



## **Preventing, detecting, investigating fraud: the audit committee's role**

### **Synopsis**

Audit committees play an important role both in helping management deter fraud – by supporting a robust control system and a healthy ethical tone at the top of the organization – and in overseeing the necessary investigations of fraud. Audit committees should be most concerned about the risk of collusive fraud – the kind that can bring down a company. Occasional *de minimus* fraud cannot be completely eliminated.

The Southeast Audit Committee Network held its third meeting in Atlanta, Georgia, on February 7, 2006. *VantagePoint* provides a synthesis of key issues that arose during the group's discussion of the audit committee's role in preventing, detecting, and investigating fraud.

In an unreported "open session," network members raised other matters they are currently dealing with, among them:

- The audit committee's relationship with the external auditor
- The impact of the current regulatory environment on that relationship
- Who in the company can determine whether an accounting matter is material

The members of the network present for the meeting, who sit on the boards of approximately 18 large-, mid-, and small-cap public companies among them, were:

- Eddie Adair, Audit Committee Chair, Tech Data Corporation
- Denny Beresford, Audit Committee Chair, Kimberly Clark and Legg Mason
- Kerm Campbell, Audit Committee Chair, SPX Corporation
- Jim Copeland, Audit Committee Chair, Equifax
- Doug Ivester, Audit Committee Chair, SunTrust Banks
- Dean O'Hare, Audit Committee Chair, Fluor Corporation
- Dave Rickard, Audit Committee Chair, Harris Corporation

Other participants in the meeting included:

- George Berry, Southeast Area Professional Practice Director, Ernst & Young
- Tom Hough, Area Managing Partner, Ernst & Young

*VantagePoint* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Network members' remarks appear in italicized quotes.



## Executive summary

The Southeast Audit Committee Network’s discussion focused primarily on collusive fraud, often perpetrated at high levels of management, including fraudulent financial statements and large-scale asset misappropriation. Understanding the types of fraud and conditions that produce them, audit committees can be vigilant in helping management minimize them. Members made the following observations about the audit committee’s role in preventing, detecting, and investigating fraud. Additional detail can be found on the pages indicated.

- **Tone at the top underpins all fraud prevention efforts – and starts with the board** *(Page 4)*

Some members are deeply skeptical that fraud can be prevented or detected, despite best efforts: clever people, colluding together and intent on committing fraud, are likely to be successful. However, many members emphasize that, in addition to strong controls, an ethical tone at the top that infuses the organization from top to bottom is a company’s best defense. Fraud prevention must be a priority; detection means damage has already occurred. [Risk factors relating to misstatements arising from fraudulent financial reporting can be found in Appendix 1 on page 11.](#)

The entire board has an obligation to assess and support an ethical culture. The audit committee and board can help reinforce an ethical culture by challenging management on judgments and assumptions, understanding the influence of compensation triggers on management behavior, knowing the organization’s people, embedding formal codes of conduct and ethics programs, and through commitment to the punishment of transgressors. [The AICPA’s fraud prevention recommendations for audit committees can be found in Appendix 2 on page 15.](#)

- **External auditors should not be burdened with greater expectations to detect fraud** *(Page 7)*

Members recognize that fraud detection occurs primarily through tips, and secondarily through internal and external audits. The audit committee must oversee robust, secure, and confidential whistleblower processes through which employees and even external parties can relay suspicions of fraud or unethical conduct, regardless of perceived materiality. While the external auditor is fully expected to fulfill its obligations under current auditing standards, including SAS 99, to plan and test for fraud and to notify the audit committee chair immediately of suspicions, network members do not believe the external auditor should be charged with additional fraud-related responsibilities beyond “reasonable assurance.”

- **Investigating fraud: the fraud response plan is an emerging best practice** *(Page 8)*

The discovery of fraud unleashes a chain of events that moves very rapidly with potentially serious ramifications internally and externally. Consequently, organizations find it helpful to have established in advance criteria for how an investigation, internal or external, will be conducted. Criteria for seeking outside help include the seniority of those implicated, and the size and pervasiveness of the fraud. While circumstances may modify the fraud response plan, its essentials cover who will take charge of the investigation; key people, roles and responsibilities; identification and “pre-vetting” of independent outside counsel, preferably with experience at or dealing with the Securities and Exchange Commission (SEC); a communications plan internally and externally; and criteria for how to know when an



investigation is complete. Examples of questions audit committees ask to determine if an independent investigation is required can be found on page 9.

## Understanding the conditions that produce fraud

In 2002, following the revelations of fraud at companies such as Enron and WorldCom, President Bush signed the Sarbanes-Oxley Act, which mandated a number of reforms to increase corporate responsibility and restore investor confidence. The SEC's final rules relating to Section 404 of Sarbanes-Oxley indicate that management must explicitly conduct an assessment of internal controls over financial reporting that includes but is not limited to "controls related to the prevention, identification, and detection of fraud."<sup>1</sup>

With theft, the absence of the stolen item is soon discovered. By contrast, fraud by its nature is not meant to be detected. Fraud is carefully constructed and cleverly hidden because the perpetrator benefits for as long as the scheme goes undetected. Preventing fraud begins with awareness of the types of fraud, how and why fraud is perpetrated, and by whom. A member noted, "*Fraud has many colors: collusion, falsification of documents, overriding controls, networks of false information, transactions with third parties, or off-balance sheet [activities.]*"

In 1996 the Association of Certified Fraud Examiners (ACFE) began to survey its members in the United States and to issue an annual report of its findings. The ACFE estimates that the "typical U.S. organization loses 6% of its annual revenue to fraud."<sup>2</sup> It defines three types of fraud. (Note: numbers do not add up to 100% because fraud cases can include more than one type of fraud.)

- **Asset misappropriation:** 90% of all the fraud cases reviewed by the ACFE involved theft or misuse of assets, such as stealing inventory.
- **Corruption:** Just over 30% of all the fraud cases involved using influence in a business transaction to gain a benefit illegally, such as kickbacks.
- **Fraudulent statements:** Just under 8% of all the fraud cases involved falsification of financial statements, such as overstating revenues. However, this type of fraud typically had the greatest financial and reputational impact on businesses.<sup>3</sup>

People may commit fraud if they believe the potential rewards exceed the probability of being caught. Three conditions are usually present when fraud occurs.

- **Opportunity.** Fraud can only occur if opportunities present themselves, as is the case when there are weak internal controls and a lack of segregation of duties.
- **Pressure.** Incentives or pressures – for example, to hit particular revenue targets to trigger bonus allocations – may become the motives for committing fraud.

<sup>1</sup> Securities and Exchange Commission, *Final Rule: Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, II, B, paragraph 3d, <http://www.sec.gov/rules/final/33-8238.htm>.

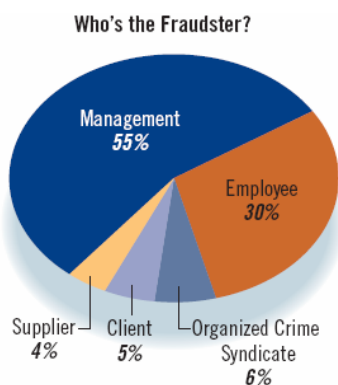
<sup>2</sup> Based on a review of 508 occupational fraud cases. Association of Certified Fraud Examiners, *2004 Report to the Nation: Occupational Fraud and Abuse* (Austin, TX: Association of Certified Fraud Examiners, 2004), iii. A pdf file is available at <http://www.cfenet.com/pdfs/2004RttN.pdf>.

<sup>3</sup> A KPMG study backs up this statement. It found that while financial-reporting fraud constitutes a very small percentage of fraud occurrences, the average annual cost for the companies it studied that experienced fraud was more than \$250 million; one company reported costs of \$4 billion.



- **Rationalization.** Individuals may rationalize committing a dishonest act on the grounds that it is in the aid of a higher purpose, for instance, to save jobs.

The majority of fraud is committed by insiders, and the CEO appeared to be associated with financial statement fraud occurrences about three-quarters of the time.<sup>4</sup>



**Figure 1. Who commits fraud? Source: Ernst & Young, reported in *Chief Legal Executive*, Spring 2003, 57.**

Where should management, the board, and auditors invest their attention? Network members primarily focused on collusive fraud that has the potential to disrupt the viability of the business, such as large-scale asset misappropriation or financial statement fraud, often involving control override by high-level management, rather than *de minimus* fraud such as might occur occasionally at subsidiary plant levels.

Ideally, all fraud would be detected – but should organizations exert equivalent efforts to expunge both types? One member said, “*Realistically, there needs to be some tolerance of fraud in the system because it’s simply not possible to catch it all – nor could we afford the cost to try; the economy would shut down.*” But even if completely eliminating fraud is impossible, minimizing the opportunities for fraud is critical.

### **Tone at the top underpins all fraud prevention efforts – and starts with the board**

Tightening formal internal control systems has a positive deterrent effect on fraud, “*whether it’s the attention that it gets, the sense that it’s more important, or a fear that you may get caught.*” One member called Sarbanes-Oxley Section 404 a “*helpful attempt by Congress to move the ball toward the front of the fraud prevention process.*”

In addition, members noted, a surprising amount of fraud deterrence derives from the company’s awareness of the board and audit committee’s active involvement, care, and alertness: “*What reduces fraud risk most is the audit committee’s vigilance and constant conduct. The most powerful thing an audit committee brings to fraud prevention is consistency of expectations for management and for the external auditor.*”

Members described the following ways their companies, boards, and audit committees deter fraud:

<sup>4</sup> The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Fraudulent Financial Reporting: 1987-1997. An Analysis of U.S. Public Companies*, March 1999.



- **Reinforce a culture of integrity.** *“Big Fraud,”* meaning substantial financial statement fraud or large-scale asset misappropriation, *“is all about culture, and always will be,”* one member said, *“and it is the role of the board to assess culture. Maybe we don’t always do that so well. We get sucked in and become part of the problem.”*

Remind the organization repeatedly that *“this 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.”* One member will add questions to a broader biennial employee survey, asking if employees have seen fraud, and if they believe management would take the right action if management got report of it. *“It will be interesting to see that as a snapshot in time, and how it changes over time, by geography or business unit – you may find pockets of unethical behavior.”* To gauge an organization’s ethical tone, one member conducts exit interviews with an outgoing corporate CFO, controller, or CAO.

- **Engage with management, the finance organization, and the external auditor.** *“Let the organization see that the audit committee is on the job, engaged, and alert. Be supportive, but also challenge management.”* Doing so in the 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 the Street’s estimates by a penny or so, another member 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?”*

By engaging with management and the finance organization, the audit committee learns whether the finance group has the technical capability to *“hold their own ... with the external auditor.”* Another member asks management *“to give us copies of documents for their key accounting judgments – what were the close calls in the quarter?”* This member also asks the external auditor what decisions they cleared with the national office – and for a copy of how the auditor documented a decision, to compare.

- **“Walk the talk” and punish offenders.** One member declared, *“Get rid of them. Don’t wrist-slap, gloss over, or find reasons to keep someone”* who has committed fraud or other unethical behavior. *“Our audit committee stepped in, and that sent a positive signal.”* In one company, discovery of a fraud that involved six people resulted in the dismissal of 40 people *“because they should have raised concerns.”*
- **Know the people.** Members stressed the importance of getting to know the finance and broader organization beyond presentations to the audit committee. *“Push to dig deeper into the organization. You learn a lot about people – their character and abilities.”* Several members 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.”*
- **Sensitize compensation committees.** Members discussed how incentive compensation plans might *“sway someone to make a number. Even if the impulse is subliminal, it can cause foolish behavior because the rewards are so great.”* The board and audit committee can familiarize themselves with structure, weighting, and metrics of compensation plans by interacting formally or informally with the compensation committee and by studying the written compensation plans that are readily available. One audit chair invited the comp committee into a portion of an audit committee meeting to ensure that both had the same facts. What was an ad hoc process became an annual meeting of the two committees, with a set of topics designed to cover any “gray areas” in their committee charters.



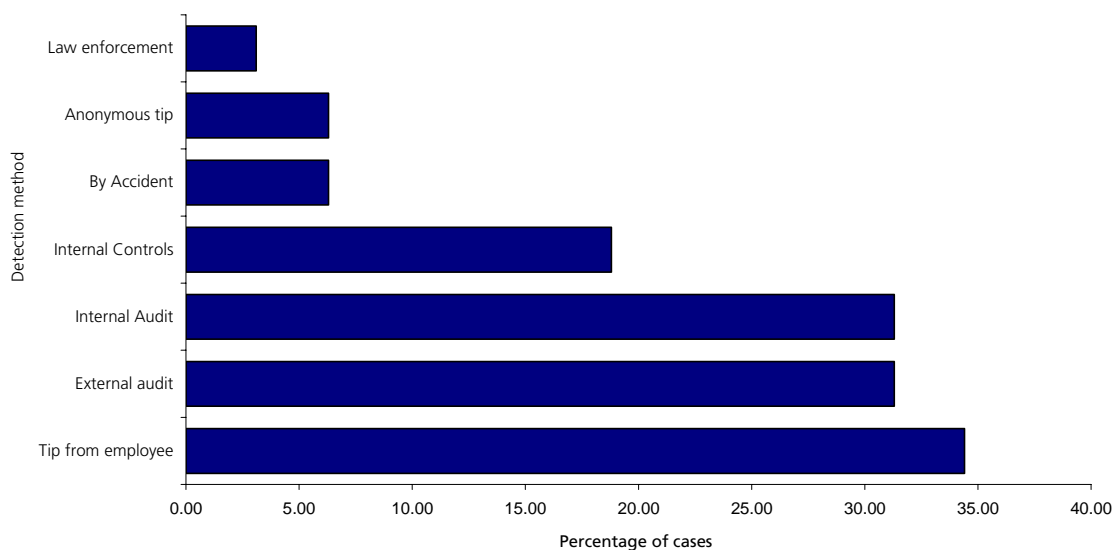
In designing internal audit programs, be aware, and ask management if moving a number could impact an individual’s compensation. *“Watch the metrics carefully. Doing so creates awareness and shows that the audit committee is involved. Make sure folks aren’t ‘achieving’ things they haven’t really achieved.”* A member suggested that rather than making executives’ bonuses dependent on a single number in the current year’s income statement, companies should use a *“smoothing device,”* such as a three-year metric, which would moderate quarter- or year-end pressure.

- **Oversee ethics programs.** The audit or another committee may have oversight of the company’s ethics-related programs, as per guidance in the Federal Sentencing Guidelines. Then, *“if there’s an issue, it flows structurally [to the committee] where it should fall.”* However, ethics should permeate all board committees. One member said, *“It’s silly for any one committee to be in charge of ethics; then what do you have, the ‘compensation and non-ethics’ committee?”* In one company the audit committee reviews the codes of conduct *“as a charge from the board”* and sees that the code is distributed, views input from the whistleblower lines, and reports back to the full board, but does not take on comprehensive responsibility for ethics. Other boards put the nominating and governance committee in charge of ensuring the distribution of the code of conduct and ethics.

If the committee wishes to pursue anti-fraud activities that differ from its current remit – for example, if it wishes to address compensation matters – members advised rewriting the committee’s charter. One member said, *“I’d be reluctant to get too outside of the audit committee charter, too pervasively”* and noted that the charter is a contract with the board for *“what’s covered where.”*

**Audit committees and the whistleblower process**

According to the ACFE, the most common method of detecting fraud in financial statements is through a tip. Tips are more important than internal audit, external audit, or internal controls.



**Figure 2. Initial detection of financial statement fraud. Source: Joseph T. Wells, *The Corporate Fraud Handbook: Prevention and Detection* (New York: John Wiley & Sons, 2004), Exhibit 12.7.**



The audit committee must oversee a robust, well-protected, well-managed whistleblower process that employees can access in multiple ways. Some fraud experts also suggest expanding the anonymous and confidential employee whistleblower procedures to include customers, suppliers, and other parties to increase the information a company receives that may lead to fraud detection.<sup>5</sup>

Members took various approaches to managing the reports from their whistleblower hotlines, and differed in decisions about whether to self-manage the hotlines or outsource them to a third party:

- **Audit committees should see all whistleblower complaints.** One member said, *“The audit committee should see it all – we’re smart enough to scan and figure out what we need to pay attention to, and I don’t want someone else doing that for us.”* Several companies, whether using outsourced whistleblower services or managing their own hotlines, used “redundancy”– having reports sent to, for example, the general counsel and the audit committee chair; or in another case, the director of internal audit and the general counsel – to ensure that nothing is suppressed, and ultimately to know that *“management has no discretion [to leave] something off”* through either inadvertent or intentional filtering or misdirection of hotline tips.

For audit committees that elect to see all complaints, the goal is to get a full picture of the organization’s culture as well as specific allegations. Other audit committee chairs advise that “the audit committee should receive reports on any illegality, immorality, or ethical lapse, no matter how small: ‘Don’t let [line managers] take refuge in materiality.’”<sup>6</sup>

- **Audit committees should see relevant whistleblower complaints only.** Recognizing that many of the calls to whistleblower hotlines cover human resources and other such matters, one member recommended setting parameters for what the audit committee needs to review, with the proviso that *“anything gray comes to me as chair to make the judgment.”*

### **Audit committees and internal audit**

Discussion at the meeting in February covered several areas in depth but did not specifically touch on the role of internal audit in preventing and detecting fraud. However, information gathered prior to the meeting indicated that members find that a strong internal audit department is integral to the control process and to fraud prevention and detection. *“If internal audit gets a whiff of fraud, they assign it a priority and give us a ‘dashboard’ report (in addition to code-of-conduct and whistleblower alerts) at every audit committee meeting,”* one member said. *“We follow those ‘yellows’ very closely to be sure management sorts it out.”*

### **External auditors should not be burdened with greater expectations to detect fraud**

Members of the Southeast Audit Committee Network, reflecting candidly on headline-grabbing corporate frauds, described a cycle in which all parties contributed to weakening the public company audit. One member observed that prior to Sarbanes-Oxley, *“auditing had gone out of vogue with the audit firms themselves. Some audit committees also put unbelievable pressure on fees and hurt auditing. In addition,*

<sup>5</sup> “The audit committee’s role in preventing fraud,” *Board Matters Quarterly*, July 2005, 3.

<sup>6</sup> “Preventing, detecting, investigating fraud: the audit committee’s role,” *ViewPoints*, Audit Committee Leadership Network, March 24, 2005



*auditors were getting pressure from management to push the edge on every issue, and [the audit] firms [did not] push back, plus boards [expected management to] meet or beat Wall Street's quarterly expectations. The good news more recently is that we're getting higher-quality audits."*

The general impression among the investing public is that an audit is designed to detect corporate fraud. In fact, however, the auditor is only required to perform the audit to obtain reasonable assurance that the financial statements are free of material misstatements, not to determine whether misstatements – if they are present – are caused by error or fraud. This “expectation gap” is under review by the Public Company Accounting Oversight Board (PCAOB), which is contemplating the need for a new auditing standard related to fraud.

The SAS 99 framework promulgated by the American Institute of Certified Public Accountants (AICPA) does require the external auditor to plan and test for fraud, including brainstorming on the audit team and asking the audit committee how it probes management's fraud prevention measures, and to notify the audit committee of areas of concern in the course of their audit. If the auditor finds or suspects a fraudulent material misstatement involving senior management, the auditor must report the matter directly to the audit committee. The full board then may conduct a forensic examination to identify and quantify the incident. Audit committee chairs also say they expect their external auditor to alert them to areas of potential geographic, industry and operational pitfalls based on the auditors' experience.

There is no panacea even for big collusive fraud, one member said, “*no list of ten things to do.*” The external auditor's nightmare is “*some relatively small undiscovered fraud, for example a 'ghost employees' scam that siphons [off] \$400k a year, fairly easy to falsify and hide in a multi-billion-dollar company – that eventually gets uncovered in year 10 after it has multiplied into a major cumulative fraud.*”

Asking the external auditor to detect more fraud, more often, is unrealistic, another member said. “*The audit firms are being asked to live up to a higher standard than even law enforcement ... but without the tools of subpoena and wiretap.*”

## **Investigating fraud**

If fraud is discovered in the organization, or there is reason to believe that fraud has occurred, a chain of events is set in motion rapidly, with potentially serious ramifications internally and externally. When one company uncovered a high-level fraud, the audit committee chair said, “*Managing the investigative process became my full-time job for six weeks – it had to [be], or it would never have gotten done.*”

## **Handling the investigation**

The decision to investigate an incident of fraud is frequently initiated by a recommendation from the chief audit executive, the general counsel, or sometimes the CFO. Several members said they do not rely solely on those recommendations, however, and will exercise the chair's prerogative. Members distinguish between degrees of investigation, which are managed differently:

- Internal audit often handles investigation of non-pervasive, lower-level frauds that would not put them in a compromised situation. The audit committee provides oversight 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. The audit committee is notified immediately if an incident involves a senior officer, the dollar amount is significant in absolute terms, or the suspected fraud involves an area that might indicate a systematic problem in controls.

**To determine if an independent investigation is required, audit committees ask:**

- Who is suspected of involvement?
- What is the nature and seriousness of the fraud for the company?
- What is the level of materiality?
- How pervasive is the fraud?

If the size of the fraud is large or the level of the individual(s) suspected of committing it (roughly any of the top 15 people, down to the division chiefs) is high, the audit committee chair typically makes the decision to engage outside counsel and, potentially, forensic accounting services, or to bring in its external auditor to help. In addition, the external auditor might recommend outside investigation, particularly if this is needed in order to help the auditor complete the audit.

### **The fraud response plan: an emerging best practice**

In some organizations, particularly in regulated companies, the process to follow may be pre-established, with clear roles and responsibilities enabling prompt and appropriate action. 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 and preserving evidence, working with the police, and reporting and publicity.<sup>7</sup> One member described how it took one large, global, complex company six months to establish a relationship with an experienced outside counsel that could be declared “independent.”

An aspect of concern to members was how to wrap up an investigation. One member remarked about an investigation, *“The investigators ... could have investigated this for six minutes – or six months! Without a framework, they’d just have kept taking apart pieces.”* Members emphasized how important it is to choose good outside counsel: *“You want someone who isn’t just happy to be on retainer and plod along; you need someone with resolve, who wants to get through this and has a process and a plan for doing so.”* They stressed that audit committees must stay on top of the investigation and must decide how they will know that the investigation is done, especially if deadlines such as SEC filings loom while an investigation lingers.

### **Conclusion**

Battling fraud may strike organizations as a losing cause in the face of determined and clever perpetrators. As one member put it, *“Fraud ... is hard to get at systematically. If you’re alert and pay close attention, and have all the formal processes and controls – and cross your fingers – you may be lucky.”* However,

<sup>7</sup> Ernst & Young, “The fight against fraud – what every company director must know,” press release, July 19, 2004, [http://www.ey.com/global/content.nsf/uk/media\\_-\\_04\\_07\\_19\\_dc\\_-\\_fight\\_against\\_fraud](http://www.ey.com/global/content.nsf/uk/media_-_04_07_19_dc_-_fight_against_fraud)

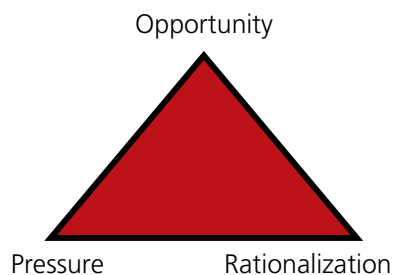


corporations have numerous tools at their disposal to prevent and detect fraud, and to manage its investigation in a methodical manner. Audit committees and boards play an important role in supporting an organization's anti-fraud efforts, particularly when it comes to reinforcing a culture that rejects fraud.



## **Appendix 1: Risk factors relating to misstatements arising from fraudulent financial reporting**

This appendix contains examples of risk factors discussed in *Consideration of Fraud in a Financial Statement Audit*, Statement on Auditing Standards No. 99<sup>8</sup>. Separately presented are examples relating to fraudulent financial reporting. The risk factors are further classified based on the three elements of the fraud triangle: incentives, opportunities, and rationalizations.



Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. The order of the examples of risk factors is not intended to reflect their relative importance or frequency of occurrence.

### **Pressure**

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- High degree of competition or market saturation, accompanied by declining margins
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
- Significant declines in customer demand and increasing business failures in either the industry or the overall economy
- Operating losses that make the threat of bankruptcy, foreclosure, or hostile takeover imminent
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
- Rapid growth or unusual profitability, especially compared with that of other companies in the same industry
- New accounting, statutory, or regulatory requirements

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Profitability or trend-level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages

<sup>8</sup> AICPA, “Examples of Fraud Risk Factors,” in *Consideration of Fraud in a Financial Statement Audit*, Statement on Auditing Standards (SAS) No. 99 (New York: American Institute of Certified Public Accountants, 2002.)



- Need to obtain additional debt or equity financing to stay competitive – including financing of major research and development or capital expenditures
- Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:

- Significant financial interests in the entity
- Significant portions of their compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow
- Personal guarantees of debts of the entity

There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

### **Opportunity**

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
- A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers and that may result in inappropriate or non-arm's-length transactions
- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult "substance over form" questions
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification



There is ineffective monitoring of management as a result of the following:

- Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls
- Ineffective board of directors or audit committee oversight over the financial-reporting process and internal control

There is a complex or unstable organizational structure, as evidenced by the following:

- Difficulty in determining the organization or individuals that have controlling interest in the entity
- Overly complex organizational structure involving unusual legal entities or managerial lines of authority
- High turnover of senior management, counsel, or board members

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required)
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems, including situations involving reportable conditions

### **Rationalization**

Risk factors reflective of rationalizations by board members, management, or employees, that allow them to engage in and/or justify fraudulent financial reporting may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Non-financial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates
- Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations
- Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts
- Management failing to correct known reportable conditions on a timely basis
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality



- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:
  - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
  - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
  - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
  - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement



## Appendix 2: Management override of internal controls

The American Institute of Certified Public Accountants (AICPA) states that due to the potential for management override of controls, “otherwise effective internal controls cannot be relied upon to prevent, detect, or deter fraudulent financial reporting perpetrated by senior management.”<sup>9</sup>

### The AICPA’s fraud prevention recommendations for audit committees

- **Maintain skepticism:** In considering the risk of management override of controls, the audit committee should set aside any beliefs about the integrity of management, because override is most often committed by “good executives gone bad” rather than by consistently dishonest people.
- **Strengthen the audit committee’s understanding of the business:** Understanding the performance measures in management’s compensation package may help identify significant incentives or opportunities for fraud.
- **Brainstorm to identify fraud risks:** Possible brainstorming agenda items include the results of whistleblower hotline calls, fraud risk assessments performed by the company’s independent auditors, and fraud risk factors or concerns identified by audit committee members.
- **Use the organization’s code of conduct to assess the financial-reporting culture:** Use as a benchmark for assessing whether the culture and management’s actions support maintenance of the highest levels of integrity under pressure and given the opportunity to commit fraud.
- **Cultivate a vigorous whistleblower program:** Automatic and direct submission to the audit committee of all complaints involving senior management (without filtering) is essential.
- **Develop a broad information and feedback network:** Focal points to consider include the general counsel, compliance or security director, human resources department, marketing or sales department, and business unit leaders. Establishing an open line of communication with members of management one or two levels below senior management is important.

## About this document

The Southeast Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Southeast region of the United States. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the audit environment.

The ultimate value of *VantagePoint* lies in its power to help all constituencies develop their own informed points of view on important issues. Anyone who receives this publication may share it with those in their own network. The more board directors, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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<sup>9</sup> AICPA Antifraud Programs and Controls Task Force, *Management Override of Internal Controls: The Achilles’ Heel of Fraud Prevention – The Audit Committee and Oversight of Financial Reporting* (New York: American Institute of Certified Public Accountants, 2005), 7. The entire document is available at [http://www.aicpa.org/audcommctr/spotlight/achilles\\_heel.htm](http://www.aicpa.org/audcommctr/spotlight/achilles_heel.htm).