrimental things for companies, and sometimes the external auditor did not see it. We should put a higher level of responsibility on them, and the results should be tested."*

An audit chair observed that the external auditor has a wide range of assurance expertise, such as in cybersecurity, compliance, and internal controls, and said that there is no reason not to leverage that expertise for the purposes of fraud detection and prevention. Another audit chair noted that external auditors currently have tools, such as data analytics and artificial intelligence, which help them detect fraud, but that *"they could do much more."*

Many audit chairs were reluctant to endorse requiring the external auditor to assume liability for fraud detection and prevention. One referred to liability as *"the elephant in the room that affects a lot of stakeholders' responses to these proposals."* Another audit chair was concerned that imposing liability on external auditors could threaten their existence: *"There aren't many big audit firms out there, and we can't lose any of them."*

Data analytics are powerful tools for detecting and preventing fraud, but concerns exist

Several audit chairs said that requiring the use of data analytics to detect and prevent fraud would be a positive step. *"You need more procedures with data analytics. There's no other practical way,"* one said. *"I would mandate the use of data analytics because the technology is available and it's so efficient and comprehensive,"* another said. Most chairs endorsed the use of data analytics and supported its continued adoption. Many reported that such technologies already are in productive use by management among large global companies.

An increased emphasis on fraud and data analytics will call for sharpened skills in both management teams and external auditors. An audit chair pointed to a skills gap between the partners in audit firms and some of the junior auditors, who may have stronger capabilities in advanced technology: *"Sometimes the partners see data analytics as a black art."*

Some audit chairs expressed hesitation about requiring the use of data analytics. One observed that the technology, while powerful, is not fail-safe: *"Data analytics depends on all the systems it touches. Poor systems, such as insufficient controls around data, curtail the ability of data analytics to do its work. Data analytics is only as good as the data."* Another audit chair observed that not all companies have data of sufficient volume or sophistication to enable effective analytics: *"Not all companies are equipped for the auditor to use those tools on their data. We still have a long way to go."*

Conversely, sometimes the auditor's systems are not well aligned with the client's data: *"Auditors have a concept of a tool, but they deploy it with data hierarchies and analytics. The question arises, How big is the sample going to be, and is it enough? It would be great if we all had big data lakes and our taxonomies were sorted out to enable data analytics, but data is one of the biggest weaknesses in the European environment. Will the external auditor have to test all these things too?"*

A suspicious mindset goes too far

While supportive of exploring ways to make auditors adopt a "suspicious mindset" toward their clients. They foresaw several negative consequences:

- **Strained auditor-client relationships that impede the flow of information.** Many audit chairs were concerned that a suspicious mindset would cause friction in the critical relationships between the external auditor and its clients. One audit chair described how a suspicious mindset would disrupt these engagements: *"Companies try to do the right thing. The auditors are there to confirm that they have. A suspicious mindset could be detrimental to the audit by disrupting that clear and open relationship. It goes a step too far."* Audit chairs worried that an attitude of suspicion would impede audits by restricting clients from voluntarily providing information. One audit chair expected that *"information flow would be constrained and everything would be looked at through liability"* if a suspicious mindset were the standard.

- **A heightened burden for the auditor, with limited potential return.** Some audit chairs doubted that a suspicious mindset would create more inquiry or meaningful improvements in fraud detection or prevention. One said, *"The auditor could probably uncover questionable internal audit decisions with a suspicious mindset—but fraud? It seems unlikely, especially in a large global company. Fraud often involves three intelligent individuals colluding, and that's hard to detect."* Another audit chair likened the suspicious mindset to *"cracking a walnut with a sledgehammer"* and noted that *"there should be appropriate challenge, but I believe that's already occurring."*
- **Unfairness to law-abiding companies.** Audit chairs were concerned that requiring a suspicious mindset would unduly burden the many companies at which material fraud is not occurring or not likely to occur. *"There will always be some fraud, but we can't be suspicious of all companies,"* one audit chair said. Another agreed: *"A suspicious mindset implies that everyone is guilty, yet 99% of the time the right thing has been done."*

Audit chairs noted that less divisive alternatives are available. Many were comfortable with the current standard of professional skepticism; others advocated for the basic concept of *"independence"* or *"thorough but not suspicious inquiry."* One audit chair, contrasting a suspicious mindset with healthy skepticism, said a suspicious mindset *"shifts burden of proof. Healthy skepticism carries an assumption of innocence. Changing the assumptions wouldn't necessarily prevent or detect more fraud."* Another audit chair suggested that *"a <u>curious</u> mindset would be better—we need auditors to be independent, ready to ask questions, probing, going from a simple question to questions of the second and third order."*

Auditors and clients would benefit from forensics training, but forensic auditing for fraud is rarely needed

Many audit chairs endorsed requiring forensics training for auditors. One chair observed that additional training could sharpen their auditor's focus on red flags: *"Training might make them more aware of what's happening rather than suspicious about everything."* Another chair agreed, calling forensics *"part of the work of getting the audit done but, due to the power of automation, not much additional work."* One believed that forensics training would be a necessary accompaniment to a suspicious mindset: *"You can't have a suspicious mindset and not know what to do or not have the tools. Giving the external auditor responsibility but not mandating capabilities would be inconsistent."*

Audit chairs were less convinced that forensic specialists should be part of most audit teams. A primary reason is that forensics accounting is retrospective and largely unrelated to preventing future fraud or detecting ongoing fraud. *"Forensic specialists come in after the event has occurred; they can't tell you what is going to go wrong before it does. They are no more capable of detecting fraud than anyone else,"* one audit chair said. Another agreed that the state of assurance practice is not geared to involving forensic specialists on every audit team: *"You only want to use forensic specialists if there's already an indication of an issue—not as part of normal practice."* Another audit chair considered forensics a *"special skill"* that should not be expected of auditors but added that *"if questions are raised, the auditors should have access to those specialists."*

One audit chair had a far more positive view on forensic skills in audit firms, especially in regulatory regimes that are driving separation between assurance and consulting services. *"Forensic accounting is an opportunity for the firms to broaden their skill bases, to embed different ways of working and thinking. They will not only be more relevant to their clients but also more attractive to young talent."*

Additional auditor disclosures would provide limited net benefit

European audit chairs did not see a need or worthy purpose for additional formal disclosures from their auditors. The audit chairs observed that, absent the discovery of a material fraud or other anomaly affecting the accuracy of financial statements, investors rarely take close interest in the work of the audit committee or the external auditor. Additional disclosures, audit chairs said, would likely have minimal impact on investor satisfaction in routine circumstances. One audit chair explained that requiring more disclosures in the normal course could have consequences: *"Investors would expect a particular structured approach to how auditors go about their business and identify controls inadequacies. That's not a good outcome."*