



## Audit committee oversight of fraud and management malfeasance

The Northeast Audit Committee Network (NEACN) held its third meeting on September 28, 2010, in New York. Prior to the meeting, members discussed the key regulatory trends in tax with Debbie Nolan, a partner in Ernst & Young's Tax Controversy and Risk Management Practices group, and Mike Baldasaro, a partner in Ernst & Young's National Tax Practice.<sup>1</sup> During the main session, network members, who sit on the boards of more than 30 public companies between them, discussed the challenges of audit committee oversight of fraud and management malfeasance. This document summarizes the key points raised during the meeting and presents selected perspectives that members shared before and after the meeting.<sup>2</sup> For a full list of participants, please see Appendix 1, on page 9.

### Executive summary

In the past year, many factors have pushed fraud and management malfeasance to the forefront of audit committee discussion, including the economic recession, increased scrutiny by regulators, and recent, high-profile cases of management misjudgment. One member said, *"We've asked the question, if our CEO is found to be [in violation of our code of conduct], what do we do?"*

Members discussed four broad issues, which are summarized below and covered in more detail on the following pages:

- **Audit committees currently have a heightened sensitivity to fraud and malfeasance.** (Page 2)

Members said they monitor potential fraud and malfeasance more closely in times of economic stress, and the rash of recent public relations problems that have impacted US companies have reinforced the importance of appropriate senior management behavior. In addition, members closely monitor financial reporting fraud and industry-specific business risks and said that stepped-up corruption enforcement in the United States and abroad demands vigilant audit committee attention.

- **International corruption risk may influence corporate strategy.** (Page 3)

Given the increased risks brought on by enhanced Foreign Corrupt Practices Act (FCPA) enforcement, members said audit committees are monitoring their companies' international strategies more closely. To prevent and detect instances of corruption abroad, audit committees are looking more closely at their companies' specific business operations all over the world and are cultivating relationships with key international contacts to better understand local regulatory regimes and business practices. Some companies are recruiting board directors with specific experience in emerging markets.

<sup>1</sup> Northeast Audit Committee Network, *"Audit committee oversight of tax issues."* VantagePoint, October 21, 2010.

<sup>2</sup> 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. Quotes in italics are drawn directly from comments made by NEACN members during the meeting; unitalicized, unattributed quotes are drawn from pre-meeting discussions with members or from discussions with audit committee chairs in other audit committee networks.



- **Whistleblower programs are necessary but not sufficient in detecting fraud.** (Page 5)

The majority of tips provided on the whistleblower hotlines mandated by the Sarbanes-Oxley Act of 2002 are motivated by employment grievances. However, members said even seemingly insignificant complaints may reveal more serious ethical transgressions. Audit committees are also taking a number of proactive steps to prevent and detect fraud, including deploying internal audit to do spot-checks throughout the organization and soliciting the external auditor’s perspective.

- **The right tone at the top is critical in preventing fraud.** (Page 7)

Some members said the audit committee can help ensure the right tone at the top by enforcing a “zero-tolerance” policy with no materiality threshold, whereas others are more cautious about applying zero-tolerance. Members said the most effective way to uncover potential instances of fraud is to look for red flags in management’s behavior. This includes observing management’s body language during questioning and probing management’s interactions with the staff.

For examples of questions audit committee members and other board directors might ask about fraud risk oversight please see Appendix 2, on page 10.

### **Audit committees currently have a heightened sensitivity to fraud and malfeasance**

In describing its “fraud triangle,” the Association of Certified Fraud Examiners notes, “Three factors are generally accepted as being necessary for fraud to occur: pressure, opportunity, and the ability to rationalize illegal behavior. Unfortunately, the presence of each of these factors may rise in periods of economic hardship.”<sup>3</sup> Members said their companies and their audit committees are more sensitive to potential fraud and scrutinize fraud more intensely during economic downturns: *“Because we think [fraud] is more likely now, we are more vigilant.”*

In addition to the risks of international corruption, which are discussed in more detail below, members said they are most concerned about fraud and malfeasance allegations that involve senior management, financial reporting fraud, and industry-specific operating fraud.

- **Senior executive fraud and malfeasance.** Members said they are most concerned about the risks of fraud perpetrated by the company’s CEO, CFO, or other members of senior management. These transgressions could have a swift and devastating financial impact, as well as a damaging, long-term effect on the company’s reputation. Even if executives do not commit outright fraud, if they display unethical behavior or poor judgment, it can have a harmful impact on the company’s reputation and bog the company down in protracted investigations. One member said, *“[Senior executives] are so high profile, everyone is more mindful of fraud at that level.”*
- **Financial reporting fraud.** Members said extensive financial reporting fraud could bring down the company. However, the controls put in place by the Sarbanes-Oxley Act of 2002 made financial

<sup>3</sup> Association of Certified Fraud Examiners, *Occupational Fraud: A Study of the Impact of an Economic Recession* (Austin, TX: Association of Certified Fraud Examiners, 2009), 6.



reporting fraud much more difficult to perpetrate. One member said prior to the meeting, “The processes and procedures that [Sarbanes – Oxley] put in place have had a dramatic effect. We are ... confident that financial fraud [would be more difficult] here.”

- **Industry-specific operating fraud.** At some companies, the audit committee monitors types of fraud that may seem immaterial in isolation, but could have a significant impact on shareholder value. In the retail industry, for example, *“shrinkage is a big problem. It can rise to 5%–6% of sales. You’ve got to remain vigilant about that.”*

### International corruption risk may influence corporate strategy

Driven by a hefty amount of cash on their balance sheets and dim prospects for organic growth, companies are increasingly looking to grow by acquisition abroad.<sup>4</sup> Joseph Gallagher, the Asia Pacific head of mergers and acquisitions (M&A) at Credit Suisse, said, “Every major multinational you talk to, all they want to talk about is the BRICs [the nations of Brazil, Russia, India, and China] ... Post-crisis, developed market companies are really faced with the fact that growth is slowing at home.”<sup>5</sup> Indeed, M&A activity in emerging markets has accounted for about one-third of total M&A volume to date in 2010.<sup>6</sup> International expansion introduces increasing regulatory risks, and members said the risks of international fraud and corruption are so pervasive that they impact corporate strategy decisions.

### International fraud and corruption risks in strategy decisions

Global law enforcement authorities have increased their oversight of international corruption because of the “widely held belief that corruption is becoming more prevalent as a byproduct of the increasingly global economy.”<sup>7</sup> Authorities around the world are aggressively enforcing existing laws, such as the FCPA, and creating new laws, such as the UK Bribery Act, to crack down on corruption.<sup>8</sup>

As the global business environment becomes more interconnected and companies operate in more countries, their risk profiles become more complex. Members said they are concerned about the financial impact of regulatory action under the FCPA and the UK Bribery Act, the risks to their employees, and their own personal liability. Indeed, an Ernst & Young global fraud survey noted that “more than three-fourths of CFOs interviewed report that their boards are concerned about personal liability” resulting from fraud enforcement.<sup>9</sup> One member said, *“It’s more than just monetary. You and your people are at risk.”*

Several members said companies are thinking more carefully about how to build these international fraud and corruption risks into their strategic business decisions: *“If you want to do business in certain countries, you may have to structure your operation in a way you may not like; you may have to engage with a local partner; you may have to franchise certain operations.”*

<sup>4</sup> “[Cheap money, growth plans ignite M&A](#),” *NewsCenter*, October 4, 2010.

<sup>5</sup> [Ibid.](#)

<sup>6</sup> “[Global M&A volume crosses \\$2 trn landmark](#),” *Economic Times*, October 4, 2010.

<sup>7</sup> Joseph Rosenbloom, “[Here Come the Payoff Police](#),” *American Lawyer*, May 17, 2010.

<sup>8</sup> Joel M. Cohen and M. Jonathan Seibald, “[Six Ways a Board Member Can Manage FCPA Risk](#),” *Boardmember.com*, October 1, 2010.

<sup>9</sup> Ernst & Young, *Driving Ethical Growth – new markets, new challenges: 11th Global Fraud Survey* (Ernst & Young Global Limited, 2010), 2.



Members said the audit committee can play an important oversight role in these decisions: *“I think we’ve gotten a little too cavalier about saying, ‘Everyone else does business [in a specific country], so we should too ... The audit committee has an ethical responsibility to the company and its employees.’”*

Companies should consider the international fraud and corruption risks in the following business decisions, in particular:

- **New market entry.** Members said the audit committee should assess the new markets that the company is considering entering and ask probing questions of management about whether the company can be competitive in those environments using ethical business practices: *“It’s the role of the audit committee to ask, ‘Should we really be in that market?’”*
- **Mergers and acquisitions.** The Ernst & Young global fraud survey, which solicited views from over 1,400 CFOs and heads of internal audit, legal, and compliance, found that “more than half of respondents will be looking for opportunities for growth in the next 12 months, particularly in Latin America and the Far East, regions that are perceived to pose ethical challenges.”<sup>10</sup> However, about 40% of those respondents said they “rarely perform fraud or corruption due diligence, despite the inherent risk that could lead to enforcement action and potential successor liability.”<sup>11</sup> Most members reported that their companies are increasingly building this analysis into their due diligence: *“You have to do it now. The risks are just too big.”*
- **Business partnerships.** One member said, *“In FCPA enforcement, the government sees more value added through [investigating] suppliers and other agents.”* As a result, members said it is important to ensure that their business partners, including suppliers and distributors, are aware of the FCPA. Similarly, the UK Ministry of Justice, in issuing guidance to help boards prepare for the forthcoming implementation of the UK Bribery Act, has said, “Companies should also consider requiring that business partners participate in anti-corruption training or at least attest that they will comply with all relevant anti-corruption laws and regulations.”<sup>12</sup> Members described the difficulty of overseeing fraud at an international level, where local cultures have different laws and ways of doing business that may be at odds with US and other international laws: *“I don’t know how an employee working in Asia will understand [FCPA]. It definitely keeps you up at night.”*

Members said the best way to understand the regulatory and compliance risks of operating in these complex markets is to establish partnerships with people who have been operating there for several years. One member said, *“You have to get to know people who really understand the country and the way the governments in those countries operate. If you are doing business in China, what are the trends you should be watching out for?”*

---

<sup>10</sup> *Ibid.*

<sup>11</sup> *Ibid.*

<sup>12</sup> Joel M. Cohen and M. Jonathan Seibald, [“Six Ways a Board Member Can Manage FCPA Risk.”](#)



### Ways to prevent and detect international fraud

Members said they are seeking more detailed information about where their companies are doing business and are building better relationships in those countries, to better assess the risks of doing business overseas.

- **Mapping the company's international risk profile.** Some members described a practice in which the compliance team lays out a map of the world describing where the company does business and the extent of the company's operations (e.g., number of employees, relationships with agents) in these locations. The members said the map provides the data that the audit committee needs to help make informed decisions. One member said, *"The chief compliance officer came in with a map of all of the different countries where we do business, and how we do business there: Do we sell direct? Do we use local agents? Then we asked internal and external audit and the GC [general counsel], 'Do you go there?'"*
- **Recruiting board members with international experience.** Some members advocated recruiting board members with international and country-specific experience and expertise, to help the board and management team identify and assess risks that may not be obvious to people without experience operating in those parts of the world. As one member said, *"If you've operated in the emerging markets, you've seen it all."* These board members may also have important relationships that the company can leverage when it enters the market: they may be able to introduce the company's executives to the right business partners. One member said, *"We've got a board member that lives in [a country where we do business]. He's been hugely valuable. He knows the ins and outs of the way business works there."*

### Whistleblower programs are necessary but not sufficient in detecting fraud

A provision of the Sarbanes-Oxley legislation requires companies to establish and maintain a whistleblower hotline for the reporting of fraud. One member said, *"The most powerful thing [related to fraud] from Sarbanes-Oxley was the empowerment of whistleblowers."* Some members get a high-level summary of the hotline tips from the GC, while others *"see the raw data that goes simultaneously to internal audit and the GC. If you scan everything, you can see the trends."*

Members said that employees and vendors use the whistleblower mechanism for a variety of reasons, but the primary motivation of most whistleblowers is not ethical, but HR related. One member said, *"It's usually just a guy who is unhappy with his job."* However, another member noted, *"Just because whistleblowers may be acting out of anger doesn't mean they are wrong."* Indeed, most members said whistleblower tips are their main method of detecting fraud.

### Whistleblowing and the financial reform bill

The financial reform bill passed by Congress on July 15, 2010, establishes a new program to encourage whistleblowing relating to all manner of securities law violations, including violations of the FCPA. The law states "that where a whistleblower provides 'original information' that leads to a successful SEC enforcement



action in which the government collects monetary sanctions exceeding \$1 million, the SEC will award the whistleblower between 10% and 30% of the total sum collected.”<sup>13</sup>

Members said they are concerned that this provision could prompt employees to notify the government, instead of the company, of potential wrongdoing, and could encourage false claims. Some companies have already created their own incentives for whistleblowers to encourage reporting to the company. According to the *Wall Street Journal*, “RAE Systems Inc., a company specializing in gas detection devices, disclosed ... that it planned to pay \$135,000 in bonuses to ‘certain finance personnel’ and \$55,000 to the company’s chief financial officer, Randall Gausman, in connection with their work on an FCPA matter.”<sup>14</sup>

### Proactive tactics to deter fraud

Members said that a company can not depend on a whistleblower hotline alone to prevent and detect fraud. While there is “*no one-size-fits-all approach to detecting fraud*,” members described other useful methods:

- **Deploy internal audit to do spot-checks throughout the company.** Prior to the meeting, several members described internal audit as being on the front lines in the battle against fraud at their companies. Members said the internal auditors “*have relationships all over the company*” and are well positioned to detect instances of fraud by “*talking to the underlings*.” Some members said sending internal audit to do spot-checks at unsuspecting places throughout the company can have a good signaling effect: “*We send internal audit off the beaten path. They think, ‘Nobody goes there, so if the audit committee does, that’s a sign they take it seriously.*”
- **Solicit the external auditor’s opinion.** Members noted that the annual financial statement audit is not designed to uncover fraud. As the Center for Audit Quality observes, “because auditors do not examine every transaction and event, there is no guarantee that all material misstatements, whether caused by error or fraud, will be detected.”<sup>15</sup> However, members said the external auditors get a much more detailed view of the company’s operations than the audit committee, and they interact with more people on a day-to-day basis. In addition, the external auditors can provide a useful perspective on the financial statements: “*I am going to ask the auditors, ‘Do you see anything in the financials that might suggest something strange is going on?’*”
- **Conduct targeted reviews of financial reports.** Some members said they review the travel and expense (T&E) reports of the CEO and other senior executives. While these reviews may not turn up fraud, they may uncover other infractions that may be symptomatic of unethical behavior at the top of the organization. One member said, “*It doesn’t have to show fraud. The T&E reports may be sloppy ... At one company, we ordered a close review of the T&E reports and found [potential] disasters.*”

One member also suggested examining business practices in different departments at the company to look for “*sloppy accounting*” or other poor business practices that may be symptomatic of larger problems: “*There was a department in [one country] that hadn’t filed tax returns for three years. When we found*

<sup>13</sup> Sarah Cox and David Esseks, “[New SEC Whistleblower Program to Alter FCPA Enforcement Landscape](#),” July 20, 2010.

<sup>14</sup> Joe Palazzolo, “[A Novel Idea: Bonuses for Building FCPA Compliance](#),” *Wall Street Journal*, September 22, 2010.

<sup>15</sup> Sarah Johnson, “[What Is the Auditor’s Role in Finding Fraud?](#)” *CFO*, April 13, 2010.



*that out, we figured there must be something else going on there. Sure enough, we uncovered a whole host of problems when we looked a little deeper.”*

Prior to the meeting, one member endorsed using analytical tools to mine the general ledger to look for unusual patterns or unorthodox accounting entries: “One red flag that the audit committee would never catch is what we call ‘on-top’ journal entries. By the sheer process of recording journal entries, oftentimes they suggest that someone or some unit didn’t like the way the numbers came out. Forensic accountants can go in and investigate this, and there are software programs to flag things like late journal entries.”

### The right tone at the top is critical in preventing fraud

Members said the board and the audit committee must communicate and enforce the code of conduct throughout the organization. Some members advocated a “zero-tolerance” approach to fraud and endorsed “public hangings” to reinforce the message throughout the organization. Members said this starts with firing senior executives who display ethical lapses, no matter the materiality: “How do you enforce your policies throughout the organization if you can’t enforce them at the top?” However, prior to the meeting, one member said boards should think carefully before deploying a zero-tolerance policy: “It depends on how well your facts are put together. There are the steps they can take to countersue you, an action that you can reasonably expect if you fire them.”

Some members advocated reinforcing ethical behavior by linking performance rewards to internal audit’s ethics report. One member’s audit committee brings business unit leaders who have received a poor internal audit report before the audit committee and discusses how those employees will change their behavior going forward. One member said, “If you don’t meet certain [ethical] conditions, you are not eligible for [a performance bonus].”

Members said the best way to ensure that management is setting the right tone at the top is to look for red flags that may signal that the staff does not feel comfortable speaking up to the CEO, CFO, or other members of senior management. One member said, “You have to understand what creates the culture that drives [unethical] behavior.” Members identified several ways to uncover these red flags:

- **Observe management body language.** Members said that they closely observe the body language of senior executives during presentations to the audit committee or the full board: “Where you ask a question and you see the eyes flash between the CEO and CFO, or if there’s an uncomfortable pause, that may give you cause for concern.”
- **Observe the senior executive’s interaction with his or her staff.** “If you have a meeting and everyone waits for the most senior person to speak, that may not be a sign of fraud, but [it] raises the question that if there were fraud, would these people speak up?”
- **Look for changes in behavior.** Members said that audit committee members who have worked with executives for several years may notice changes in those executives’ behavior: “There is a snapshot in



*time versus the longitudinal experience. If someone is acting different [from the] way that you are used to, you may want to probe a bit more.”*

- **Meet with the finance staff below the CFO.** *“There’s an annual dinner of [the finance staff] at my company. The board goes and sits socially with them. You’d be surprised at the stuff they tell you, and you also let them know they can trust you.”* Some members advocated devoting a day around the board meeting to *“management by walkabout.”* One member said, *“We added an extra day to our [audit committee] meeting to see the team beneath the team.”*

## Conclusion

Audit committees are rightly concerned by the risks posed by fraud and management malfeasance, given the increased enforcement activities of regulators and several recent, high-profile corporate scandals. Some international fraud and corruption risks are so acute that they may influence strategic decisions. Members rely on whistleblower hotlines to detect the most important types of fraud, including financial reporting manipulation and top management malfeasance.

To proactively deter fraud at their companies, members said audit committees should ensure positive tone at the top by closely observing senior management behavior and enforcing a zero-tolerance policy. In addition, members said that new technologies, such as software programs that mine financial statements to detect possible instances of fraud, represent innovative ways to combat fraud. Ultimately, however, members said a strong ethical culture is the most powerful deterrent to fraud and management malfeasance, and as one member said, this culture requires complete buy-in from the board, management, and the auditors: *“The best line of defense is having a great culture: a great management team, a great board, and great auditors.”*

## About this document

The Northeast Audit Committee Network is a group of audit committee chairs drawn from leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. 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 new audit committee 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 *VantagePoint* 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 Northeast 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 advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the US member firm of Ernst & Young LLP.*

*This material is copyright Ernst & Young and prepared by Tapestry Networks. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends.*



## **Appendix 1: Meeting participants**

The members of the network present at the meeting were:

- Gail Deegan, Audit Committee Chair, EMC
- Nick DiPaolo, Audit Committee Chair, Foot Locker
- Dave Flaschen, Audit Committee Chair, Paychex
- Michael Hines, Audit Committee Chair, TJX Companies
- Dr. William Joyce, Audit Committee Chair, CVS
- Nancy Leaming, Audit Committee Chair, Biogen Idec and Hologic
- Doug Maine, Audit Committee Chair, Rockwood Holdings and ATK
- Brian McAuley, Audit Committee Chair, United Rentals
- Ken Reiss, Audit Committee Chair, Harman International
- George Zoffinger, Audit Committee Chair, Virgin Media

Ernst & Young participants in the meeting included:

- Linda Lam, Northeast Sub-Area Assurance Managing Partner
- Mark Manoff, Vice Chairman and Northeast Managing Partner



## **Appendix 2: Questions for audit committee members**

- ?** What types of fraud are of greatest concern to the board and the audit committee? What other malfeasance should the board concern itself with?
- ?** How has the economic crisis affected your perception of fraud risk at your companies?
- ?** What role should internal and external audit play in fraud prevention, detection, and investigation?
- ?** How does the audit committee evaluate tone at the top and whether it resonates across the workforce? How does the audit committee contribute favorably to tone at the top?
- ?** Given the benefits and drawbacks of a zero-tolerance policy, how does the audit committee enforce tone at the top?
- ?** What specific tools can the board and the audit committee use to help oversee the risks of fraud and corporate corruption (e.g., whistleblower hotlines, code of conduct)? What structures (e.g., quarterly reviews) are necessary to facilitate effective oversight of fraud and corruption risk?
- ?** What steps has your company been taking to address the fraud risks associated with foreign operations? How well does the board understand its legal obligations under the FCPA?
- ?** How is the introduction of new technologies creating more fraud risks? How is the audit committee using new technology to detect and prevent fraud?