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MIND THE GAP SERIES

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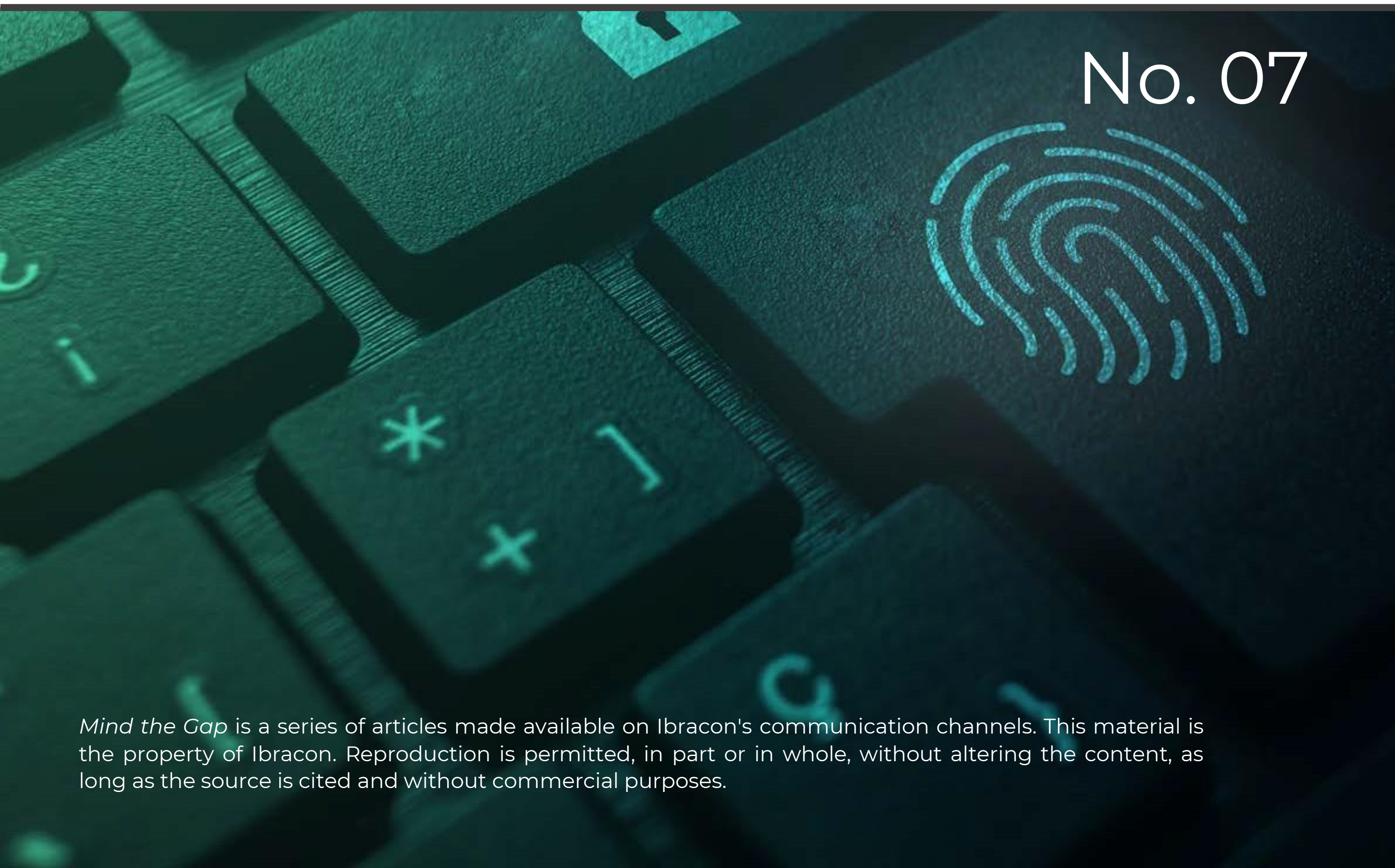
Errors and fraud and the responsibilities of the Independent Auditor and

OF THE PREPARERS OF FINANCIAL INFORMATION



No. 07

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PUBLICLY-TRADED COMPANIES present a unique set of features which have long been studied by academics at universities. While, as a rule, small businesses are owned and managed by their shareholders, the managers of large corporations are not the owners of the company (owned by the shareholders). This gives rise to an agency conflict (addressed in a previous issue of the *Mind the Gap* series), when the interests of the agent (management) conflict with the interests of the person(s) who appointed him/her (the shareholder). If the manager does not own the company's business and have access to the sources of owner capital – which ultimately belonging to the shareholders – how can incentives be aligned so that the manager acts in the benefit of the organization, its shareholders and other stakeholders?

Typically, this is addressed by the concepts of corporate governance, which the Brazilian Institute of Corporate Governance (IBGC)[1] defines as a system formed by principles, rules, structures and processes by which organizations are directed and monitored, with a view to generating sustainable value for the organization, its partner-owners and society in general. The governance system provides direction for the relationship among partners, board members, supervisory board members, directors, governance officers, members of advisory committees to the board, as well as the internal and independent auditors. The Independent Audit thus operates within a comprehensive corporate ecosystem, which

1 Brazilian Institute of Corporate Governance. Code of Best Corporate Governance Practices. 6th ed. Brazilian Institute of Corporate Governance. São Paulo, SP: IBGC, 2023. https://conhecimento.ibgc.org.br/Paginas/Publicacao.aspx?PubId=24640#msdynttrid=geWJutax-5v5Qhn2HLle6ZFDDXDLb3o_K6nMUUNCGi0

aims to foster good governance: the Auditor is an external agent, independent of management and the shareholders, who analyzes the financial statements with a view to expressing an opinion/ conclusion furnishing "reasonable" (but not absolute) assurance as to whether the financial statements are free from "material" misstatements. Thus, the Auditor is commonly seen as a gatekeeper promoting quality in the presentation of companies' financial statements. This is consistent with the view that the Independent Audit contributes to good governance. Therefore, as more companies are audited, an improvement in the quality of information can be expected, serving as the basis for decision making (whether they be by regulators, investors, shareholders or other interested party).

Agency conflict risks arise, however, when mal intentioned employees or managers seek to manipulate their positions of trust by deceiving those by whom they were appointed to protect – including the Auditors – by generating misleading or fraudulent information, promoting their self interests, or by concealing the misappropriation of assets or unlawful payments.

To mitigate the risk of errors, fraud or non-compliance with laws or regulations, it is essential to have a system of checks and balances within the organization, as part of a system of good governance. It is equally important that a company adopt a code of ethics, to regulate daily tasks, strengthening the organization's culture of ethics and integrity, beginning with a top down approach by senior management.

A system for preventing misconduct begins with mapping and assessing the management risks to which the entity is exposed. The implementation of appropriately designed and effective internal controls, that exist in practice and not just on paper, are critical. Internal controls must be able to continuously monitor the systems/procedures and need to tested and results communicated through appropriate channels when violations or suspicions of mal practice are identified.

A governance model establishes rules for oversight of controls and monitoring of management practices. The independent auditor is but one of many gatekeepers who share different responsibility for the reporting and functioning of an adequate system of corporate governance. A governance model relies heavily on the integrity of the shareholders, the Board of Directors, Board sub committees (such as, for example, the Audit Committee), the executive board, management committees and the governance department[2].

Publicly-traded companies and those in regulated sectors must necessarily have a Board of Directors, whose members are elected by the general meeting of shareholders which can be removed by the Board at any time.

The rules for convening, installing and operating the Board of Directors (BoD) must be defined in the bylaws/ articles of association, respecting corporate legislation. The bylaws can only be changed by the same general meeting. Among other functions, the BoD is responsible for electing and removing the company's directors and determining their duties, pursuant to the provisions of the bylaws and corporate law.

The executive board is responsible for conducting the company's business, fulfilling its social objectives, ensuring the sustainability of the business and pursuing the strategic objectives defined by the BoD. Therefore, in addition to implementing operational and financial functions, the Board is also responsible for proposing and implementing internal control systems, constantly monitoring and evaluating the execution of strategic decisions. It may also create specific management committees for certain strategic matters, including for the compliance areas by establishing anti-fraud and anti-corruption programs. This latter item became especially relevant with the enactment of Law 12,846/2013, known as the Anti-Corruption Law, which provides for administrative penalties and defines civil liabilities for companies committing acts of corruption. The Law was a response to numerous corruption scandals that occurred in Brazil's recent past exposing companies to the consequences of harmful acts carried out in their name or

2 More details about the central elements of governance can be found in Silveira, A D M. (2015). Corporate Governance in Brazil and in the World. 2nd ed. Editora Atlas, and in the IBGC Code of Best Corporate Governance Practices (2023).

for their benefit. Before being enacted, only managers, employees or agents involved in illegal acts could be subject to sanctions. They continue to be subject to the same penalties as before, but now the company, at a corporate level, may suffer sanctions for the acts carried out by them.

The Board of Directors acts as a central body for promoting corporate governance. It is a collegiate body, responsible for defining the company's strategic plans, to ensure the business operates as a going-concern and generates value for its shareholders.

The Board of Directors is responsible for setting the direction of the company's business and, among other duties, to oversee the management of the executive directors, with free access for examining documentation, books and to request clarifications from the appropriate person. Corporate legislation places on the BoD the responsibility for appointing the company's independent auditor, and is empowered to establish an Audit Committee, which will act as a support body reporting to the Board.

The rules and regulations of the Brazilian Securities Commission – CVM and the IBGC Code of Best Corporate Governance Practices describe the duties of the Audit Committee. Although the functions of the Audit Committee and Independent Audit are different, both seek to promote the reliability and integrity of in-formation and accounting records, in a constant process of improving governance. The CVM establishes that the Audit Committee is responsible for receiving and investigating internal or external complaints concerning the company's business. It must be endowed with operational autonomy and command a sufficient budget allocation, approved by the Board, to conduct investigations, and carry out consultations and evaluations. Among its duties, the Audit Committee is responsible for proactively exercising supervision to assist in the quality control of financial statements, internal controls, risk management, compliance and internal audit. It is also its role to issue an opinion on the hiring and removal of the independent auditor, supervise their activities, monitor the quality of their work and their integrity, particularly as to their independence. The existence of the Audit Committee, whether statutory or not, does not relieve the Board of its legal responsibilities. Regulatory requirements indicate that the Audit Committee must meet with the BoD at least quarterly, in addition to having at least one financial advisor among its members.

Law 12,846/2013, known as the Anti-Corruption Law, which provides for administrative penalties and defines civil liabilities for companies committing acts of corruption.

The independent auditors must be comprised of teams composed of professionals qualified under the Technical Qualification Examination as required by the Federal Accounting Council – CFC. They are subject to a strict international code of ethics and comprehensive auditing standards, as well as being required to be knowledgeable of

capital market legislation. The Auditor must perform his/her role with competence and integrity, the firm's reputation being its most valuable asset.

The users of financial statements expect a high level of excellence from the Auditor's work, as already addressed in previous articles of this *Mind the Gap* series. The Auditor is generally the first to be questioned when suspicions of fraud or errors in the financial statements arise, being the last link in overseeing the design and effectiveness of internal controls in the process of auditing the financial statements through to the date of their issuance. But the preparation of financial statements is not the responsibility of the auditor, nor is it his/her task to implement the internal controls of the company being audited, such as systems and areas of compliance, anti-fraud and anti-corruption programs. This is not always clear to the public at large.

The Independent Auditor determines the audit procedures to be performed, consistent with the audit standards for the expression or not of an opinion/ conclusion based on evidence obtained in the course of those audit procedures. As already discussed in another issue of the *Mind the Gap* series, the primary objective of the Auditor's work is not to identify fraud. In relation to fraud, the standards determine that the Auditor must:

(a) identify and assess the areas and risks of material misstatement in the financial statements, of which fraud is but one element; (b) define and implement responses that aim to obtain sufficient and appropriate audit evidence as to the areas and risks identified; and (c) respond appropriately to situations in which fraud or suspected fraud has been identified or has come to his/her attention during the audit.

In a previous issue of this series, we discussed the Brazilian and international auditing standards addressing errors/risks which may cause material misstatements being undetected by the audit. This is especially true in situations of fraud, particularly involving collusion by management, as the fraudster is more likely to circumvent controls to conceal the illegal nature of the actions. In such a situation involving distorted information and/or forged documents, the Auditor may be more easily misled into believing that the evidence is correct, when, in fact, it is false.

In the same vein, as the objective of the Auditor's work is not to identify fraud, responsibilities cannot be attributed to risks similar to those covered by an insurance policy. The underlying details of fraud committed within an organization, which was not subsequently detected by the auditor's work, must be subject to thorough investigation and retributions attributed to proponents. In the event the fraud had been perpetuated before the start of the Auditor's mandate, the Auditor is less likely to identify the errors. Therefore, the Auditor should not be held liable to compensate for financial losses resulting from fraud.

The work of the independent auditor should also not be wrongly misconstrued with the work of forensic experts or fraud investigators[3]. These are professionals whose role is to understand, collect evidence and analyze issues generally related to illegal acts or inappropriate conduct. Their work brief relies on specific work methodologies directed to deeper investigation with broader access to data and information sources. However, these professionals also face limitations as their mandates which are not as wide as that enjoyed by judicial authorities which can carry out investigations, subpoena individuals, conduct witness interviews and, therefore, obtain a level of cooperation that is not available to private investigators.

Management is solely responsible for establishing the general direction of the company's business and for supervising employees and agents.

3 Further information about forensic accounting investigation work can be found in *A guide to forensic accounting investigation* (Ref.: Skalak, S. L., Golden, T. W., Clayton, M. M., & Pill, J. S. (2011). *A guide to forensic accounting investigation. 2nd ed. John Wiley & Sons.*).

This includes, as a primary responsibility, implementing systems for the prevention and detection of fraud and errors.

The independent auditor must carry out his/her work adjusting the level of diligence and skepticism when he/she identifies or suspects fraud might cause a material misstatement; this must be communicated to those charged with governance (independent of management), informing them of the nature, timing and extent of any additional work required to complete the audit[4].

In general, those charged with governance – usually, the Board of Directors – should form a special committee comprised of independent professionals to investigate the suspected cases of wrong doing; contracting specialized outside legal counsel and an expert in forensic investigation will provide the essential objectivity required and add to the credibility of the investigation.

The independent auditor will monitor the investigation carried out under the responsibility of the Board of Directors. That is, the Auditor has no responsibility for directing the investigation. The results from the investigation will be analyzed by the Auditor in forming his/her opinion/ conclusion. Evidently, attributing any responsibility to the Auditor for directing the investigation would impair his/her independence in assessing whether its results are adequately reflected in the financial statements. By the same token, the Auditor must obtain sufficient and appropriate audit evidence to enable his/her report to be issued; this requires a full understanding of the fact pattern underlying the fraud/misstatement, those involved, the internal controls that failed and the corresponding amounts.

Therefore, the Auditor must have unrestricted access to all documents produced in the context of the investigation.

With sufficient and appropriate information in hand, the Auditor reassesses the impacts on the original audit plan and adapts the audit procedures accordingly. For example, additional audit procedures may be required to adjust the nature, timing and extent of the audit response to identified risks of material misstatement which might affect the original audit plan. To be able to issue his/her opinion/ conclusion, the Auditor must obtain additional, reliable and relevant evidence.

Combating fraud requires instituting policies, programs and controls that are appropriately designed and operate effectively within companies. This is only possible with an appropriate investment and the creation of a culture of ethics within the company, which is implemented with the support and good examples set by senior management.

Fraud committed within an organization, which was not subsequently detected by the auditor's work, must be investigation and retributions attributed to proponents.

4 The board of directors and/or the Audit Committee and/or the independent auditor are obligated to formally communicate to the regulators (pursuant to CMN Resolution No. 3198, CNSP Resolution No. 321 and CVM Resolution No. 23).

All those involved should be encouraged to follow a journey of continuous improvement. From the company's perspective, there must be continuous monitoring and reassessments of mapped risks, recommendations on deficiencies reported by external auditors; these will foster an environment to encourage suitably designed and effective processes and controls. All elements of the governance systems need to be constantly updated, for example, by providing continuous training and promoting events and discussion forums. The Auditors are obliged to undergo continuous professional education and monitor changes to accounting and other standards; they must accompany the results and developments of dialogues with regulators, professionals and investors and those from public hearings promoted by the International Auditing and Assurance Standards Board (IAASB). The IAASB is currently reviewing its standard on fraud through the International Ethics Standards Board for Accountants (IESBA). In Brazil, the Federal Accounting Council (CFC), seeks continuous improvement in the quality of the work of auditors, promoting compliance with the ethical and technical precepts of the profession.

The IAASB project to revise auditing standard ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of the Audit of Financial Statements (NBC TA 240 issued by the CFC), aims to clarify the role and responsibilities of the Auditor with respect to cases of fraud in an audit of financial statements.

This will promote consistent behavior and facilitate effective responses to identified risks of material misstatement in the financial statements due to fraud, establishing more robust requirements, in addition to improving and clarifying concepts of materiality whenever necessary. It will reinforce the importance, throughout the audit, of exercising appropriate professional skepticism in audit procedures relating to fraud and improve transparency in fraud-related procedures, where appropriate, including strengthening communications with those charged with governance and the reporting requirements in ISA 240 and other relevant standards.

The IAASB's schedule indicates that a draft from the public hearing will be released in December 2023 and final approval of the standard will occur in March 2025.

Ibracon acknowledges the vital role played by the independent auditor in promoting confidence in the capital market by assuring the reliability of information and achieving consistent reporting across all platforms. This is a critical function played by the Auditor by furnishing a high-quality service benefiting society as a whole.

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