

Audit committee roles in fighting fraud: a network compendium

Introduction

The EU's 8th Company Law Directive on Statutory Audit sought "to restore credibility of financial reporting and to enhance the EU's protection against the type of scandals that occurred in the past at companies such as Parmalat and Ahold".¹ The Sarbanes-Oxley Act in the US and the various national governance codes and laws across Europe assign varying levels of responsibility to boards or audit committees for overseeing whistleblowing processes, the tone at the top, and formal codes of conduct or ethics programmes.

Deterring fraud is essential to the health and integrity of public companies in Europe. Since fraud is difficult to uncover, audit committees can play an important role in preventing, detecting and investigating fraud. Unfortunately, many companies do not have effective measures in place for doing so. Ernst & Young's 9th *Global Fraud Survey*, released in June 2006, noted that 42% of companies do not have a formal anti-fraud policy², and in some European countries it is still unusual for the audit committee to take a proactive role in fraud risk management.

This issue of *InSights* will help audit chairs whose committees play a role in overseeing fraud risk management – as well as those who don't – to evaluate their company's anti-fraud programmes and determine the effectiveness of the measures their companies have in place. While acknowledging that the audit committee must be concerned about all types of fraud, European audit committee chairs are concerned primarily with financial statement fraud. This issue of *InSights* shares that focus. For tips on managing fraud risk in emerging markets, see Appendix 1 on page 10.

Topics covered in this issue of *InSights* include:

- **Fraud prevention** (page 2)

The audit committee can, and should, play a central role in fraud prevention by demonstrating that fraud is an important issue, ensuring internal controls are in place and working as planned, working closely with both internal and external auditors to keep track of possible problems, and assessing management behaviour for appropriate tone at the top.

- **Fraud detection** (page 5)

Having appropriate systems in place to detect fraudulent activity is crucial. Internal auditors should be the audit committee's first line of defence by, among other things, keeping track of a company's fraud risks. External auditors can also be an important resource, providing guidance on fraud risks and behaviour observed within the company. For lessons learned from the accounting scandals at Parmalat and Royal Ahold, see Appendix 2 on page 11.

¹ 8th Company Law Directive on Statutory Audit – Vote in EP Plenary, 28 September 2005. Available at: http://europa.eu.int/comm/internal_market/auditing/docs/statutory_audit_info_note_en.pdf

² Ernst & Young, *Global Fraud Survey*, June 2006. Available at: http://www.ey.com/global/Content.nsf/International/FIDS_-_9th_Global_Fraud_Survey_-_Press_Release



- **Fraud investigation** (page 7)

If there is reason to believe that a fraud may have occurred, it is up to the audit committee to determine the extent of the investigation and what resources should be used. Some audit chairs manage investigations differently based on the nature of the alleged fraudulent activity, calling on internal auditors to handle incidents of non-pervasive or lower-level fraud and reserving the audit committee's efforts for pervasive or high-level fraud.

InSights features a compilation of best practice suggestions identified over the past two years by members of the European Audit Committee Leadership Network, the Audit Committee Leadership Network in North America, and other US regional audit committee networks. For further information, see [Bibliography on page 9](#). This document uses the Chatham House Rule whereby comments made in discussions before or during network meetings are not attributed to individuals or companies.

Fraud prevention

The CEO and senior management play an integral role in preventing financial statement fraud by setting an ethical tone at the top and nurturing a company-wide anti-fraud culture (and its attendant processes). However, the audit committee should be in a position to identify risks arising from management override of internal controls, and it must work closely with the internal and external auditors to identify warning signs of lapses in management behaviour. Since whistleblowers are a key element in detecting fraud, the audit committee needs to take special care to test whistleblower processes and continuously investigate allegations of fraud and, in the opinion of some audit chairs, regardless of materiality.

To help prevent fraud, network members recommend that audit committees should:

- **Assess the integrity of the culture and the tone at the top.** *“Big Fraud”*, meaning substantial financial statement fraud or large-scale asset misappropriation, *“is all about culture and always will be, and it is the role of the board to assess culture. Maybe we don’t always do that so well”*, said one audit chair. Another audit chair said the audit committee should remind the organisation repeatedly: *“Corporate culture values integrity, honesty and fairness in everyone from the top to the bottom, so that when someone sees something bad, they will pick up the phone”*. To gauge an organisation’s ethical tone, one audit chair even conducts exit interviews with outgoing corporate CFOs, controllers and chief accounting officers.
- **Create an environment of openness and accountability.** The audit committee must indicate its willingness to listen to information and encourage the internal and external auditors to report any concerns they have about the company. *“Is the audit committee independent enough to enable the [internal and external] auditors to be candid?”* asked one audit chair.
- **Ask difficult questions.** *“Let the organisation see that the audit committee is on the job, engaged and alert. Be supportive but also challenge management”*. Doing so in the external auditor’s presence is especially effective in making it clear to management that the audit committee gives the auditor its full support. If the company regularly hits estimates, another audit chair said: *“I want to know [what we did] accounting-wise to come within a penny. Did we do anything with reserves? Did we change any assumptions?”*



- **Ensure adequate processes and controls.** The audit committee needs to look at the pattern of fraud allegations to ensure there are no underlying process issues to be resolved. The committee needs to ask the internal and external auditors what the controls are, and whether those controls are adequate or need to be strengthened. The audit plan also needs to address areas of higher exposure to fraud risk. One member recommended a focus on the balance sheet rather than the income statement because *“sooner or later, fraud will hit the balance sheet”*.
- **Oversee codes of conduct and associated ethics programmes.** The audit committee may oversee the company’s ethics-related programmes. For SEC registrants, this is also the guidance in the US Federal Sentencing Guidelines.³

Audit committees overseeing the code of conduct

Members of the European Audit Committee Leadership Network believe the audit committee should ensure that management:

- Keeps the code refreshed and reinforced through training. One member pointed out: *“Someone in the company needs to be responsible for monitoring, refreshing, and promulgating the code of conduct. Like any product or service, it needs to be relaunched periodically ... to actively get it into people’s heads”*.
- Mentions the code of conduct in the company’s internal communications.
- Reminds employees and third parties that the company upholds high standards. *“For example, is a joint-venture partner ... fully respecting the group’s code of conduct?”*
- Lives the code in how they punish and promote. *“If a company has a good culture, you ... are able to recruit top management from within. Who you promote is a great message to the organisation [to demonstrate] what you value”*.

- **Oversee effective whistleblower processes.** Audit committees should insist on effective whistleblower processes. Differences in national, legal and regulatory requirements, as well as differing national cultural attitudes towards whistleblowing, make the establishment of such processes a difficult but not impossible procedure for multinational companies. One audit chair commented that for whistleblowing to be effective: *“You need openness and willingness to share”*. Cultural resistance to ‘informing’ anonymously may influence whistleblowing effectiveness, as another audit chair noted: *“In some countries, even if you set up [the whistleblower hotline], no one calls”*. Fraud awareness training can be used to make fraud something that is talked about in an open and constructive way, even in cultures where this is not the norm.

Poor internal promotion of the whistleblower process may also have a detrimental effect. One audit chair said: *“You don’t get [whistleblower calls] because of low awareness”*. Another audit chair suggested: *“Open [the hotline] up so it’s not just something you call with concrete proof of fraud, but with any ethical concerns”*. Other audit chairs regularly test the effectiveness of their whistleblower processes by planting complaints to see if they surface at audit committee meetings.

³ The United States Sentencing Commission Guidelines Manual is available at: <http://www.ussc.gov/2005guid/gl2005.pdf>. Please see the section on *Effective Compliance and Ethics Program* on page 475.



- **Insist on complete, unfiltered reporting of whistleblower complaints.** The audit committee should receive reports on any illegality or ethical lapse, no matter how small: *“Don’t let [line managers] take refuge in materiality”*, said one chair. There is also a need to give positive recognition to those managers who do surface issues and deal with them. One audit chair reported: *“Anything involving senior management always comes to the audit committee ... Every single [call] is investigated”*. Some audit chairs recommend that companies hire an independent firm to screen and analyse calls, rather than giving that task to the company’s own legal department or internal audit team. This removes any worries about the audit committee receiving filtered information.
- **Gain exposure to the wider management team, customers and vendors.** One audit chair suggested looking two to three layers below executive management by inviting people at lower levels to present to the audit committee, saying: *“You need to trust but verify management”*. This enables the committee to assess the quality of management and hear about issues without them being filtered. Another audit chair said his company regularly surveys the top 60 critical employees to ensure the tone at the top is not being compromised. Some members have found that rotating board meetings through multiple corporate locations, thereby giving the audit committee the opportunity to meet with local management, customers and vendors, is a good way to reinforce the importance of company standards and test for tone at the top.
- **Use employee surveys to gauge corporate culture.** One audit chair added questions to a broader biannual employee survey, asking if employees had seen fraudulent activity within the company and whether they believed management would take appropriate action if it were reported to them. The same audit chair said: *“It will be interesting to see that [survey] as a snapshot in time, and how it changes over time, by geography or business unit – you may find pockets of unethical behaviour”*. Another audit chair said: *“Attitude surveys that show tremendous inconsistencies between departments are a signal [of potential problems]”*.
- **Get to know finance people at levels below the CFO.** *“Do you totally rely on reporting, or look people in the eye?”* asked one audit chair. Many audit chairs stressed the importance of getting to know the finance organisation, in order to look beyond the presentations made to the audit committee. *“Push to dig deeper into the organisation”*, advised one chair, *“you learn a lot about people – their character and abilities”*.
- **Provide support to the internal audit function.** One audit chair noted that internal audit is *“always in a tough situation – coming into operations, looking over shoulders ... tell them the board counts on them and they can count on the board’s support”*. Audit chairs in the US agree that the audit committee could play a key role in supporting the recommendations of internal audit. One audit chair said: *“When there is a trouble spot, the person responsible on the ground comes to the audit committee. The audit chair and internal audit decide when to trigger this – it is not a pleasant thing”*. In addition, since internal audit is a relatively new function in many European companies, a European audit chair said the audit committee – through its approval of the internal audit plan – can highlight areas and issues it wishes internal audit to focus on. However, one member cautioned against becoming complacent if the company has a particularly good internal audit function: *“You need to be careful that you don’t get lulled to sleep by a strong internal audit department”*.



- **Talk to the remuneration committee of the board.** Audit committee members can familiarise themselves with the structure, weighting and metrics of compensation plans by interacting formally or informally with the remuneration committee, and by studying the written compensation plans. One audit chair meets annually with the head of the remuneration committee and members acknowledge that cross-committee meetings or memberships are desirable, saying: *“We must explain to shareholders that how we incentivise management to create value affects their behaviour”*. Another audit chair invited the remuneration committee into a portion of an audit committee meeting to ensure that both had the same facts. What began as an ad hoc process became an annual meeting of the two committees, with a set of topics designed to cover any ‘grey areas’ in their committee charters.⁴
- **Demand separation for the fraudster.** Tone at the top is so important that the audit committee should insist that perpetrators of fraud are always fired. One audit chair commented: *“If people lose their jobs, it impacts everyone. The fraudsters are often the top producers, and the audit committee needs to ensure they go”*. Another declared: *“Get rid of them. Don’t wrist-slap, gloss over, or find reasons to keep someone [who has committed fraud]”*. In one company, discovery of a fraud that involved six people ultimately resulted in the dismissal of 40 people because *“they should have raised concerns”*.

Questions to ask your company about fraud

In 2006, Ernst & Young published *Fraud: Six Myths that Hold Companies Back*.⁵ As part of the conclusion, Ernst & Young posed six key questions that should be asked in an effort to strengthen organisational fraud assessment processes.

- Do you know the top ten fraud risks most prevalent in your organisation?
- Are you focused on the three sites or divisions where you are most vulnerable to fraud?
- What pressures are your managers and employees exposed to?
- Is your internal controls environment aligned to address the fraud risks that matter?
- How much do you rely on chance to discover fraud?
- Are you comfortable with your organisation’s ability to recover from fraud?

Fraud detection

Though a company may tirelessly work to prevent incidences of fraud, there may be no failsafe way to eradicate the temptation. *“If you’re alert and pay close attention and have all the formal processes and controls – and cross your fingers – you may be lucky”*, says one audit chair. But luck is hardly an effective strategy. Having systems in place that not only help to prevent but also to detect fraudulent activity can be critical.

⁴ For further discussion on the relationship between the audit and remuneration committees see Tapestry Networks and Ernst & Young, *Improving communication between audit and compensation committees* in *InSights* 13, 22 December 2006. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_Dec06_InSights_13.pdf

⁵ Ernst & Young, *Fraud: Six Myths that Hold Companies Back*, 2006. Available at: [http://www.ey.com/global/download.nsf/Belgium_E/BRS_pdf_Fraud/\\$file/Fraud.pdf](http://www.ey.com/global/download.nsf/Belgium_E/BRS_pdf_Fraud/$file/Fraud.pdf)



Before looking outside for tools to facilitate fraud detection, the audit committee should consider establishing their own red flags for fraud detection. These red flags may include performing consistently too close to earnings guidance, or too well in comparison with competitors. Audit committee chairs should also evaluate the availability of independent metrics to enhance their understanding of the company's performance. These independent sources may include the provision of analysts' and credit rating agencies' reports on the company, and the software-based analytics developed to assess Directors' and Officers' (D&O) insurance risks.

Both internal and external auditors play key roles:

- **Internal audit.** The audit committee is dependent on the fraud detection capabilities of internal auditors. One audit chair said: *"The audit committee ... is continuously looking at high-exposure areas of the company with internal audit"*. Several audit chairs said that attending internal audit's annual meeting and talking to people in the field *"gives you a feel for how aggressive or conservative the company is, whether they're stretching"*. One audit chair commented that training in forensic skills for internal audit *"has been a serious push within the company, not because outrageous fraud has been found, but [internal auditors] are coming on their own for the training to enhance their careers and help the company at the same time"*. Another audit committee requires internal audit to go beyond the corporate boundary and visit vendor organisations to *"do more than check transactions, to get a feel for the vendor's ethics ... if something is wrong with how the vendor behaves, that will affect your reputation"*.

Ideas for enhancing fraud detection from the six largest global audit networks

In November 2006, the leaders of the six largest global audit networks published their perspectives on how global financial reporting and public company auditing can better serve global capital markets.⁶ The document includes a section outlining their proposals for closing the 'expectation gap' that the investing public has around the role of independent auditors in detecting fraud. Options include:

- **Subjecting all public companies to a forensic audit on a regular basis.** The most aggressive (but also costly and intrusive) suggestion is to involve forensic auditors, giving them new investigative powers to interview employees under oath and scrutinise all company records every three or five years.
- **Subjecting all public companies to a forensic audit on a random basis.** This would be a less onerous and costly version of the first suggestion as it would involve selecting a sample of public companies, on a random basis, for a forensic audit. The authors noted: "Though such a system might uncover fewer frauds, the deterrent effect could still be the same [as the first suggestion]".
- **Giving investors or board directors more choices regarding forensic audits.** Within this model, the authors propose either (a) letting shareholders determine the intensity of the fraud detection efforts they want auditors to implement, with full costs of the different options disclosed in proxy materials, or (b) allowing audit committees or entire boards to decide the optimum level of intensity.

⁶ *Global Capital Markets and the Global Economy: A vision from the CEOs of the international audit networks*, November 2006. Available at: http://www.globalpublicpolicysymposium.com/CEO_Vision.pdf



- **External audit.** Audit chairs want their external auditors to:
 - **Provide helpful indicators on fraud.** Many members expect their external auditor to offer industry- and geography-specific indicators of fraud risk.
 - **Help identify when a company's culture is shifting in the wrong direction.** Ask the auditor their observations on what they see occurring behaviourally and culturally, as well as what they consider to be best practice.
 - **Discuss the firm's client re-acceptance process.** Audit firms conduct a detailed financial risk analysis of their client's company. Audit committees would like the audit firm's view of their company's financial risk considerations to be shared with them.
 - **Meet informally with the audit chair.** One audit chair has lunch with the external auditor four times a year to establish a relationship and have conversations on any sensitive topics. They reach agreement on how, together, to bring these issues to the board.
 - **Ask for a list of disputed areas with management.** One audit chair asks management *"to give us copies of documents for their key accounting judgments – what were the close calls in the quarter?"* This audit chair also asks the external auditor what decisions they cleared with the national office – and for a copy of how the auditor documented a decision.
 - **Involving forensic auditors in the external audit team.** Involving forensic auditors in the audit is seen as an attractive, low cost option for improving auditors' fraud detection capabilities. Audit firms are also focused on improving the training of existing account teams to raise awareness of fraud risk, as well as adding new forensic investigative practices to the audit process, which may include psychological and behavioural skills.⁷ In fact, The Netherlands requires fraud detection training for all auditors.

Fraud investigation

If there is reason to believe that a fraud may have occurred, the audit committee is responsible for determining the extent of the investigation and whether internal, or internal and external, resources should be included. Audit chairs recommend the following approaches:

- The decision to investigate an incident of fraud typically begins with a recommendation from the head of internal audit or the company's legal department. However, one audit chair said: *"I try to let management be the initiator of an investigation, rather than have the perception that 'the board had to make management do this'. It's better to be able to say management, together with the audit committee, hired an independent investigator"*.
- Most audit committee chairs rely on their intuition in applying a 'smell test' to determine when to widen an investigation and involve outside legal counsel or investigative resources. One audit chair said: *"There have been matters where the audit committee ... wanted a second opinion to compare to the external auditor's view. It has never been mandatory but [it is] helpful to use forensic accountants"*.

⁷ Audit Committee Leadership Network, *Preventing, detecting, investigating fraud* in *ViewPoints*, 24 March 2005, page 5. Available at: http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar05_View8.pdf



- Some audit chairs distinguish between degrees of investigation and manage them differently:
 - Internal audit often handles investigations of non-pervasive or lower-level frauds. The audit committee oversees the investigation and reports to the board.
 - When there are suspicions of more serious pervasive or high-level fraud, the audit committee is more likely to take charge. Audit chairs say the committee is notified immediately if an incident involves a senior officer, the amount is significant in absolute terms, or the suspected fraud involves an area that might indicate a systematic problem in controls. In these cases, the board reaches out to an independent law firm, who may bring in a forensic auditor, and to the external auditor.
- Some audit chairs recommend putting a fraud response plan in place. Matters to consider in developing a fraud response or contingency plan include who will lead the investigation, objectives and powers of the investigating team, identifying suspects and obtaining/preserving evidence, working with the police, and reporting and publicity.⁸ One US audit chair described how it took one large, global company six months to establish a relationship with an experienced outside law firm that could be declared “*independent*”. In Europe, the law firm must also be well-versed in privacy law, particularly with regard to the collection and review of electronic evidence.
- An aspect of concern to audit chairs is how to wrap up an investigation. Members stressed that audit committees must stay on top of an investigation and decide how they will know that the investigation is complete, especially if filing deadlines loom while an investigation lingers.

Conclusion

Audit chairs believe that fraud, like death and taxes, is always with us. For many audit chairs, that in itself is a call to action to ensure that the audit committee is doing everything it can to prevent fraud from occurring. The audit committee, for instance, is uniquely placed at the hub of an early warning system consisting of senior management, the finance organisation, and the internal and external auditors. How audit committee members respond sends a powerful signal to the rest of the company about how important the independent directors believe the fight against fraud to be.

About this document

InSights is produced by Tapestry Networks to provide assessments of key issues of interest to audit committee members in Europe. Initially, *InSights* will be distributed to members of the European Audit Committee Leadership Network who, in turn, will share it with colleagues on audit committees and boards, and their advisers. It will be distributed by Ernst & Young to its partners. Anyone who receives *InSights* may share it with those in their own network. The ultimate value of *InSights* lies in its power to help all constituencies develop their own informed points of view.

The views expressed in this document represent those of the European Audit Committee Leadership Network, the Audit Committee Leadership Network of North America, and other audit committee networks – a group of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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⁸ Ernst & Young, *The fight against fraud – what every company director must know* press release, 19 July 2004. Available at: http://www.ey.com/global/content.nsf/uk/media_-_04_07_19_dc_-_fight_against_fraud



Bibliography

Further detail on audit committee chairs' views on the prevention, detection and investigation of fraud can be found in the following documents:

European Audit Committee Leadership Network

Preventing, detecting and investigating fraud. Available at:

http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Mar06_View.pdf

Major emerging markets risk. Available at:

http://www.tapestrynetworks.com/documents/Tapestry_EY_Euro_ACLN_May06_View9.pdf

Audit Committee Leadership Network in North America

Preventing, detecting and investigating fraud: The audit committee's role. Available at:

http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar05_View8.pdf

Risk in major emerging markets. Available at:

http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Nov06_View16.pdf

Pacific-Southwest Audit Committee Network

Preventing and investigating fraud: the audit committee's role. Available at:

http://www.tapestrynetworks.com/documents/Tapestry_PacSouthwest_ACN_Jan07.pdf

Southeast Audit Committee Network

Preventing, detecting, investigating fraud: The audit committee's role. Available at:

http://www.tapestrynetworks.com/documents/Tapestry_EY_SE_ACN_Feb06.pdf



Appendix: Tips for managing fraud risk in major emerging markets⁹

- **Be prepared.** Conduct due diligence in advance of entering the market; be sure joint venture agreements provide safeguards to ensure control. The audit committee should insist that the company screens local partners and key hires, using several different organisations to do background checks. The focus should be on professional skills over language skills.
- **Develop personal contact.** Bring local leaders such as the head of internal audit and lead external audit partner to relevant board or committee meetings. One US chair said: *“We bring in the foreign CFOs and internal auditors. They go through a course about tone [at the top] for about a week, where I speak. We bring them in for education”.*
- **Regularly review operations.** One audit committee examines accounting procedures, tax questions, anti-corruption measures, audit processes and resources, based on the findings of a special joint assignment of internal and external auditors in the country concerned. The audit committee should have a clear view of authorisations and ensure there are good controls.
- **Look intensively at local leaders.** One European chair said: *“Make a generation cut, and hire young people with different value systems”.* Bringing those young people to headquarters on temporary assignments can be a *“strong [retention] incentive”.* The external auditor is a good source of information on local management.
- **Rotate headquarters people.** The audit committee should review the rotation plans for top finance people. One US audit chair said: *“The CFO should be a legacy company person”.* Another mentioned that the finance organisation leadership team travels to various markets and works there for about two weeks each time: *“It is about them working within the region”.*
- **Use the same technology and accounting platforms across the company.** Several members recommended having all entities on the same technology and accounting platforms. One audit chair said: *“All financial-control IT is on a global standard ... it forces discipline into the culture”.*
- **Ensure a strong internal audit focus.** Corporate internal audit should focus on high-risk emerging markets as part of its annual plan, even if these operations are immaterial from a revenue perspective. *“The most important thing is to put the corporate head of internal audit in charge of [assessing internal] controls and technology”*, said one European audit chair.
- **Ensure that a code of conduct is rolled out across the company.** One European chair said: *“Maintain your values wherever you are”.* Also, make telephone hotlines available: *“When employees have confidence in the code, calls increase”.* The rollout needs to be backed by a training and education programme.

⁹ This list of tips is drawn from discussions on risk in major emerging markets held by members of the European and North American Audit Committee Leadership Networks. See Bibliography on page 9 for links to the *ViewPoints* summaries of these discussions.



Appendix 2: The audit committee's role in high-profile accounting scandals

Since 2001, several high-profile scandals have brought to light reporting deficiencies that were sufficient to destroy hundreds of billions of dollars of market capitalisation. The fact that these deficiencies went unchecked despite audit committee oversight has served as a lesson to audit committee chairs the world over. The case studies below recount some of the key points of each scandal with, where possible, analysis of how these companies' audit committees failed shareholders.

Parmalat: insufficient corporate governance structure

The Parmalat case is one of an individual's wrongdoing, with little or no oversight by the audit committee. Though the company was not formally required to maintain an audit committee one did exist, albeit with the CFO as a member. In general, the audit committee "accepted procedures that were clearly inadequate (recall [CFO] Mr Tonna's role as member of the audit committee)".¹⁰ Furthermore "the complexities of the group's structure and finance required a great amount of work and financial understanding, and [the directors] were not prepared to dig into Parmalat's intricate business".¹¹

The main problem with this governance structure was that a controlling shareholder – the Tanzi family, which had also founded the company – "exploit[ed] the company rather than monitoring its managers".¹² The Tanzis oversaw a "disclosure policy [that] was characterised by its management's opaque and arrogant approach towards analysts and investors",¹³ the loudest and most important warning sign that fraud was taking place. Other signs of fraud that a more competent audit committee might have noticed included:

- **Lots of cash on the books, yet continued management interest in borrowing.** This baffled the financial community and led many top analysts to steer clear of the firm's securities.
- **Lowered debt ratings.** More than three years before the scandal broke publicly, rating agencies reduced Parmalat's ratings to the lowest commercial grade level, signalling the market's worries about the disconnect between the company's debt levels and the large amounts of cash on its balance sheet.
- **The creation of a special-purpose entity after a required change in auditors.** With a change in auditors pending, management created a wholly-owned subsidiary in the Cayman Islands to house a fictitious cash account worth almost €4 billion.
- **Nepotism at the highest levels.** Tanzi family members were put in charge of various pet projects, such as professional football teams and tourism businesses, at the expense of other shareholders – running up large debts with little to show for them.

¹⁰ Guido Ferrarini and Paolo Guidici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case*, European Corporate Governance Institute Working Paper No. 40, 2005. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=730403.

¹¹ Ibid

¹² Ibid

¹³ Ibid



Royal Ahold: growth outstripping management's capabilities

Royal Ahold was a well-respected grocery market chain that had expanded from a local shop in the West Netherlands to a global corporation with stores located around the world. The company made a name for itself through successful acquisitions and an aggressive growth strategy, which expanded the company's presence into Europe and the US, Latin America and Asia.

By early 2002, however, it appeared that Ahold's growth had outstripped its management capabilities. In February 2002, its stock fell 7% based on reports that US Foodservice, an American subsidiary, had misstated its numbers. Ahold vehemently denied improprieties and then disclosed growth figures that excluded US Foodservice accounts, decreasing overall transparency.

In its 2001 annual report, Ahold confirmed what investors had dreaded. During the ensuing crisis, Ahold board members and management maintained a distant attitude, with one board member saying "we are grocers, not accountants or bankers".¹⁴ By the end of the scandal, both the CFO and CEO had resigned, few board members remained, and Ahold had negotiated a €3.1 billion emergency loan to cover immediate cash needs. The ramifications of the scandal are far reaching: Ahold has put US Foodservice up for sale and has begun the process of divesting assets in Poland, Slovakia and Portugal.

The key problem for Ahold was management's consistent drive to expand, without any corresponding corporate governance changes. While the company's rapid expansion may have looked good to investors, it decreased opportunities for the board and the audit committee to identify problems. An expert consulted by Tapestry Networks stated that after the crisis Ahold's audit committee processes had to be rebuilt from the ground up. Several steps the reconstituted audit committee took to enhance its capabilities included:

- **Implementing a tough attendance policy to demonstrate commitment.** Before the scandal, the audit committee did not always require that the members appear at committee meetings in person. This changed under new leadership.
- **Providing audit committee members with as much information as possible.** Audit committee members now receive regular and detailed reports on whistleblowing, fraud and internal controls.
- **Committing to professionalism.** In searching for new audit committee members, as well as other directors, the remaining board members were determined to find people committed to professionalism. They looked for people who had a broad professional background and would take the work seriously.

¹⁴ Stewart Hamilton and Alicia Micklethwait, *Greed and Corporate Failure: The Lessons from Recent Disasters*, (New York: Palgrave MacMillan, 2006), page 143.