



AUDIT COMMITTEE INSTITUTE

Fraud Risk Considerations

Audit Committee Roundtable Workshop—Spring 2004

KPMG



KPMG's Audit Committee Institute

Communicating with Audit Committees Since 1999

KPMG's Audit Committee Institute (ACI) has been communicating with audit committees since our formation in 1999. Our programs have allowed us to meet personally with thousands of directors and officers. ACI's initiatives include semiannual roundtables, publication of *Audit Committee Quarterly*, conference and board presentations, a toll-free hotline, periodic distribution of time-sensitive information, and our Web site, www.kpmg.com/aci.

ACI's Web site, which hosts audit committee tools and information, has been highly rated by directors and officers. The site's resources include additional information on topics discussed in *Audit Committee Quarterly*, published articles from ACI, regulatory and technical content, audit committee "hot topics," and additional resources.

ACI can be reached toll-free at 877-KPMG-ACI (877-576-4224) or via e-mail at auditcommittee@kpmg.com.

KPMG's Audit Committee Insights

Register for KPMG's *Audit Committee Insights*

KPMG LLP (U.S.) recently launched a biweekly electronic publication to help audit committee members, executives, and others stay up to date on the ever-increasing volume of news, opinions, research, and trends related to corporate governance and the role of the audit committee. KPMG's *Audit Committee Insights* contains relevant articles selected from hundreds of sources on such topics as financial reporting, audit committee surveys, shareholder issues, and items in the news. It also features articles offering KPMG's commentary, perspectives, and insights on key issues leveraging the knowledge gained through KPMG's Audit Committee Institute. Registration for this complimentary electronic publication is available at www.kpmginsights.com.

Introduction

Fraud continues to present organizations in every industry and sector with significant risks: According to the KPMG ForensicSM practice's *Fraud Survey 2003*,¹ 75 percent of organizations surveyed said they had experienced fraud within the previous 12-month period—an increase of 13 percentage points since 1998. The survey found employee fraud was most prevalent, and financial reporting and insurance/medical fraud most costly. Since 1998 the greatest percentage point increase was in the theft of assets and expense account abuse.

With the increased awareness of fraud risks—and their financial, legal, and reputational consequences—audit committees are reevaluating their role, responsibilities, relationships, and practices with an eye toward enhancing oversight of the financial reporting process in general and the areas that present the greatest risks of fraud in particular. From assessing management's approach to risk mitigation and implementing antifraud measures, to recognizing fraud's "red flags" and monitoring, assessing, and influencing the right "tone at the top," audit committees have a pivotal role to play in helping organizations address fraud risk through sound oversight and corporate governance practices.

Audit committee members, C-level executives, and other professionals from leading organizations around the country discussed fraud and the evolving corporate governance environment at "Fraud Risk Considerations," an interactive workshop hosted by KPMG's Audit Committee Institute (ACI). Held in conjunction with ACI's Spring 2004 Audit Committee Roundtable series, the forum facilitated an open dialogue on the challenges audit committees face in addressing fraud-related risks. Following are highlights of key discussion topics as well as experiences, insights, and practices that panelists and participants shared relative to enhancing audit committee effectiveness in overseeing a company's fraud-related risks.

¹ The KPMG Forensic *Fraud Survey 2003* comprised interviews with more than 450 executives from multiple industries as well as state and federal government agencies.

The Evolving Fraud Risk Environment

Factors That Foster Fraud

As noted in *Risk from the CEO and Board Perspective*,² three overarching conditions can allow fraud to occur: “incentives and/or pressure, opportunities, and attitudes (e.g., lack of integrity.)” These conditions can be triggered by a host of factors, including:

- Weak internal controls
- Unquestioned authority in the hands of one or two senior executives
- Management compensation linked too closely to short-term financial results
- Lack of effective mechanisms for reporting or acting on reports of misconduct
- Poorly managed and poorly paid employees
- Lack of a comprehensive compliance program
- Inappropriate “tone at the top”

Sophisticated technologies and increasingly complex global enterprises, transactions, and financial reporting processes have helped to expand the opportunities for—and potential costs of—fraud in a variety of areas and from a host of sources. According to the KPMG Forensic *Fraud Survey 2003*:

- The prevalence of financial reporting fraud more than doubled to 7 percent (since KPMG’s last survey in 1998).
- Although financial reporting fraud constitutes a very small percentage of the total fraud occurrences reported, it constitutes a large majority of the total fraud costs. For organizations that experienced this type of fraud, the average annual cost was more than \$250 million³.
- Employee fraud was the most prevalent reported, followed by consumer fraud, third-party fraud, computer crime, misconduct, medical/insurance fraud, and financial reporting fraud.
- The most common factors contributing to fraud were collusion between employees and third parties and inadequate internal controls. Other contributing factors included management override of internal controls, collusion between employees and management, and lack of oversight of management by directors.

In addition, 43 percent of respondents in the KPMG Forensic survey thought that the incidence of fraud would decrease in the future, while 47 percent thought it would stay the same. Whether fraud increases or decreases, the prevalence of fraud-related risk has prompted many audit committees—as the representatives of investor interests—to take steps to enhance their understanding of the organization’s risks and oversee policies and practices implemented by management to help identify and mitigate those risks.

² Mary Pat McCarthy and Timothy P. Flynn, McGraw-Hill, 2004.

³ One company reported costs of financial reporting fraud of \$4 billion.

The Audit Committee and Fraud-Related Risk

Headlines of financial reporting scandals, sweeping corporate governance reforms, and unprecedented scrutiny by regulators and shareholders have elevated awareness of fraud to an all-time high. These pressures, along with increased corporate sensitivity to fraud, are driving many audit committees to focus greater attention on the organization's approach to risk management as well as the audit committee's own processes and policies for addressing fraud.

Indeed, the incentives for the audit committee to implement an effective oversight approach are compelling. They include:

- Meeting the audit committee's fiduciary responsibilities and duty of care in overseeing the integrity of the organization's financial reporting process
- Addressing regulatory requirements, such as section 404 of the Sarbanes-Oxley Act of 2002 regarding internal control over financial reporting and Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*
- Strengthening confidence among investors, rating agencies, and other stakeholders
- Identifying opportunities to improve performance and efficiency as a result of an effective internal control environment

SAS No. 99 states that "management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee, board of trustees, board of directors, or the owner in owner-managed entities), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly."

The High Cost of Fraud

In its *2002 Report to the Nation on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners found that fraud costs organizations an estimated 6 percent of annual revenue. In the KPMG Forensic *Fraud Survey 2003*, 36 percent of companies reported having incurred \$1 million or more in costs due to fraud. Such losses often do not factor in the potential long-term costs of a tarnished reputation and loss of marketplace or investor confidence.

Implementing a successful approach to fraud risk management—and realizing its potential benefits—can be significantly impacted by the audit committee's ability to define and clearly articulate its role and responsibilities.

Evolving Roles and Responsibilities

Audit committees typically play a prominent role in overseeing investigations into alleged or suspected fraudulent actions, and often retain legal, accounting, and other professional advisers for assistance. In addition, from a *proactive* perspective, the audit committee is often charged with overseeing the company's risk management approach—and facilitating a process for, and environment that is conducive to, preventing, detecting, and mitigating fraud.

To this end, audit committee responsibilities might encompass such core activities as:

- Evaluating management’s process for the identification and mitigation of fraud risk, including the measures implemented by management designed to help detect and prevent fraud
- Assessing, monitoring, and influencing the tone at the top and reinforcing a zero-tolerance policy for fraud
- Evaluating management’s processes and procedures for screening potential employees, including whether background checks are performed
- Providing oversight to management’s internal control over financial reporting and contemplating the potential for management override of—or inappropriate influence over—those controls
- Comparing the reasonableness of financial results with prior or forecasted results and considering quarterly analysis of key reserves
- Evaluating management’s processes, procedures, and documentation of all significant estimates used in the financial reporting process
- Evaluating management’s approach and documentation with respect to the processing of manual journal entries and the reporting cycle closing process
- Establishing a program for employees and others to report anonymous concerns about fraud and unethical behavior, i.e., a whistleblower process, and implementing a detailed process for the audit committee to monitor and follow through on these communications
- Providing other insight into and guidance on implementing or strengthening antifraud measures

These activities should both complement and serve as a check on senior management’s antifraud activities, which generally include establishing and monitoring all aspects of the organization’s fraud risk-assessment and prevention activities; overseeing its management team; reporting on the effectiveness of internal control over financial reporting in the annual report; and implementing and promoting an appropriate tone at the top. Importantly, the audit committee must be informed and actively engaged in overseeing the process while avoiding taking on the role or responsibilities of management.

Participant Views

ON ASSESSING, MONITORING, AND INFLUENCING THE RIGHT TONE AT THE TOP

- “Communicate your views clearly.”
- “Consider how your individual actions reflect on company policy.”
- “It’s all about fostering a culture of accountability, integrity, and ethics.”

After gaining an understanding of the organization’s fraud risks and antifraud programs, an audit committee should consider what it believes needs to come from the antifraud programs to assist the audit committee in its oversight role. While establishing its expectations regarding these antifraud programs, an audit committee should seek input from legal counsel and the internal and external auditors. This information along with insight from members’ own experiences should help facilitate the audit committee in clearly delineating its expectations.

Participant Views

ON WHISTLEBLOWER PROCEDURES

- “If you have no calls coming in, consider whether the process is effective.”
- “Training is very important. Everyone needs to understand the policy and the process.”
- “Make sure that information about the whistleblower process is communicated clearly and in multiple languages if necessary.”

Approaches to Fraud Risk Oversight

Audit committees are taking a variety of approaches to their oversight of management’s approach to preventing, detecting, and effectively responding to corporate fraud and misconduct. Many audit committees are bolstering their financial reporting and enterprise risk oversight processes by encouraging management to implement fraud-focused programs and controls that include:

- Regular reassessment of fraud risks. A fraud risk assessment cannot be done once and then put on a shelf.
- Company education and training to enhance awareness of fraud.
 - Is the training updated regularly?
 - Was the training designed to address specific fraud risk at the company?
 - Was an evaluation done to determine that the training was effective?
- New or enhanced “whistleblower” policies and procedures.
 - Who receives and documents the initial communication?
 - Do policies document how to address communications based on the type of allegation, the potential monetary exposure, or the position of the alleged wrongdoer, etc.?
 - How are calls investigated and who decides when to involve external parties?
 - How and when are whistleblower communications brought to the attention of the audit committee?
- Additional resources and tools to assist with antifraud efforts, such as internal audit, a designated antifraud team, and fraud-tracking and -monitoring software.
- A detailed fraud response or mobilization plan.
- Regular assessment of the company’s insurance programs, including coverage.

Clearly, antifraud programs must be designed to address the audit committee’s and the organization’s distinct needs and objectives—one size does not fit all; however, in overseeing effective antifraud programs, many audit committees are drawing on the following resources:

- Committee of Sponsoring Organizations (COSO) of the Treadway Commission’s *Internal Control Framework*
- New York Stock Exchange (NYSE) and NASDAQ corporate governance listing-standard requirements
- American Institute of Certified Public Accountants’ (AICPA’s) *Guidance on Anti-Fraud Programs and Controls*

Participant Views

ON AVOIDING PROSECUTION

- “When fraud is detected, consider contacting the SEC right away.”
- “Discuss with legal counsel the possibility of ‘waiving privilege.’”
- “Be forthcoming and cooperative.”

In addition, in April 2004 the United States Sentencing Commission proposed significant changes to the federal sentencing guidelines (*U.S. Sentencing Guidelines Criteria for an Effective Program to Prevent and Detect Violations of Law*), strengthening the criteria an organization must follow in order to create an effective compliance and ethics program—and mitigate potential punishment. These new federal sentencing guidelines are effective as of November 1, 2004. Audit committees should ask management how it has addressed these new requirements.

The New York Stock Exchange requires that audit committees of listed companies discuss risk assessment and risk management policies set by management, including “major financial risk exposures and the steps management has taken to monitor and control such exposures.” As part of this process, the audit committee should also discuss fraud-related risk exposures. Considering that the NYSE also requires its listed companies to “maintain an internal audit function to provide management and the audit committee with ongoing assessments of the company’s risk management process and system of internal control,” audit committees should be cognizant of internal audit’s involvement in and knowledge of the prevention and detection of fraud. Audit committees should also understand whether the internal or external auditors have identified or reported any suspected cases of fraud.

As audit committees work to understand management’s risk assessment and risk management policies, they should consider any cultural or organizational aspects of the company that may be a potential “red flag” of fraud. Possible risk indicators include:

- Low morale and motivation among employees
- High turnover in the accounting department or among key officer positions
- Excessive pressure to meet unrealistic financial targets
- Understaffed accounting and internal audit departments
- An employee living a lifestyle well beyond his or her means
- A high level of complaints from customers, suppliers, or regulatory authorities
- Infighting among top management

Leveraging these and other resources, many audit committees are integrating their consideration of fraud risks—and mitigation of those risks—with efforts to help ensure the effectiveness of the organization’s internal control over financial reporting in accordance with section 404 of the Sarbanes-Oxley Act.

Audit committees also should monitor the company’s documentation and testing of its internal control over financial reporting under section 404 of Sarbanes-Oxley. In this regard, audit committees should consider whether management is appropriately addressing fraud risk areas. Special consideration may need to be given to the existence of fraud risk factors in various geographical locations of the company or particular functions or divisions of the business as well as fraud risk factors identified within certain processes, such as those covering the reporting of revenue or where there is a potential for the misappropriation of assets.

The financial reporting process is another area of oversight in which audit committees should integrate their consideration of fraud. During the audit committee’s review and discussion of the company’s financial results, audit committee members should pay particular attention to certain conditions that also may be a potential fraud risk indicator if such conditions are not consistent with the company’s business, market, or industry. Examples of such conditions might include sales and income decreasing while accounts payable and receivable rise, a line of credit that is “maxed out” for long periods of time or loans that are continuously rolled over, significant excess levels of inventory or a large number of customer returns or account write-offs, and significant changes in key financial estimates.

Conclusion

The increased awareness of fraud and fraud-related risks—among investors, regulators, the media, and the organization’s management and board—has dramatically elevated the expectations of the role of the audit committee. As part of their oversight of the organization’s accounting and financial reporting processes, audit committees are increasingly focused on the potential sources of fraud and oversight policies and approaches for mitigating such risks. Clearly defining the audit committee’s role and responsibilities—most importantly, evaluating management’s risk management approach and encouraging the right tone at the top—is an essential step in preventing, detecting, and effectively responding to fraud. Another critical success factor is leveraging the knowledge and resources of key participants in the financial reporting process—including management and internal and external auditors—as well as emerging practices and guidelines for strengthening internal controls.

By focusing on fraud risk—and considering it within the context of the organization’s overall approach to risk management—the audit committee can respond to the heightened expectations of the marketplace and new regulatory requirements while helping to strengthen internal controls, financial reporting, corporate governance, and—ultimately—shareholder value.

Participant Views

WORDS OF WISDOM

- “Ask plenty of questions.”
- “Pay close attention.”
- “Don’t assume that if you don’t understand something, everyone else does.”
- “Be active, engaged, and concerned.”
- “Understand the characteristics and character of those involved in the company’s internal controls and financial reporting.”
- “Make sure the process for reporting issues is very detailed so that everyone feels accountable to report important issues upward.”
- “When considering fraud risks, don’t ignore basic things—like hiring and termination of employees.”
- “Be a skeptic.”

Previously published *Audit Committee Roundtable Highlights*:

- *Oversight of Auditors: Audit Committee Roundtable Highlights—Spring 2004*
- *Audit Committee Oversight of Taxes and Other Issues: Audit Committee Roundtable Highlights—Fall 2003*
- *Building a Framework for Effective Audit Committee Oversight: Audit Committee Roundtable Highlights—Spring 2003*

These and other ACI publications are available at www.kpmg.com/aci.

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