



Preventing and investigating fraud: the audit committee's role

Introduction

The Pacific Southwest Audit Committee Network is a group of audit committee chairs drawn from leading companies based in the Pacific Southwest region of the United States. The network held its fifth meeting on January 10, 2007, to discuss “Preventing and investigating fraud: the audit committee’s role.” This document is a synthesis of insights and comments from that meeting.

In addition, members participated in an unreported open session, during which they discussed other concerns, including the top issues their audit committees will face in 2007. Among the issues preoccupying members were: implementing new rules for reporting executive compensation;¹ dealing with the Financial Accounting Standards Board’s Interpretation No. 48 (FIN 48) on accounting for uncertainty in income taxes;² oversight of enterprise risk management; and likely changes in what will be required for Section 404 compliance. Members are expecting “*a stable, routine year,*” but realize that they could be blindsided by an issue such as the backdating of stock options, which cannot be predicted in advance.

Collectively, members of the network sit on the boards of approximately 24 large-, mid-, and small-cap public companies. Members who attended the meeting were:

- Barbara Alexander, Audit Committee Chair, Harrah’s Entertainment
- Frank Biondi, Audit Committee Chair, Amgen
- David Engelman, Audit Committee Chair, Fleetwood Enterprises
- Diana Laing, Audit Committee Chair, The Macerich Company
- Lou Lavigne, Audit Committee Chair, BMC Software
- Marty Melone, Audit Committee Chair, Countrywide Financial Corporation
- Mike Murphy, Audit Committee Chair, Jack in the Box

Also attending the meeting:

- Peter Griffith, Pacific Southwest Area Managing Partner, Ernst & Young
- Bruce Stump, Pacific Southwest Area Senior Client Service 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. *VantagePoint* also includes select comments and perspectives that emerged from pre-meeting discussions with members.

¹ For more information, see Ernst & Young and Tapestry Networks, “Improving communication between audit and compensation committees,” *InSights*, December 2006. Available at http://www.tapestrynetworks.com/documents/Tapestry_EY_Dec06_InSights_13.pdf.

² Documentation on FIN 48 can be found at <http://cpcf.aicpa.org/Resources/Accounting/FASB+Interpretation+48.htm>.



Executive summary

The Pacific Southwest Audit Committee Network’s discussion focused primarily on the prevention of fraud and, to a lesser extent, on effective tools for investigating fraud once it is discovered. By understanding the types of fraud and conditions that produce them, audit committees can help management in its efforts to prevent potential wrongdoing.

- **Preventing fraud: ethical tone at the top underpinned by a code of conduct** *(Page 3)*

Members acknowledge that, practically speaking, it may be impossible to prevent a determined person who is intent on committing fraud from doing so. However, members believe that an ethical tone at the top, codified in a written code of conduct, is a company’s most important preemptive step in deterring fraud.

The company also needs some method of reinforcing its mores and values on a regular basis. Recommended steps to help reinforce an ethical tone include conducting board meetings in different locations (to enable board members to meet directly with customers, vendors, and the next level of senior management), having a CEO who “walks the walk,” and ensuring the company develops an education process based on the code of conduct.

- **Red flags for audit committees** *(Page 4)*

Internal audit is a company’s first line of defense in the fraud discovery process, and wrongdoing is often found “accidentally” by junior finance people. Nevertheless, certain red flags – such as a CFO’s unwillingness to disclose complete financial data, a consistent record of meeting stated goals flawlessly, and comparative metrics that show the company consistently outpacing its competitors – indicate that fraud may be present.

Whistleblower hotlines, which are a primary source of tips about fraudulent behavior, are another resource for audit committees. Members recommend outsourcing the collection and analysis of hotline information to a third party and having quarterly presentations of the results to the audit committee and management. Audit committee chairs are immediately notified if a hotline item is financial in nature.

- **Investigating fraud and firing fraudsters** *(Page 6)*

Members feel that financial statement fraud is a fairly rare occurrence. However, audit committees need to be prepared for that eventuality. Regular forensic audits were viewed as having a “horrendous” cost-benefit ratio, but members agreed that involving forensic auditors in the external audit team is an attractive option. Once fraud is discovered, there was unanimous agreement that perpetrators should be dismissed directly and usually prosecuted, regardless of whether they are high performers. One member commented that swift and strong punitive measures help reinforce the corporate culture and provide an effective deterrence mechanism.



Understanding the conditions that enable fraud to occur

To add context to any discussion of how audit committees can help management prevent and investigate fraud, it is useful to revisit the underlying causes of fraud. In its 2006 report, the Association of Certified Fraud Examiners (ACFE) estimates that the “typical U.S. organization loses 5% of its annual revenue to fraud.”³ The report provides the following details regarding the impact of three categories of fraud:

Category	Cases reported	Percentage of all cases
Asset misappropriation (e.g., fraudulent invoicing, payroll fraud, and skimming revenues)	1,038	91.5
Corruption (e.g., accepting or paying a bribe, engaging in a business transaction that involves undisclosed conflicts of interest)	349	30.8
Fraudulent statements (e.g., booking fictitious sales, recording expenses in the wrong period)	120	10.69

Figure 1. Types of occupational fraud and abuses.⁴

While acknowledging that the audit committee must be concerned about all types of fraud, audit committee chairs are concerned primarily with financial statement fraud. However, as one member commented, “*Everything translates to financial risk eventually.*” When fraud does occur, companies may suffer not only financial loss, but also second-order effects, such as diminished employee morale, damaged reputation, and stock price pressure. As for who commits fraud, it appears that the majority of fraud is committed by insiders, and the CEO appears to be associated with financial statement fraud occurrences about three-quarters of the time.⁵

Preventing fraud: ethical tone at the top underpinned by a code of conduct

Members agree that good tone at the top is critical to fraud prevention. They note that tone at the top is more than just words: if a CEO’s actions don’t support his or her words, those words will have little force. References to “CEOs who walk the walk” came up repeatedly throughout the discussion, and members also agreed that tone at the top must be reinforced by practices designed to imbue the entire corporate culture with that ethical tone. One audit chair commented ironically, “*What is conveyed by the tone at the top in a once-a-year memo may not do the job fully.*”

An ethical tone at the top is, at a minimum, the cost of entry for successful fraud deterrence; without it, a negative corporate culture may develop. One audit chair outlined the potential downside in stark terms: “*If*

³ Association of Certified Fraud Examiners, *2006 Report to the Nation on Occupational Fraud and Abuse* (Austin, TX: Association of Certified Fraud Examiners, 2004), 8. Available at <http://www.acfe.com/documents/2006-rttn.pdf>.

⁴ *Ibid.*, 10. Numbers do not add up to 100% because fraud cases can include more than one type of fraud.

⁵ The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Fraudulent Financial Reporting: 1987–1997. An Analysis of U.S. Public Companies* (Committee of Sponsoring Organizations of the Treadway Commission, 1999). Available at http://www.coso.org/publications/FFR_1987_1997.PDF.



the [CEO's] tone is 'get whatever you can,' the junior levels will start cheating too." Another member noted that dishonesty among company leadership may cause good people to leave: *"It is a sickness if the top people are not honest."*

Find opportunities to interact with local management, customers, and vendors

Some members found that rotating board meetings through multiple corporate locations, thereby giving the board the opportunity to meet with local management, customers, and vendors, was a good way both to reinforce the importance of company standards and test for tone at the top. One member reported, *"We do two- or three-day board meetings out in the field."* Another member's board meetings are also held at various company locations, making it possible for the member to interact regularly with the heads of business units: *"I try to maintain some type of relationship [with the business unit heads]. It is important that audit chairs don't become complacent."*

Codes of conduct

A code of conduct is a written, public statement of a company's ethical expectations and requirements. However, one member pointed out that it is one thing to create a code of conduct and another to ensure that the document is adhered to and recognized as the definitive articulation of company standards. The code of conduct needs to be reinforced in the minds of employees through constant reminders. *"Just distributing the code of conduct is virtually worthless. If you have an integrated program, it could mean something, though."*

A program designed to regularly articulate the company's expectations can reinforce the code of conduct. One member suggested that the code be placed in every coffee-break station, while another member, whose company distributes the code of conduct to employees annually, invites employees to respond to the code or to bring up any issues with it by including a personal e-mail address and telephone number in the cover letter. This serves as a visible signal, coming directly from the audit committee chair, that the board takes the code and its provisions seriously.

Red flags for audit committees

Internal audit, with help from external audit, is the functional area best positioned to watch for fraud. Although not specifically focused on fraud detection per se, internal audit can uncover certain patterns and actions that will then trigger a deeper look into potential fraudulent activities. Often, what internal audit finds is not outright fraud, but sloppy controls or procedures that provide the opportunity for fraud. As one member recounted, fraud can also be uncovered "accidentally" by a junior internal audit person who just happens to discover something slightly amiss. Nevertheless, the more diligence internal audit exhibits in examining a company's procedures and controls and the stronger the internal controls are, the better chance internal audit has to discover fraud.

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."* This member's summary judgment was that companies need a vigorous internal audit



function, but that audit committees must remain proactive and vigilant about fraud prevention measures, particularly where there is suspicion of pervasive firm-wide fraud.

Examples of red flags

Members gave examples of red flags that the audit committee should look for, such as how executive bonuses are triggered at year's end. Another warning sign is when a company or its officers consistently perform too closely to earnings guidance or too well in comparison with competitors. One member described a case in which the *"leading indicator [of fraud] was exceptional performance, relative to peers and competition."* Another member's audit committee decided to launch an investigation when *"the company met every metric the board set – every quarter. I knew something was wrong – nobody is that accurate."*

Members discussed whether independent metrics, such as analysts' or credit rating agencies' reports on the company, are made available to the audit committee. Another source of independent, comparative metrics that members mentioned are the software-based analytics developed for directors' and officers' (D&O) insurance risk.

The deployment of finance people may also raise red flags. One member offered some clear questions that audit committees should be asking: *"What does the finance organization look like? Do you have embedded finance people throughout the organization? What about the sales and marketing department? Who is looking at them?"* One way to ensure business units are operating aboveboard is to mandate that *"the CFO of every operating company have solid or dotted reporting line to the company CFO. They have to be able to report on [the CEO or head of the business unit]."*

Audit committees should also pay attention to how willingly the finance organization makes financial disclosures, how detailed those disclosures are, and what level of capitalization the company is undertaking. One member said, *"When a company is capitalizing everything in sight, there is usually smoke. That's what we look for – the smoke."* Another member, speaking from bitter experience, noted that if a CFO cannot provide a definite report on the company's cash position, the audit committee should consider that a red flag.

Whistleblower hotlines

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 (see Figure 2 overleaf). Whistleblower hotlines thus continue to serve as a primary source of information about fraudulent behavior.

Members suggested that companies hire an independent firm to screen and analyze calls rather than giving that task to the company's own legal department or internal audit. This removes any worries about the audit committee's receiving filtered information. One company had the results prepared and delivered to the audit committee in a quarterly statement: *"The audit committee gets a spreadsheet broken out by issue, level of issue, and location. This helps us track things. If there are a lot of e-mails from one location relative to others, we know to look more deeply into that location."*

Since audit committees are primarily concerned with financial impropriety, it is not surprising that most members reported that they were immediately alerted whenever a financial tip came through the hotline.



One member’s company even maintained separate hotlines: *“We have one hotline for just financial issues and another for everything else.”* Redundancy can also be built into the hotline process, with tips also coming to either the general counsel’s office, internal audit, or the compliance department.

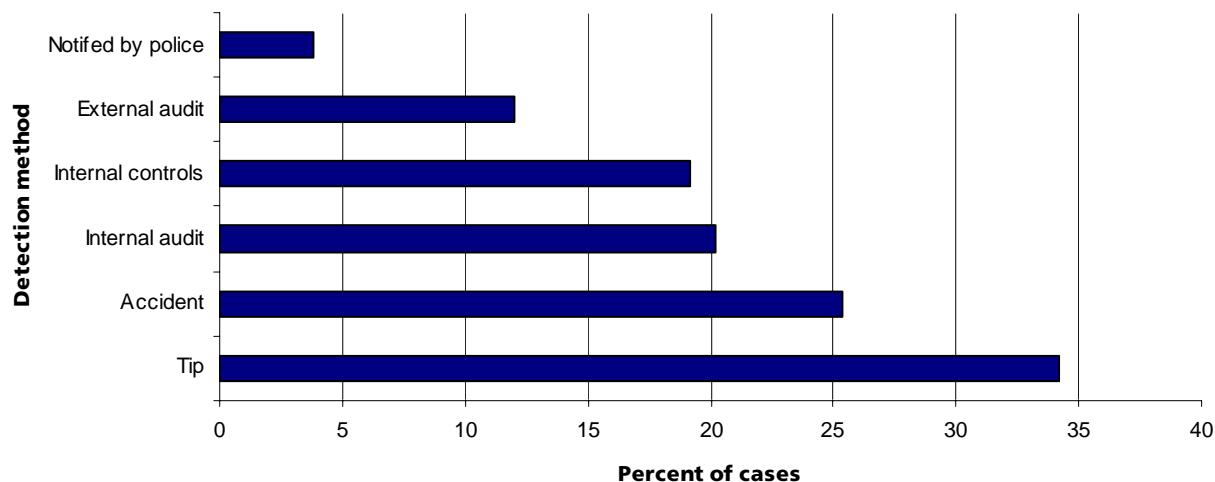


Figure 2. Initial detection of financial statement fraud. Source: Association of Certified Fraud Examiners, 2006 Report to the Nation on Occupational Fraud and Abuse, 28.

Investigating fraud and firing fraudsters

If material fraud is discovered, then it is incumbent upon the audit committee chair to, in the words of one member, *“kick into high gear.”* However, one member hastened to add that the audit committee should look at every fraud, regardless of size, because *“this goes to corporate culture.”*

Once an investigation is under way, retaining outside, independent counsel is paramount. One member strongly recommended having outside counsel already in place: *“As a board, we have a law firm that only does business with the board. Every board should have its own counsel.”* This will ensure that the outside counsel is already familiar with the organization, which will save critical time should the need for an active investigation arise.

Members were also concerned about the deployment of a full forensic audit as either an investigative or a preventative anti-fraud measure. They felt this should be an action of last resort, used only in the most extreme fraud cases because such audits *“tend to look at every transaction.”* One member said, *“The cost-benefit of a forensic audit is horrendous. If there is not pervasive fraud, there is no need for a forensic audit.”* Another member agreed: *“A forensic audit will make Section 404 [implementation] look cheap.”* However, members agreed that involving forensic auditors in the external audit team is an attractive option.

If fraud is discovered, members held the unanimous view that strong remedial action should be taken, even if the fraudsters are high-value employees or officers. *“When you catch fraudulent behavior, you need to send a message by firing [the perpetrators of the fraud]. Too often management will overlook high performers.”* Another member counseled going after fraudulent behavior regardless of the level or severity in order to



send a clear message to all employees: *“We really drill down on fraud – even immaterial fraud. We want to reinforce in our corporate culture that this [fraud] will not be tolerated on any level. If in every case people are summarily fired [and prosecuted], it reinforces the culture. There need to be repercussions.”*

Conclusion

Preventing and investigating fraud can be a thankless task for management, boards, and audit committees alike, requiring an almost Herculean effort combined with a healthy dose of luck. Clever fraudsters can always circumvent internal controls, and some level of fraud invariably exists in most organizations, but there are methods and tools audit committees can employ to help deter fraud. However, most members agreed that preventing fraud often seems easier after the fact. *“In hindsight, you pick up fraud easily,”* said one member. The challenge is for companies in general, and audit committees in particular, to identify potential frauds and their perpetrators without the benefit of 20/20 hindsight.

About this document

The Pacific Southwest Audit Committee Network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment. *VantagePoint* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public.

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

The views expressed in this document represent those of the Pacific Southwest Audit Committee Network. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.

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