

## Preventing, detecting and investigating fraud / Insuring against risk

### Synopsis

**Fraud.** Audit committees can play an important role in reinforcing management efforts to minimise fraud by supporting a robust control system and a healthy, ethical tone at the top of the organisation. Despite the existence of an expectation gap between the views of the investing public and the actual role of the external auditor in fraud detection, audit committee chairs only expect the auditor to provide “reasonable assurance” about financial statements and to share the firm’s view of fraud risks in the company.

**Insuring against risk.** Audit committees do not spend sufficient time to understand the company’s insurance policies and processes, given the substantial risks and costs involved. An emerging best practice is for the audit committee to receive an annual presentation from the company’s risk insurance manager. Audit committees also want advice on insurance risk from their external auditor.

### Introduction

The European Audit Committee Leadership Network held its fifth meeting in Brussels on 17 February 2006. The members of the network participating in the meeting, or contributing through individual discussions beforehand, sit on the boards of about 50 large, mid and small cap public companies. For further information about the network, see “About this document” on page 11.

Members attending the meeting included:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Dr DeAnne Julius, Audit Committee Chair, Roche Holdings
- Mr Tom McGrath, Global Managing Partner, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young
- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi Universal
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Mr Gerhard Schulmeyer, Audit Committee Chair, Zurich Financial Services

Members who participated in individual discussions before the meeting were:

- Sir Anthony Greener, Audit Committee Chair, BT
- Mr Jan Hommen, Audit Committee Chair, Royal Ahold
- Sir Ian Prosser, Audit Committee Chair, BP
- Dr Ronaldo Schmitz, Audit Committee Chair, GlaxoSmithKline
- Lord Sharman of Redlynch, Audit Committee Chair, ABN-AMRO

*ViewPoints* 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 before and during meetings are not attributed to individuals or corporations. Comments described as being provided before the meeting were drawn from discussions with all those listed above.

## Executive summary

### Preventing, detecting and investigating fraud

Financial scandals in Europe and the US produced new legislation, regulation and voluntary governance codes. A strong tone at the top, combined with rigorous internal controls, is seen as the key defence against fraud, particularly when combined with the vigilance of management, the audit committee, internal audit and the external auditor.

- **An ethical culture supported by the board can deter fraud** *(Page 4)*

In addition to strong controls, members unanimously support the development of a strong organisational culture and ‘tone at the top’, upheld in varying degrees by codes of conduct or ethics; and whistleblower processes. However, codes of conduct need to be refreshed and re-launched periodically. Most importantly, senior leadership must be seen “living” the behaviours in the codes to embed them effectively in the company. *Oversight of the code of conduct, see page 4.*

- **The audit committee should focus on financial statement fraud** *(Page 5)*

In determining where to focus attention in support of management’s efforts to minimise fraud, members say the audit committee should focus on financial statement fraud. Audit committees should spend more time questioning management’s assumptions and judgements about numbers. The audit and remuneration committees can communicate more regularly to understand how bonus-related performance metrics might have unintended consequences in driving management behaviour. *Approaches audit committees can take to support tone at the top, see page 5.*

- **Detection occurs mainly through tip-offs but not necessarily through official whistleblower hotlines** *(Page 6)*

Employees and outside parties have various means by which to relay suspicions of fraud and unethical conduct. Members were disappointed that even where whistleblower processes are in place, take-up has been very low. It is clear that whistleblowing is not universally accepted in Europe, in part for cultural reasons.

- **Different expectations of internal and external audit in detecting fraud** *(Page 7)*

Some members are concerned about the ability of their internal audit function to detect fraud. As internal audit is a relatively new function in many European companies, the audit committee’s guidance is useful to set its agenda to probe for fraud. The external auditor is not expected by most members to do more than provide reasonable assurance about financial statements, although auditors should provide helpful indicators on fraud, based on their breadth of experience. For example, they should help identify when an organisation’s culture is shifting in the wrong direction; discuss the firm’s detailed financial risk analysis; and meet informally with the audit chair to discuss fraud risks, among other topics. *What audit chairs want from external auditors, see page 8.*

- **There is no clear audit committee role in investigating fraud** *(Page 8)*

Some audit committees function strictly in an advisory role to the full board in investigating fraud. Others have a hands-on role in directing investigations. The decision to bring in outside legal counsel, forensic accountants, or the external auditor specifically to investigate fraud may be triggered at management’s suggestion, or the board’s, or on the advice of the external auditor.

## Executive summary continued

### Insuring against risk

The Sarbanes–Oxley Act in the US and the 8<sup>th</sup> Directive in the EU have put pressure on senior management and audit committees alike to identify and manage risk effectively. This may include the role of insurance in transferring risk to a third party.

- **Audit committees should understand the company’s insurance policies and processes**

*(Page 10)*

The company’s insurance coverage concerns the optimal use of capital and the protection of shareholder assets. Yet boards and audit committees spend little (if any) time discussing insurance. Limited time and expertise compel audit chairs to rely primarily on management briefings. However, an emerging best practice is for the audit committee to receive an annual presentation from the company’s risk insurance manager. Examples of questions the audit committee may want to ask the insurance manager can be found on page 10.

- **Audit committees want advice on insurance risk from the external auditor** *(Page 10)*

Members said the external auditor could help them understand the intricacies concerning captive insurance companies or the impact of complex insurance products on the financial statements.

### Preventing, detecting and investigating fraud

The 8<sup>th</sup> 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”<sup>1</sup>. In the US, the Sarbanes–Oxley Act and the various national governance codes and laws across Europe assign varying levels of responsibility to boards or audit committees for overseeing whistleblowing processes, ‘tone at the top’, formal codes of conduct or ethics programmes.

When fraud occurs, companies may suffer tangible financial loss as well as indirect loss such as diminished employee morale, corporate reputation, and stock price. In 1996 the Association of Certified Fraud Examiners (ACFE) which has chapters in 22 countries, began to survey its members in the US and to issue an annual report of its findings. It defines three types of fraud:<sup>2</sup> (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.

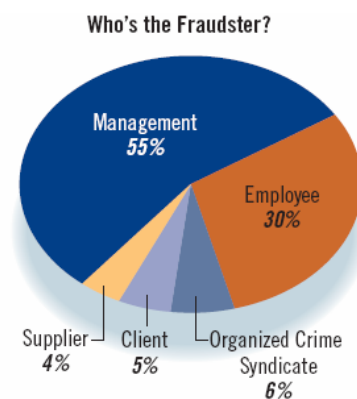
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<sup>1</sup> 8<sup>th</sup> Company Law Directive on statutory audit – Vote in EP Plenary, 28 September, 2005.  
[http://europa.eu.int/comm/internal\\_market/auditing/docs/statutory\\_audit\\_info\\_note\\_en.pdf](http://europa.eu.int/comm/internal_market/auditing/docs/statutory_audit_info_note_en.pdf)

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

The network's discussion covered all types of fraud since, as one member said: *"All of these can have [an impact on the] financial accounts"*. In particular, members focused on the audit committee's role in challenging management's judgements in areas such as revenue recognition and reserves.

Various studies<sup>3,4</sup> present a wide spectrum of estimated fraud loss costs, but all reveal that the majority of fraud is committed by management. However, management, the board and the audit committee can help minimise the opportunity for fraud and aid in its detection if it should occur.



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

### **An ethical culture supported by the board can deter fraud**

EACLN members agree that though completely eliminating fraud is impossible, it is critical to minimise the opportunities for it to take place. In addition to strong controls, they unanimously support the development of a strong organisational culture and 'tone at the top', upheld in varying degrees by codes of conduct or ethics; and whistleblower processes.

#### **Oversight of the code of conduct**

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 re-launched 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 of what you value"*.

The audit committee tends to focus on financial statements and accounting principles but members believe that behaviour is *"as important as economics and numbers"*. *The audit committee looks at the*

<sup>3</sup> Mike K. Savage: "Fiercely Fighting Fraud", *Chief Legal Executive*, Spring 2003, page 57.

<sup>4</sup> Committee of Sponsoring Organizations of the Treadway Commission: *Fraudulent Financial Reporting: 1987-1997. An Analysis of U.S. Public Companies*, 1999, [http://www.coso.org/publications/FFR\\_1987\\_1997.PDF](http://www.coso.org/publications/FFR_1987_1997.PDF).

*numbers but they are produced by human beings*". Culture is not easily established by top management in large organisations, a member noted, although it can quickly be destroyed. *"The board should make sure there is the right tone at the top: the code of conduct document should be the tool to install in the organisation the behaviour you expect."*

In all companies, violations will occur. What course of action management takes, and how visibly, influences behaviour. One member said: *"When reputation is all we have, we need to have 'public hangings' for violators"*. In one company a high profile firing led to a whistleblower coming forward, saying: *"If you're willing to fire [the executive], I felt confident you'd take action if I came forward"*.

### Approaches audit committees can take to support tone at the top

- **Use employee survey instruments** as a gauge of corporate culture. *"Attitude surveys that show tremendous inconsistencies between departments are a signal [of potential problems]."*
- **Provide support to the internal audit function** which 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."*
- **Use 'skip-level' discussions to have greater contact within the company.** *"Do you totally rely on reporting, or look people in the eye? If you get sucked in too high, you risk liability exposure; but the more you stay away, you get questioned, 'Did you go deep enough?' It's tough".* However, not all audit committee chairs find this acceptable. *"Management gets touchy if the audit committee wants to go into operations,"* a member cautioned.
- **Talk to the remuneration committee.** One audit chair meets annually with the head of the remuneration committee and members acknowledge that cross-committee meetings or memberships are desirable. *"We must explain to shareholders that how we incentivise management to create value affects their behaviour."*

### The audit committee should focus on financial statement fraud

Both the 8<sup>th</sup> Directive and Sarbanes–Oxley focus on the audit committee's oversight of internal controls as one of the primary mechanisms for detecting or preventing fraud in the financial reporting process. While audit committee chairs of European SEC registrants believe that corporations have already invested more than enough time and resources in what they believe is an anti-fraud programme; fraud professionals state that the vast majority of internal controls are designed to detect errors, not fraud (particularly when that fraud is perpetrated by management override of internal controls).<sup>5</sup>

Members said the audit committee and board are most concerned with fraud that occurs within management. One member explained: *"Big chunks of fraud come from management, not Joe Blow in Turkey. We defocus by looking at the smaller issues"*. Some members said that *"asset misappropriation is [for] internal audit [to handle]"* though eventually it comes to the audit committee, as do allegations of corruption.

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<sup>5</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), page 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)

The range of oversight provided by audit committees varies across country and industry:

- **No oversight role on fraud.** In one non-SEC registered company: *“it is management’s role to create and assess the culture, there is no whistleblower provision or requirement in the corporate governance code, and the audit committee has no role in fraud”*.
- **Major oversight role on fraud.** In one regulated industry, where an *“indictment can put you out of business”*, one audit committee requires sub-committees to report back on variances and drive deep down into fraud issues.

Shareholders tend to believe that every bad decision is a potential fraud, one member noted. *“It’s not ‘manipulation’ if management have all the information, but some things are very judgemental – such as reserves or impairment”*. The audit committee’s responsibility is to help distinguish between management error and intentional fraud. *“The audit committee must be vigilant regarding best judgements and help the board. Investors rely on our doing that... Audit committees don’t spend enough time looking at or challenging the judgements”*, such as the value of an asset or impairment, a member asserted.

How things are done in a company may be influenced by national, industry and company practices, but *“‘industry practice’ is where the danger lies”*, a member said. *“It’s not [that] people [are] trying to do illegal things: they’re doing ‘industry practice’ which [may be] good until someone sues. Consequently, it is important to question industry practices. Better yet, be sure you get cross-industry exposure to best practices for comparison”*.

## **Detection occurs mainly through tip-offs but not necessarily through whistleblower hotlines**

Whereas management override of internal controls is the primary instrument of internally-driven fraud, effective whistleblowing programmes<sup>6</sup> are widely viewed as the most effective method of deterrence and detection. The ACFE finds that tip-offs surface fraud more frequently than do internal audit, external audit or internal controls.

For European foreign private issuers and SEC registrants, Sarbanes-Oxley and the New York Stock Exchange listing requirements state that audit committees should oversee “whistleblower” processes and procedures that allow employees to raise allegations of fraud, questionable accounting or auditing matters, or ethical violations, in safety and anonymity.<sup>7</sup> The 8<sup>th</sup> Directive does not explicitly cover whistleblowing, but many audit committees, for example in the UK, The Netherlands and Sweden, nonetheless assume the responsibility. In some countries hotlines are only just beginning to be put in place, as in France.

As whistleblower hotlines are a relatively new phenomenon, members are trying to gauge their effectiveness. One member was concerned that in a handful of fraud cases in one company, *“none were discovered through the whistleblower line”*. Members described two main reasons for this situation:

- **Cultural resistance to “informing”** anonymously may influence whistleblowing effectiveness, as one member noted before the meeting: *“In some countries, even if you set up the [whistleblower hotline], no one calls”*. One Swiss company audit chair commented: *“[The]*

<sup>6</sup> The audit committee’s role in preventing fraud, E&Y *BoardMatters Quarterly*, European Edition, September 2005, page 2.

<sup>7</sup> New York Stock Exchange: *Final NYSE Corporate Governance Rules*, page 10, approved by the SEC on 4 November, 2003. Available for review at <http://www.ecgi.org/codes/documents/finalcorpgovrules.pdf>

*culture does not tolerate whistleblowers, despite [legal] protection*". Members also noted similar issues in Eastern Europe.

- **Poor internal promotion.** *"You don't get [whistleblower calls] because of low awareness".* One member suggested: *"Open it up so it's not just something you call with concrete proof of fraud but with any ethical concerns".*

## Different expectations of internal and external audit in detecting fraud

Both the external auditor and internal audit function can help detect fraud, members said. An important underlying foundation is for the audit committee to establish confident, direct and transparent relationships with each group.

### Internal audit

Globally, fraud is detected by internal audit in 26% of cases.<sup>8</sup> One member said: *"Internal audit has a much better chance to uncover fraud through friends in the system"*. However, some members said that internal audit was not meeting their expectations. *"We're not getting much value on fraud issues from internal audit. They did not discover any of the frauds in the company"*, although they do investigate them. Another member found that *"the reports that internal audit gives management are bland. We'd like to get more helpful reports from them"*.

One step audit committees can take is raising the quality of internal audit to the right level, so that it is not a 'graveyard' but a career-enhancing position.<sup>9</sup> In addition, since internal audit is a relatively new function in many European companies, a member said the audit committee, through its approval of the internal audit plan, can highlight areas and issues it wishes internal audit to focus on.

Another member's 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"*.

### External auditor

The general impression among the investing public is that an independent audit is designed to detect corporate fraud. 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.

The difference between the public's expectation and the auditor's professional responsibilities is often referred to as the 'expectation gap'. This gap is currently under review by the US regulator, the Public Company Accounting Oversight Board (PCAOB), which is contemplating the need for a new auditing standard related to fraud.

One proposal to close the expectation gap is to have a forensic accountant on every audit team. Fraud professionals believe there is a role for fraud experts in helping audit teams determine whether there is a high risk of fraud and to advise those teams on the high risk areas. A forensic fraud expert, interviewed

<sup>8</sup> PricewaterhouseCoopers and Martin-LutherUniversity, Germany, *Global economic crime survey 2005*, page 18.

<sup>9</sup> *"The future of internal audit in Europe/Tax governance"*, European Audit Committee Leadership Network, 31 October 2005, page 5. Available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_EuroACLN\\_Oct05\\_View5.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Oct05_View5.pdf)

before the meeting, said: “Many auditors have a forensic mindset, but they’re looking for confirmation that nothing is wrong. [Forensic accountants] look for proof that [bad] things are happening”.

Firms are also focused on improving the training of existing account teams to raise awareness of fraud risk and on adding new forensic investigative practices to the audit process which may include psychological and behavioural skills.<sup>10</sup> Last year, The Netherlands became the first country to require fraud detection training for all auditors.

Beyond an expectation that the external auditor will notify them immediately if fraud is discovered or suspected, members are cautious about the auditor’s role. One member said: *“It would be too costly, and the external auditor would be at a significant disadvantage to uncover every fraud”*. Another member said it is *“preferable to have a close relationship between the audit committee and external auditor so the auditor will raise these matters; not protocols that create a bureaucratic requirement”*.

#### What audit chairs want from their external auditors on fraud

- **Auditors should provide helpful indicators on fraud.** Many members expect the auditor, based on breadth of knowledge and experience, to offer industry- and geography-specific indicators of fraud risk.
- **Help identify when an organisation’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.** Members are aware that audit firms conduct a detailed financial risk analysis of their company. They would like the audit firm’s view of the company’s financial risk considerations to be shared with the audit committee.
- **Meet informally with the audit chair.** One member has lunch with the external auditor, four times a year, to establish a relationship and have conversations on any sensitive topics. They reach agreement of how, together, to bring these issues to the board.

Members are aware that detecting fraud is very complicated. One member quipped that perhaps the best way to uncover it may still be the old-fashioned way: *“make the guy in charge take a holiday!”*.

#### There is no clear audit committee role in investigating fraud

If fraud is discovered, or there is reason to believe that fraud has occurred, who is charged with investigating it? Common answers from members included internal audit, external audit and independent forensic investigators, with the audit committee in some cases overseeing the investigation. In the interests of maintaining shareholder value, a member stressed: *“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’”*.

Some audit committees in Europe function strictly in an advisory role to the larger board and have no direct role in investigating fraud. In Sweden for instance, *“management doesn’t like the board taking over responsibility for management. If fraud or judgement enters in, the audit committee gets involved,*

<sup>10</sup> Audit Committee Leadership Network, “Preventing, detecting, investigating fraud,” *ViewPoints*, March 24, 2005, page 5. [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_ACLN\\_Mar05\\_View8.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_ACLN_Mar05_View8.pdf)

*but it's a matter of degree*". In other countries, the audit committees can have a hands-on involvement in hearing reports of investigations; or in directing investigations.

For smaller frauds, companies often handle investigation themselves, using internal audit. The trigger for when to involve external parties may be if the fraud is pervasive or has been perpetrated at a high level. In cases such as these, the board reaches out to the auditor, a law firm or forensic auditor.

The legal environment may also dictate how an investigation unfolds. In Sweden, *"the public prosecutor and police get involved if someone is accused."* In France, the statutory auditor must notify the local magistrate once they have ascertained that fraud may exist. Many countries also offer an employee protection and certain rights. In The Netherlands, for example, the right of response governs a forensic auditor's investigation.

In some US organisations, the investigation process may be pre-established, with clear roles and responsibilities enabling prompt and appropriate action.<sup>11</sup> European audit chairs expect that their companies will rely on an existing crisis communication plan and do not see a need for a fraud response plan. However, one member recognised: *"We're empiric: it may have to happen before we get smart"*.

## Insuring against risk

Both Sarbanes-Oxley and the 8<sup>th</sup> Directive have put pressure on senior management and audit committees alike to identify and manage risk effectively. The in-depth discussion on insuring against risk built on the network members' previous look at risk management in June 2005. *ViewPoints* reported after that meeting: "Risk management in Europe is still evolving. In some countries and companies, risk management is little more than a perfunctory board discussion of insurance and exposures. In other companies, risk management has become a complex internal function of the company with its own staff, resources and processes".<sup>12</sup>

Companies have four basic approaches available to manage a particular risk once it has been identified. These approaches can be used separately or in combination. The four approaches are:

- Avoidance of the risk
- Transference of the risk to a third party, typically through an insurance contract
- Assumption of the risk by the company, including self-insurance, or the formation of an insurance subsidiary, commonly called a "captive insurer"
- Mitigation of the impact of the risk

However risk is managed, there is growing concern that companies are not as proactive as they might be, especially since insurance premiums may be the largest portion of a company's "total cost of risk".<sup>13</sup> Companies may be spending too much on insurance premiums, when it would make more sense to self-insure or set up a captive insurance company. One insurance expert interviewed before the meeting said: "Companies often have programmes in place for several years and don't change them

<sup>11</sup> "Preventing, detecting, investigating fraud: the audit committee's role", Southeast Audit Committee Leadership Network, February 22, 2006, page 9. Available at: [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_SE\\_ACN\\_Feb06.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_SE_ACN_Feb06.pdf)

<sup>12</sup> For a refresher on the discussion see European ACLN, "Converging roles and diverging practices", *ViewPoints* 3, 15 July 2005, available at [http://www.tapestrynetworks.com/documents/Tapestry\\_EY\\_EuroACLN\\_Jul05\\_View3.pdf](http://www.tapestrynetworks.com/documents/Tapestry_EY_EuroACLN_Jul05_View3.pdf)

<sup>13</sup> Marsh: "An executive's guide to risk management and total cost of risk", *Risk Alert*, Vol. III, Issue 4, October 2004.

much, yet the company's risk landscape may have changed through diversification into new markets, M&A, or growth that provides an opportunity for more self-insurance (retaining risk)".

## **Audit committees should understand the company's insurance policies and processes**

The interest of the board and/or the audit committee in the company's insurance coverage concerns the optimal use of capital and the protection of shareholder assets. Yet insurance experts and most network members report that boards and audit committees spend very little (if any) time discussing insurance, appearing to focus only on D&O insurance. Most members are unapologetic, concerned that insurance is a subject beyond their expertise and that taking it on could increase their liability. *"We need to understand the aggregate risk picture and management's appetite for risk. Otherwise, putting the insurance question in front of a board, they have only upside by saying 'Insure!'"*

Other members expressed a range of views on a possible role for the audit committee:

- **Ensure that management is dealing with insurance issues.** A member interviewed before the meeting said: *"The audit committee has to be involved to satisfy itself that the keys risks have been identified and procedures are in place to manage those risks – insurance is part of that. However, insurance is a management issue. The audit committee should ensure there is a process in place for a review of insurance"*.
- **Discuss an annual report from the insurance manager.** Another member said: *"This is a very valuable discussion as there is a lot of expertise in the audit committee and we can pick their brains on this"*. The audit committee then reports to the board.

### **Examples of questions the audit committee may want to ask the insurance manager**

- What insurance coverage and products does the company have?
- How much is the company paying? How does this compare with other companies in the same sector (based on revenue or industry SIC code)?
- What are the balance sheet implications of the decision on whether to insure or self-insure?
- What processes and controls are in place to monitor risks in the insurance area?
- What is the procurement process for insurance coverage and how often is it reviewed? How are insurance vendors managed and paid (fees and/or commissions)?
- What is management's assessment of the quality of insurance carriers and vendors and the concentration of insurance coverage with those carriers?

## **Audit committees want advice on insurance risk from the external auditor**

Members strongly recommended that the audit committee request management *"to lay out the 'why and what' of their insurance plans, and to have the external auditor opine on it"*. Most members look to the external auditor to educate the audit committee on insurance's impact on the financial statements. One member's audit committee requested a briefing from the auditor on a recommendation by management to self-insure through a captive. *"We asked ourselves, are we comfortable with management's decision not to insure?"*. The operations of a captive insurer, and its balance sheet impact, concerned members: *"What are the tax motivations? Is the entity properly staffed and run?"*

Another factor pushing insurance coverage higher up the agenda is the controversy over finite insurance products, following the recent probe of AIG and other insurance companies by the SEC and New York's Attorney General Eliot Spitzer, together with an SEC investigation into a mobile phone distributor, Brightpoint.<sup>14</sup> As the SEC's deputy chief accountant has said: "Finite insurance is not solely an insurance company issue. ...A number of companies have this issue".<sup>15</sup>

While finite insurance policies are legal, they are beginning to fail the "sniff test" that most audit committee chairs would apply to them. Regulators and rating agencies across Europe, including the UK's Financial Services Authority (FSA) and the German Financial Supervisory Authority (BaFin) are starting to ask questions about what accounting principles should apply and how such policies should be disclosed. For complex financial instruments such as finite insurance products, members said, "*Get the protocol from your external auditor*".

## Conclusion

The audit committee, already charged with important responsibilities, finds itself again a significant voice and player in matters of preventing fraud through its leadership in supporting tone at the top in addition to overseeing strong financial controls. In better understanding the complexities of the company's insurance policies and procedures, the audit committee with the external auditor's assistance, may have greater comfort that this significant aspect of risk management is well in hand.

## About this document

The European Audit Committee Leadership Network is a select group of audit committee chairs from leading European 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 environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, advisers and auditors 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 European Audit Committee Leadership Network, a select group of audit committee chairs from Europe's 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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<sup>14</sup> For a definition of finite insurance see David M. Katz, "Finite insurance: beyond the scandals", *CFO.com*, 14 April, 2005. Available at <http://www.cfo.com/article.cfm/3860547>

<sup>15</sup> Reported by Ronald Fink, "Infinite risk?", *CFO Magazine*, 1 June, 2005