

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

Introduction

The Audit Committee Leadership Network (ACLN) held its eighth meeting in New York on March 10, 2005. During discussions that day, the network covered the topic of fraud and the role of the audit committee and focused on three areas:

- **Preventing fraud:** what is the oversight role of the audit committee?
- **Detecting fraud:** what are the roles of external and internal auditors?
- **Investigating fraud:** what is the decision-making role of the audit committee?

Network members also identified other related issues they are currently dealing with, including:

- The impact of Securities and Exchange Commission (SEC) rules and other regulations on companies (and the capital markets), which is complicated by simplistic media reporting
- Increased tension in the relationship between the audit committee and the external auditor
- Resources, fees, and internal audit plans for the second year of Section 404 implementation

The members of the network participating in the meeting, who sit on the boards of about 25 large-, mid-, and small-cap public companies between them, were:

- Jim Adams, Audit Committee Chair, Texas Instruments
- Bob Burt, Audit Committee Chair, Pfizer
- John Clendenin, Audit Committee Chair, The Home Depot
- Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- John Ferraro, Vice Chairman, Ernst & Young
- Tom Flannery, Americas Director, AABS Quality, Ernst & Young
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Sandy Warner, Audit Committee Chair, General Electric Company

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 during the meetings are not attributed to individuals or corporations.

Executive summary

Following frauds at companies such as Enron and WorldCom, President George W. Bush signed the Sarbanes-Oxley Act, which mandated a number of reforms to enhance corporate responsibility and restore investor confidence. The SEC's final rules relating to Section 404 of the Sarbanes-Oxley Act 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."¹ Members were particularly interested in the role of the audit committee in preventing fraud.

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. Applied to the U.S. gross domestic product for 2003, this translates to approximately \$660 billion in total losses."² The ACFE defines three types of fraud:³

- **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

The network's discussion on fraud focused on fraudulent statements, as these have the largest financial and reputational impact on businesses. The specific issues found to be most important to members are highlighted below, with more detailed discussion on the following pages.

- **Preventing fraud: What is the oversight role of the audit committee?** (*Pages 3-4*)

Members believe that senior management has primary responsibility for creating and nurturing an antifraud culture in a company. However, members believe the CEO should defer to the audit committee in judgments about fraud. Members listed six tasks the audit committee should undertake to prevent fraud; these include creating an environment of openness and accountability to encourage the reporting of fraud concerns, ensuring that adequate processes and controls are in place, and receiving reports on any illegality, immorality, or ethical lapse, regardless of materiality.

- **Detecting fraud: What are the roles of external and internal auditors?** (*Pages 5-6*)

Members are skeptical about attempts to close the gap that exists between what the investing public expect of audit firms with regard to fraud detection, and what those firms can actually accomplish (the "expectations gap"). Members insist they cannot afford to have the external auditor provide more than

¹ 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>

² 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/2004RtN.pdf>

³ Numbers do not add up to 100% because fraud cases can include more than one type of fraud.

“reasonable assurance” on fraud, and they want auditors to alert the audit committee about leadership and culture conditions that could precede fraud.

Members say the internal audit function is vital to fraud detection and that audit committees should regularly review high-exposure areas of the company with the internal auditor. Members also discussed the specific problems connected with detecting fraud during the due diligence process conducted when contemplating potential acquisitions.

• **Investigating fraud: What is the decision-making role of the audit committee?** (Pages 6-7)

Members recognize that most fraud is brought to light by whistleblowers. They see reports of all internal and external whistleblower calls to the company hotline. Members say the decision to investigate an incident of alleged fraud is typically initiated by a recommendation from the chief audit executive or general counsel. Most members rely on their intuition to determine when to widen an investigation and involve outside counsel or investigative resources.

Preventing fraud: What is the oversight role of the audit committee?

Despite the fact that most audit committee chairs believe that completely eliminating fraud is impossible, they agree that minimizing the opportunities for fraud is critical. Furthermore, recent trends in director liability cases seem to indicate that directors need to be seen to be following through on best practices in fraud prevention.

Many audit committee chairs, having overseen the laborious activities involved in implementing Section 404, believe that corporations have invested substantial time and resources in an antifraud program. However, many fraud professionals, who are trained and work in the area, believe Section 404 is not enough. The vast majority of internal controls are designed to detect errors, not fraud. The American Institute of Certified Public Accountants 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.”⁴

Members believe senior management has primary responsibility for creating and nurturing an antifraud culture in a company. One member said, “*Management is the first line of defense, not the audit committee. The CEO drives this. It has to be performance with integrity, not just performance ... The CEO has to be on message all the time and not slip up.*”

However, the CEO’s relationship with the audit committee is critical, and members believe the CEO should defer to the audit committee in judgments about fraud. The audit committee ought to be the final arbiter when it comes to matters of fraud. Based on discussions with CEOs held last year, it appears that some CEOs agree. *InSights* reported one CEO as saying, “I rely on the audit committee to ensure there is no

⁴ 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

unethical behavior in the system. Their role is to be a guard dog to ensure no one is drifting. That is why it is good to have a very strong leader of the audit committee.”⁵

So, what can the audit committee do? Members listed six tasks the audit committee should undertake to prevent fraud:

To prevent fraud, audit chairs recommend that audit committees should:

- **Create an environment of openness and accountability.** The audit committee has to indicate its willingness to listen to information and encourage the internal and external auditors to report any concerns they have about the corporation: *“Is the audit committee independent enough to enable the [internal and external] auditors to be candid?”*
- **Insist on complete reporting.** 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.”* There is also a need to give positive recognition to those managers who do surface issues and deal with them.
- **Ensure adequate processes and controls.** The audit committee needs to look at the pattern of fraud allegations to ensure there are no underlying process issues to be resolved. The committee needs to ask the internal and external auditors what the controls are and whether those controls are adequate or need to be strengthened. The audit plan needs to address areas of higher exposure. One member also recommended a focus on the balance sheet rather than the income statement because *“sooner or later fraud will hit the balance sheet.”*
- **Oversee effective whistleblower processes.** Audit committees should insist on effective whistleblower processes. However, audit committee chairs are frustrated by inconsistency in processes across national cultures and by differing attitudes towards whistleblowing. One member commented that for whistleblowing to be effective, *“You need openness and willingness to share.”*
- **Gain exposure to the wider management team.** One member suggested looking two to three layers below executive management by inviting people at lower levels to present to the audit committee: *“You need to trust but verify management.”* This will enable the committee to assess the quality of management and to hear about issues without them being filtered. Another member said his company regularly surveys the top sixty critical employees to ensure the tone at the top is not compromised.
- **Demand separation for the fraudster.** Tone at the top is so important that the audit committee should insist that perpetrators of fraud are always fired. One member commented, *“If people lose their jobs, it impacts everyone. The fraudsters are often the top producers, and the audit committee needs to ensure they go.”*

⁵ Audit Committee Leadership Network, “The CEO’s perspective,” *InSights*, March 2, 2004, 4.



Detecting fraud: What are the roles of external and internal auditors?

The role of the external auditor

The general impression among the investing public is that an 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 investing public’s expectations and the auditor’s professional responsibilities is often referred to as the “expectations gap.” The expectations gap is now under review by the Public Company Accounting Oversight Board, which is considering whether there is a need for a new auditing standard related to fraud.

The audit firms are concerned that the audit is not designed – nor the audit team usually equipped – to detect large-scale, collusive fraud by senior management. Yet, these are the very cases that attract media headlines and often drive regulation and legislation. The firms are focusing on improving the training of existing account teams to raise awareness of fraud risk, and on adding some new forensic procedures or investigative techniques to the audit process, including:

- improved training, direction, and procedures around client inquiries and information gathering
- enhanced financial statement analysis
- solicitation of industry input on high-risk companies
- use of technologically advanced auditing tools

Members suggested that such moves, although welcome in themselves, might actually increase the expectations gap. One member said, *“My expectations would be higher if I knew they had been trained [in these skills].”*

Members are adamant that they cannot afford to have the external auditor provide more than “reasonable assurance.” They are also pessimistic about the external auditor’s chances of finding a specific instance of fraud. However, audit chairs do believe that auditors could alert the audit committee to leadership and culture conditions such as *“cowboy activities and orphan units”* that raise a red flag for fraud potential. Members believe audit chairs should be meeting alone with the audit partner several times a quarter, not once, *“They should feel they report to you.”* Members commented that these meetings should feel like regular occurrences so they don’t trigger undue management concern.

The role of the internal auditor

While the role of the external auditor is under review, most audit chairs are clear about the role of the internal auditor. One member said, *“The audit committee is dependent on internal audit capability, and so that function is vital to fraud detection.”* Another said, *“The audit committee ... is continuously looking at high-exposure areas of the company with internal audit.”* These views will be reflected in the objectives for the chief audit executive and in the internal audit plan, both of which are developed jointly with the audit committee.

However, there is a need to avoid creating a new expectations gap for internal audit. One member said he had become aware of “*silos of expertise*” within the internal audit function that impaired the antifraud effort by making it harder for individual experts to see patterns of problems. This means that some issues may not “bubble up” to the audit committee. The challenge for the audit committee is to encourage the broadening of experience in the function or to develop a more multidisciplinary team approach to help with pattern recognition.

Many internal audit functions also lack forensic accounting skills. One audit chair commented that training in forensic skills for internal audit “*has been a serious push within the company, not because outrageous fraud has been found, but they are coming on their own for the training to enhance their careers and help the company at the same time.*”

The heavy involvement of internal audit functions in Section 404 implementation, particularly in small- and medium-cap public companies, has raised concerns about their involvement in antifraud programs. One audit committee chair was quoted in *ViewPoints* last May as saying, “Section 404 has taken a tremendous amount of internal audit staff [time]. There is an opportunity cost. What is not being done? And what is the risk of that?”⁶ Other companies have taken steps to add additional resources to the function: “*We made sure that internal audit had the capacity to be involved with fraud while they were implementing 404.*”

Detecting fraud during the due diligence process for acquisitions

Members also discussed the specific problems connected with detecting fraud during the due diligence process conducted when contemplating potential acquisitions. They noted that fraud concerns seem to emerge after the deal is complete and the integration process is under way. One audit chair commented, “*The process of due diligence is fraught with peril for the audit committee.*” Another member suggested adding a forensic accountant to the due diligence team.

Last year, members discussed the role of the audit committee in transaction risk. *ViewPoints* reported, “One audit chair saw the committee’s role in due diligence as ‘asking questions that will irritate the recipient of the questions. The audit committee is not managing due diligence, but has an active role in asking questions that force management to do a good job of the due diligence.’”⁷

Investigating fraud: What is the decision-making role of the audit committee?

Members recognize that most fraud is brought to light by whistleblowers. According to the ACFE, the most common method of detecting fraud in financial statements is through a tip, rather than by internal audit, external audit, or internal controls.⁸ Most members see reports of all internal and external whistleblower calls to the company hotline, with tabulations by category. One member said, “*Anything involving senior management always comes to the audit committee ... Every single [call] is investigated.*”

⁶ Audit Committee Leadership Network, “Section 404: Lessons learned and value earned?” *ViewPoints*, June 4, 2004, 3.

⁷ Audit Committee Leadership Network, “Transaction risk: A role for the audit committee?” *ViewPoints*, March 5, 2004, 4.

⁸ Joseph T. Wells, *The Corporate Fraud Handbook: Prevention and Detection* (New York: John Wiley & Sons, 2004), Exhibit 12.7.

If there is reason to believe that fraud may have occurred, the audit committee is responsible for determining the extent of the investigation and whether it should include only internal or both internal and external resources. Members say the decision to investigate an incident of fraud typically begins with a recommendation from the chief audit executive or general counsel. One member said, *“We rely on the judgment of the internal audit function ... You need confidence in your internal auditor.”*

Most audit committee chairs rely on their intuition in applying a “smell test” to determine when to widen an investigation and involve outside counsel or investigative resources. One member said, *“There have been matters where the audit committee ... wanted a second opinion to compare to the external auditor’s view. It has never been mandatory, but [it is] helpful to use forensic accountants.”*

Questions audit committees ask to determine if an independent investigation is required:

- Who is involved in the alleged fraud?
- What is the nature of the alleged fraud and how serious are the consequences for the company?
- What is the level of materiality?
- How pervasive is the alleged fraud?

Conclusion

According to many audit chairs, fraud, like death and taxes, is unavoidable. The key to preventing financial statement fraud is for the CEO and senior management to set a highly ethical tone at the top and nurture an antifraud culture and processes throughout the company. However, the audit committee should be in a position to identify risks of management override of internal controls, and it must work closely with the internal and external auditors to identify warning signs of lapses in management behavior. Since whistleblowers are a key element in detecting fraud, the audit committee needs to take special care to test whistleblower processes and continuously investigate allegations of fraud, regardless of materiality.

About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American 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, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. 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 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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