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Canadian Public Accountability Board Symposium:

The evolving fraud landscape

In September 2023, the Canadian Public Accountability Board (CPAB) held its fifth Audit Quality Symposium. The symposium was attended by corporate directors, regulators, standard setters, leaders from public accounting firms, other professional organizations, publicly traded companies, investors and academics.

2023 marks CPAB's 20th anniversary. CPAB promotes audit quality through proactive regulation, robust audit assessments, dialogue with domestic and international stakeholders, and practical insights that inform capital market participants and contribute to public confidence in the integrity of financial reporting.

To mark our 20th anniversary, CPAB chose to use the Audit Quality Symposium to focus on the topic of fraud. Over the past 20 years and more significantly in the past few years, the fraud landscape has evolved, and we continue to see examples of the massive impact that large scale fraud can have on investors and other stakeholders.

Fraud continues to be an important challenge for both domestic and global capital markets and requires a renewed focus and effort from all stakeholders in the financial reporting ecosystem.

CPAB thanks our keynote speakers, panelists, moderators and participants for their contributions to this event and this critical topic. A copy of the detailed symposium agenda can be found here.

Introduction

> "Risks facing capital markets are rarely specific to a single country, or to a single stakeholder. Regulators, governments, boards and management, and auditors, all have an important role to play in creating environments that discourage fraud, and where, in the event of fraudulent activity, it can be detected quickly."
> *Benita Warmbold, Board Chair, Canadian Public Accountability Board*

A recent study[1] estimated "that corporate fraud destroys 1.6 per cent of equity value each year, equal to $830 billion in 2021". The symposium provided an opportunity for stakeholders across the financial reporting ecosystem to reflect on the impact of emerging fraud risks and their own role in managing and detecting the risk of fraud.

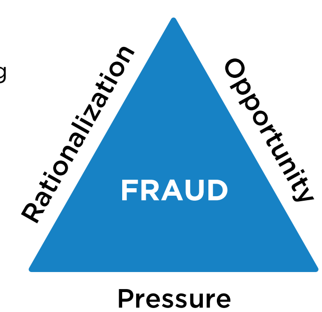
We heard from a wide variety of stakeholders with varying perspectives, including views of securities regulators, of anti-money laundering experts and of leaders in the ESG domain.

For the purpose of this summary, we have grouped perspectives into three categories.

(1) Fraud risks are evolving rapidly.
(2) All stakeholders need to be hyper-vigilant to the risk of fraud.
(3) Each stakeholder in the financial reporting ecosystem has a role to play in preventing and detecting fraud.

Since 2019, CPAB has integrated fraud thematic reviews into our inspections of audit files. The results of our reviews suggest that auditors could do more to enhance the quality of their fraud risk identification and assessments. CPAB has also been engaging with forensic specialists, investors and other regulators to better understand the public's expectations of auditors relating to fraud detection and to inform our views about good practices and how auditing standards can evolve in the future.

(1) Fraud risks are evolving rapidly



Fraud risk is not new. From Enron to Lehman Brothers, Wirecard to WorldCom, there are many historical examples of fraud that we can learn from. The underlying reasons for why individuals commit fraud hasn't changed, with the concepts of opportunity, pressure and rationalization remaining key components of why individuals commit fraud.

Panelists highlighted that while many of the underlying reasons for fraud have not changed, the individuals who are committing fraud and how they are doing it has changed and will continue to. While traditional forms of fraud still exist, many of our panelists expressed the concern that advancements in technology have, and will continue to, result in new approaches to fraud that are easier to commit but harder to detect, leading to an increased risk of fraud in our financial systems.

The impacts of new technology on fraud risk include:

- Generative artificial intelligence (AI) will allow individuals to be able to commit fraud more easily and in ways beyond their normal skillset due to the assistive capacity of the technology.

[1] Dyck, A. Morse, A. Zingales, L. "How pervasive is corporate fraud?". *Review of Accounting Studies*, 2023, p.1.

- The use of AI to develop deepfakes (videos or audio that have been digitally altered to appear to be someone else) could make it nearly impossible to detect bad actors and could lead to significant negative impacts such as significant stock price changes driven by disinformation.
- New digital tools and an increasingly interconnected online world means that fraudsters no longer have to be physically present to commit fraud.
- Technology could facilitate further exploitation of victims of fraud.

While advancements in technology have a significant impact on fraud risk, there are many other factors impacting the fraud landscape. Criminal actors continue to leverage the changing environment to design and perpetuate new types of fraud such as new internet scams. Additionally, illicit drug trafficking remains one of the main and most important money laundering threats in Canada.[2]

Interest in Environmental, Social, and Governance (ESG) reporting and associated standard setting activity has increased significantly over the past few years. With growing interest and activity surrounding ESG reporting across the financial reporting ecosystem, new pressures and incentives will emerge that may lead companies or individuals to misrepresent their ESG performance or commitments. As ESG reporting increases, boards of directors and leadership teams will need to consider where the line is between optimism, misrepresentation and fraud both in what is reported publicly and what is not reported.

While the evolving fraud landscape will continue to present new challenges, there are things that we can all do to help improve our ability to identify and detect fraud early:

> **"Stay active in fraud risk oversight. Ask questions, review procedures, identify gaps, and bring people together."** *Sarah Paquet, CEO, Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)*
>
> **"Be relentlessly curious."** *Anthony Scilipoti, President and CEO, Veritas Investment Research*

(2) All stakeholders need to be hyper-vigilant to the risk of fraud

Fraud does not discriminate. All companies and individuals (regardless of industry, size or jurisdiction) can be the target of fraudulent activity. In addition, changing societal dynamics (such as income inequality, conflict, political extremism and economic pressures) generate additional incentives and motivations to commit fraud.

Fraud can have significant societal, economic and political consequences. These include increased victimization of individuals, reduced confidence in private and public sector institutions, increased economic distortions, reputational damage, loss of credibility and influence internationally, and eroding of public institutions and the rule of law.[3]

[2] Government of Canada, *Updated Assessment of Inherent Risks of Money Laundering and Terrorist Financing in Canada*, March 2023.
[3] Government of Canada, *Updated Assessment of Inherent Risks of Money Laundering and Terrorist Financing in Canada*, March 2023.

Throughout the symposium, the audience heard examples of recent high-profile frauds such as Wirecard in Germany and FTX Trading Ltd. in the US. The common denominator amongst the panelists' experiences in investigating fraud was a lack of skepticism by those both within and outside organizations.

"Professional skepticism is inherently linked to audit quality, ethics, independence, and the confidence people have in the auditing profession."
Grant Vingoe, CEO, Ontario Securities Commission

Concerns regarding Wirecard and its operations had been raised publicly for a number of years leading up to the fraud being identified. Red flags such as the company having a weak internal control system and continually increasing profits were factors which allowed the fraud to get bigger and bigger.

If a company's success story makes it "too big to fail" in the eyes of some, it can be harder for those who raise concerns to be heard. This provides a cautionary tale, like many large scale frauds, of the consequences of not asking the right questions, not being skeptical, and the risk of wanting to believe something is true, even when there is mounting evidence that it is not.

Lessons learned from the Wirecard fraud:

- If auditors don't understand how the company earns its money (or the business processes), they need to keep asking questions until they do.
- It is important to pay attention to whether management is investing in internal control systems or views them as not necessary. Consistent pushback from management when questions are asked or behaviors that do not align with relevant ethical standards are indicators that something may be wrong.
- Auditors need to maintain sufficient independence from and skepticism of the company they are auditing. Regulators need to communicate with each other, maintain professional skepticism and a birds-eye view of what is happening in the market.
- Fraud can happen anywhere, be alert.

(3) Each stakeholder in the financial reporting ecosystem has a role to play in preventing and detecting fraud

"In recent years we have seen numerous high-profile incidents of fraud. The collapse of cryptocurrency exchange FTX in January of this year is perhaps the most recent, and sensational, example. But most examples of fraud do not capture global attention. In fact, perpetrators of fraud would much prefer to remain hidden from sight. And they are innovative in their efforts to keep their activities secret."
Carol Paradine, CEO, Canadian Public Accountability Board

A common thread throughout the day's discussion was that all stakeholders have a role to play in preventing and detecting fraud and that there is a large human element to fraud.

Discussions focused on the roles of three key players: auditors, board members and management.

Auditors

Auditors have an important role in public trust that underpins capital markets around the world. Auditors, and other stakeholders, need to guard against inherent biases and assumptions and remain alert to early indicators of fraud and contradictory evidence.

Auditors have the potential to detect fraud which could mitigate investor losses and losses of confidence in the profession. Through the use of professional judgement and a commitment to lifelong learning, auditors have the ability and skillset to deeply understand a company's business and associated risks, including the risk of fraud.

The Association of Certified Fraud Examiners' (ACFE) 2022 Report to the Nations reported that external auditors initially detected only four per cent of occupational fraud. While auditors cannot be expected to detect all fraud, there is considerable room for improvement.

Paul Munter (Chief Accountant, US Securities and Exchange Commission) noted that often times where auditors stumble is when they focus on the limits of their responsibilities, what they are not supposed to do versus what they could or should be doing. Consideration of fraud risks is deeply embedded in the auditing standards and is a foundational requirement.

It is important that auditors ensure appropriate audit documentation of their consideration of fraud risks, timely review of documentation, and appropriate supervisory mechanisms. In order to appropriately assess the risk of fraud in an audit of financial statements, auditors must ensure they understand the pressure points of a business and challenge information they receive from management.

> "Auditors assume a public responsibility and owe ultimate allegiance to investors."
> *Paul Munter, Chief Accountant, US Securities and Exchange Commission*
>
> "Auditors need to ensure they understand the reasons underlying these transactions and structures and ensure the right audit procedures have been followed with a heightened level of professional skepticism." *Grant Vingoe, CEO, Ontario Securities Commission*

Best practices for auditors:

1. Use forensic auditors more often when dealing with complex business models or corporate structures, emerging industries, or higher risk jurisdictions.
2. Leverage the use of technology.
3. Ensure your fraud risk assessment considers the specific fraud risks the company will face (including understanding related party transactions, the impact of analyst expectations and management compensation structures and consideration of issues raised by short sellers).
4. Avoid a checklist approach, ensure you sufficiently understand risks that could exist.
5. If you see or suspect something, say something.

Board members

Board members play an important role in monitoring and mitigating the risk of fraud. It is critical that the board has a fundamental understanding of fraud risks that could exist, and the controls and processes put in place to manage those risks, is critical.

> “To fulfill our fiduciary responsibility and duty of care, we can’t have blind spots and assume everyone is a nice and ethical person. We have to change that mindset.”
> *Lori-Ann Beausoleil, Audit Committee Chair, Brookfield Income Trust Inc.*

Panelists discussed various steps that board members can take to better prepare themselves to prevent and detect fraud.

These include:

1	Ensure you have in depth conversations with both the external auditors and management regarding the risk of fraud. Avoid making this a compliance exercise and really dive into the risks that could arise.
2	Ask about the company’s whistleblower line. Understand the process behind it and provide feedback on how that process could be improved.
3	Stay alert to near misses. Even if an event is immaterial from a financial reporting perspective, small fraudulent events, particularly at the management team level, can indicate broader risks to investigate.
4	Incorporate consideration of fraud risks when developing or pursuing new strategies or business opportunities (such as new product lines or new jurisdictions).
5	Review and understand the results of recent employee surveys.
6	Discuss different scenarios with management to assess fraud risk readiness.
7	Go on site, see how things are done, and talk to as many team members as you can in different locations.
8	Look for behavior that is outside the norm. Issues like employee disgruntlement, financial instability, discord within the management team and overly involved management team members can be cause for discussion.
9	Understand the impacts of evolving areas, such as ESG reporting on the business and the new pressures and incentives that could arise.

Board members should also take the time to step back and assess if they are comfortable with the steps they have taken. Specific questions board members could ask include:

1. How can we better align our oversight approach to fraud prevention with the culture we want for the organization?
2. How can we give people comfort that when they raise concerns related to fraud that there is a process based on rehabilitation rather than retribution?
3. Do we have a good crisis management program?
4. Is the company’s code of conduct appropriate? Does it outline the appropriate ethical behaviors?

Management

Throughout the day, symposium participants agreed that there is a significant human element to fraud in corporations. Many times, those perpetrating fraud are trusted insiders who have identified an opportunity for personal gain or retribution. Often, a natural bias to trust people means that management, and others, assume fraud is not likely to happen.

One panelist, Andrew Chester (President and CEO, Juno Risk Solutions) shared a quote that has stuck with him. **"There has never once been an insider threat problem that couldn't be addressed through the early application of employee assistance".**

> **Key concepts that management should keep in mind to help minimize the risk of fraud include:**
> 1. Promote a culture of transparency.
> 2. Ensure the whistleblower program is operating appropriately and being used by employees when needed.
> 3. Be aware of what is going on across your organization and set the right tone from the top.
> 4. Pause and make sure you don't have any blind spots. If you do, take corrective action as soon as possible.
> 5. Have a code of ethics that clearly outlines the behaviors that are important for your organization.
> 6. Have uncomfortable conversations.

Next steps

CPAB encourages continued dialogue on this important topic and discussed fraud prevention and detection at the 2023 Canadian Audit Quality Roundtable.

Within this document we have shared key takeaways and actions that different stakeholders can take to better address the evolving risks of frauds in their organizations.

CPAB also plans to engage with standard setters regarding upcoming revisions to international auditing standards in relation to fraud.

If you would like to discuss this topic further with us, please reach out to us at thoughtleadership@cpab-ccrc.ca.

Learn More

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