CENTER FOR AUDIT QUALITY

Financial Reporting Fraud Deterrence and Detection
Action Steps for Boards and Audit Committees

Tone at the Top

A strong ethical culture starts with an organization's most senior leaders and cascades down through the entire organization to create a "mood in the middle" and a "buzz at the bottom" that reflects and reinforces the company's operating values.

1. Personally "walk the talk" of the company's core values and code of conduct. Be visible outside the boardroom, and interact personally with employees at various levels to obtain their perceptions of the corporate culture and reinforce high ethical standards.

2. Adopt a strong tone of compliance, communicate it to the entire organization, and hold management accountable. Take decisive action against any member of senior management who does not adhere to the company's ethical standards and code of conduct.

3. Regularly review key strategies and business plans and assess the achievability of goals in light of current circumstances. Goals should be structured to avoid a rigid short-term focus that might push management or employees to commit fraud.

4. Establish a regular process for assessing management integrity, and do not let this activity become perfunctory.

5. Approve the internal audit charter and the annual work plan to ascertain that it is aligned with and addresses the audit committee's needs and its expectations for internal audit.

6. Review and understand the results of reports to the whistleblower program, focusing on complaints that involve senior management or reflect on the ethical culture of the company. Leverage the internal audit function.

7. Evaluate ways to strengthen relationships between the audit committee and the compensation committee—either through overlapping membership, joint meetings, or audit committee chair attendance at relevant meetings of the compensation committee—with the objective of designing compensation packages that promote ethical behavior, as well as providing incentives to meet financial goals and build long-term shareholder value.

8. Consider the role of the audit committee in evaluating the performance and compensation of the chief audit executive, as well as the benefits of adopting a policy that the audit committee concurs in employment or termination decisions for both the chief financial officer and the chief audit executive.

This information originally appeared in the Center for Audit Quality's Report, Deterring and Detecting Financial Reporting Fraud: A Platform for Action*. For more resources on this topic visit our website at www.THECAQ.org.*

Skepticism

Skepticism—a questioning mindset and an attitude that withholds judgment until evidence is adequate—promotes risk awareness and is inherently an enemy of fraud.

1. Confirm that all board and audit committee members have a strong understanding of the company's business and its industry. Leverage outside training and consultants as necessary, with the objective of enabling all members of the board and audit committee to ask probing questions about strategy and operations. Audit committee members should also have a working understanding of financial reporting, even if they are not financial experts.

2. Ask questions of management, internal auditors, and external auditors to elicit potential concerns related to opportunities or incentives for financial reporting fraud.

3. Use face-to-face meetings whenever possible to obtain information, encourage open discussion, and assess nonverbal communications such as body language.

4. Actively oversee those aspects of the company's strategy and risk management program that affect financial reporting, with a specific focus on risks that could potentially create incentives for financial reporting fraud.

5. Question management in depth about its program for managing fraud risk, focusing on areas where management has identified the greatest vulnerabilities, including the risk of management override of controls. Ask management to explain how those vulnerabilities are being addressed and consider utilizing internal audit to evaluate the effectiveness of management's activities.

6. Leverage the internal and external auditors as key resources. Have regular, confidential meetings between the audit committee and the chief audit executive, and perhaps separately with other senior members of the internal audit department, as well as executive sessions with the external auditor.

Communications

Each of the participants in the financial reporting supply chain has a separate but interconnected role in the shared responsibility to deter and detect fraud. Fulfilling this responsibility successfully requires leveraging each party's complementary activities by sharing and communicating information and concerns and identifying any gaps in the collective efforts to mitigate the risk of financial reporting fraud.

1. Routinely ask questions of management, internal auditors, and external auditors to elicit indications of potential concerns related to incentives or opportunities for financial reporting fraud.

2. Work to connect with the organization outside the boardroom. Seek opportunities to interact with managers, employees, vendors and customers to enhance knowledge of the company and possible risks of financial reporting fraud.