

# The Fraud Advisory Panel

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Dear Derek,

## **Review of the Role and Effectiveness of Non-Executive Directors**

I am sorry that this letter will reach you after the deadline for comment on your Consultation Paper has passed. However, I hope that you may still be able to take our comments into account.

The Fraud Advisory Panel is an independent body of volunteers drawn from a range of disciplines that acts as a forum for discussion and a catalyst for more effective measures in the fight against fraud and other economic crime. We have in the past commented on a range of corporate governance topics where we believed there was a fraud risk aspect and we thought we should draw to your attention the following views about the role of non-executives which have been developed by the Panel over a period of time.

The Hampel report commented that good governance can make a significant contribution to the prevention of malpractice and fraud, although it cannot prevent them absolutely. We agree. The Combined Code recognizes that a key element of board oversight is working with management to achieve corporate legal and ethical compliance. Such oversight includes ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipating financial risks and promoting accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders. Internal control for this purpose can be taken to include as a minimum business risk assessment and response, financial management, compliance with laws and regulations and the safeguarding of assets, including minimising the risk of fraud.

The "Guidance for Directors on the (Internal Control aspects of) Combined Code" (the "Turnbull Report") requires boards of listed companies to review the effectiveness of their internal control arrangements, including risk management, and to report to shareholders

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that a review has taken place. Audit committees comprised of non-executive directors will normally be involved in the review process.

Our experience is that there are too many companies where the review process pays relatively little attention to fraud risks and the controls needed to guard against actual fraud and malpractice taking place. We believe this is often due to a complacent attitude that the risk of fraud is so low as to be unimportant to the board; also in many organisations there is a tendency to avoid the subject because it is human nature to assume that management and employees have proper motives. There are exceptions, typically fraud risk has a higher profile in the financial services industry. However, the reality is that serious fraud can affect all types and sizes of organisation and the effects can be catastrophic to shareholders, management, employees and other stakeholders.

Often the issue is exacerbated by too narrow a definition of the risks faced by the company. In many companies if there is any focus at all on fraud it is on low value employee fraud, whereas the most serious frauds tend to involve management or even executive directors and the most damaging events for the company often go beyond simple misappropriation to wilful mis-reporting, corruption and unethical behaviour causing reputational loss.

Our recommendation is that non-executive directors should have an explicit role on behalf of the board in assessing whether risks of fraud, unethical behaviour, corruption or other such events causing financial loss or reputational damage have been properly identified, and whether measures are in place to respond to the risks in a satisfactory way.

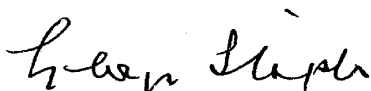
- The first step is for non-executive directors to be aware of their responsibilities and of good practice for discharging them. Training for directors is more common now than it used to be, but we suspect there are still many non-executives whose understanding of their responsibilities is limited. We suggest there should be an expectation that all non-executives will undergo appropriate training from time to time, sufficient for them properly to discharge their role. This should include at least awareness of the matters referred to in this letter.
- The second step is for the non-executives, at least those on the audit committee, to be satisfied, through adequate review, that the company has communicated clear policies on these issues, emphasising ethical, proper and honest behaviour. Communications should cover the consequences for those who transgress.
- The 'Turnbull review' process should then satisfy the directors as a whole, and the non-executives in particular, that the company has in place risk management and internal control procedures that will as far as practicable, on an ongoing basis, guard against behaviour, at any level within the organisation, contrary to the policy. The review should address the risk of fraud, corruption, unethical behaviour and reputational damage at all levels, including at director and senior management level.
- Any events contrary to the policy, however small, should be reported to an appropriate level untainted by suspicion and more material matters reported to the non-executives and if necessary the Board. The non-executives should be satisfied that appropriate actions are taken.

- Companies should be required to report material matters involving director or senior management malpractice to the shareholders (naturally a sensitive matter with the result that very few material frauds are reported, but a more open approach should be seen as enhancing a company's reputation rather than the reverse).

The Combined Code and the Turnbull report go a long way towards providing a framework for Board review of effective control, but do not go far enough, either in relation to fraud and related reputational risks or the role of non-executives. Non-executives can play an important part in holding the executive to account for the company's fraud risk management, probity and reputation, which should be seen as a source of shareholder value in the long-term. We hope your Review will result in recommendations that remedy these deficiencies.

If the Panel can be of further help, or if you would like to meet to discuss our comments, please let me, or Helen Fay know.

With best wishes  
Yours ever



George Staple  
Chairman  
Fraud Advisory Panel