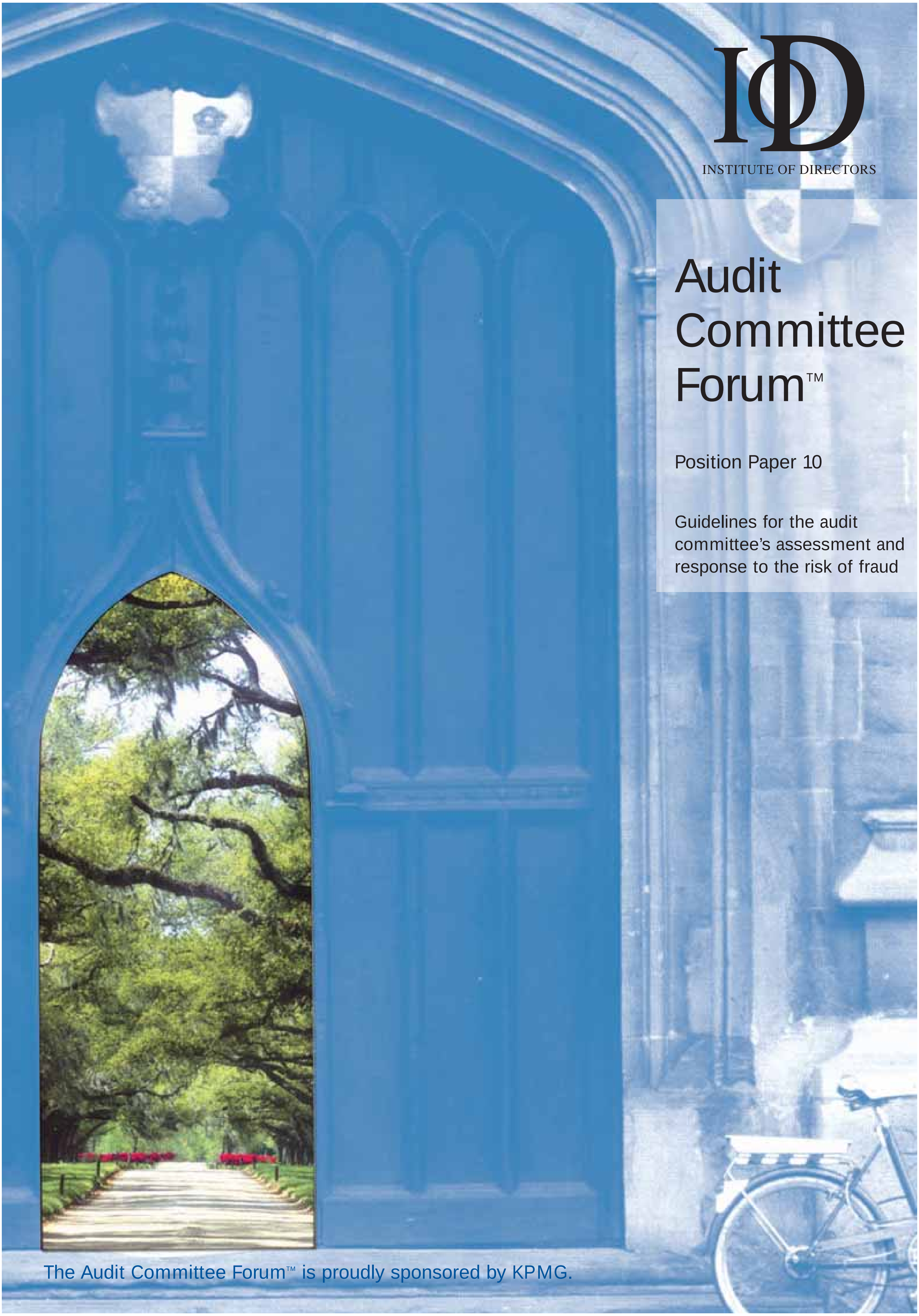

INSTITUTE OF DIRECTORS

Audit Committee Forum™

Position Paper 10

Guidelines for the audit committee's assessment and response to the risk of fraud

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Guidelines for the audit committee's assessment and response to the risk of fraud

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Introduction

Sophisticated technologies and increasingly complex global enterprises, transactions and financial reporting processes have resulted in and expanded the opportunities for fraud in a variety of areas. 65% of respondents from Africa to the KPMG Africa Fraud and Misconduct Survey of 2005 believed that fraud is a major problem in their businesses and 68% believed it would increase in future.

Three[1] conditions are found to increase the likelihood of fraud: "incentives and/or pressure, opportunities, and attitudes (e.g. lack of integrity, transparency, arrogance etc.)". These conditions may be triggered by a myriad of factors, including some of the following (Refer to Appendix A for further examples of fraud risk factors):

- Inappropriate "tone at the top".
- Poor human resources screening processes during recruitment.
- Weak internal controls.
- Unquestioned and/or excessive authority in the hands of one or two senior executives.
- Management compensation linked too closely to short-term financial results.
- Poorly managed and poorly paid employees.
- Lack of a comprehensive compliance programme.

What is the role of the audit committee?

With the increased awareness of fraud risks – and their financial, legal and reputational consequences – audit committees are re-evaluating their role, responsibilities, relationships and practices with a view to enhancing oversight of the financial reporting process in general, and in particular, the areas that present the greatest risk of fraud.

In terms of the revised International Standard on Auditing (ISA) 240: *The auditor's responsibility to consider fraud in an audit of financial statements,* it is the responsibility of management, with the oversight of those charged with governance, to place a strong emphasis on fraud prevention and to establish and maintain internal controls to prevent and detect fraud.

Audit committees typically play a prominent role in overseeing investigations into significant fraudulent actions, and ensuring that the process is followed. ISA 240 requires those charged with governance to consider the potential for management to override controls or other inappropriate influence over the financial reporting process.

The audit committee may also be charged with overseeing the entity's risk management approach, ensuring an environment that is conducive to preventing, detecting and mitigating fraud risks. In the event the audit

[1] Risk from the CEO and Board Perspective, Mary Pat McCarthy and Timothy P. Flynn, McGraw-Hill, 2004.

committee is so charged, they may refer this responsibility to the risk committee.

Audit committees should also be aware of the responsibility of the external auditor, in terms of section 45 of the Auditing Profession Act to report irregularities to the Independent Regulatory Board for Auditors and that all instances of fraud, regardless of materiality, involving any person in management would fall within the definition of a "reportable irregularity". A future position paper will deal with reportable irregularities in more detail.

Audit committee approaches to fraud risk oversight

Audit committees are taking a variety of approaches to their oversight of management's process of preventing, detecting and reporting corporate fraud that includes the following:

- Regular and continued assessment of fraud risks.
- Company education and training to enhance awareness of fraud.
- New or enhanced "whistleblower" policies and procedures (Please refer to Position Paper 11).
- Additional resources and tools to assist with fraud prevention and detection efforts, such as internal audit, a designated fraud prevention team, fraud-tracking and monitoring software.
- A detailed fraud response or mobilisation plan.
- Regular assessment of the entity's insurance cover.
- A fraud prevention plan (as is required in terms of the PFMA and MFMA for public sector entities).

The audit committee's response to fraud risk

Importantly, the audit committee must be informed and actively engaged in overseeing the process while avoiding taking on the role or responsibilities of management.

To this end, audit committees should consider the following activities:

- Assess, monitor and influence the tone at the top and reinforce a zero-tolerance policy for fraud.
- Evaluate management's process and procedures for:
  - the identification and mitigation of fraud risk, including the measures implemented by management designed to help detect and prevent fraud;
  - screening potential employees, including whether proper background checks are performed;
  - significant estimates used in the financial reporting process;
  - the processing of manual journal entries and the reporting cycle closing process; and
  - establishing a whistleblower process.
- Provide oversight to management's internal controls and contemplate the potential for management override of, or inappropriate influence over, those controls.
- Compare the reasonableness of financial results with prior or projected results and consider quarterly analysis of key provisions.
- Provide other insight into and guidance on implementing or strengthening fraud prevention and detection measures.

Appendix A

Fraud risk factors

As audit committees work to understand management's risk assessment and risk management policies, they should consider any cultural or organisational aspects of the entity that may be a potential risk factor of fraud. Possible risk factors include the following:

Risk factors relating to management characteristics

- Dominant CEO or chairperson of the audit committee.
- A significant portion of management's compensation is represented by bonuses, stock options, or other incentives, the value of which is contingent upon the entity achieving aggressive targets for operating results or financial position.
- An excessive interest in maintaining or increasing the entity's stock price or earnings trend through the use of unusually aggressive accounting practices.
- Non-financial management's excessive participation in, or preoccupation with, the selection of accounting principles for the determination of significant estimates.
- A practice by management of committing to analysts, creditors, and other third parties to achieve what appear to be aggressive or unrealistic forecasts.
- High turnover of accounting personnel, senior management, counsel, or board members.
- Known history of law violations or claims against the entity or its senior management alleging fraud or violations of laws, including tax structures.
- Strained relationship between management and the current or the previous external auditors.
- Management recommendation for changes in auditors.
- Infighting among top management.
- Insistence by the CEO or CFO that he/she be present at all meetings between the audit committee and internal or external auditors.
- Hesitancy, evasiveness and/or lack of specifics from management or auditors regarding questions about the financial statements.
- Instances of differences in views between management and external auditors.
- Frequent and unusual dealing in the shares held by management, especially when shares are sold.
- Inappropriate behaviour with regards to company expenses.

Risk factors relating to internal controls

- A weak control environment.
- Identified and reported deficiencies in internal controls which remain uncorrected without appropriate justification or a reluctance to make changes in systems and procedures recommended by internal and/or external auditors.
- A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process e.g. instances of management override of controls and lack of segregation of duties.
- Internal audit operating under scope restrictions, such as the head not having a direct line of communication to the audit committee.
- Reference in and monitoring of trends in internal and external audit reports.

Risk factors relating to human resources

- Low morale and motivation among employees.
- High turnover in the accounting department or among key officer positions.
- Understaffed accounting and internal audit departments.
- An employee living a lavish lifestyle or a lifestyle well beyond his or her means.
- Employees with known gambling habits and/or substance abuse.
- Employees with significant days leave due to them.
- Failure to enforce the company's code of conduct.

Risk factors relating to industry conditions

- New accounting, statutory, or regulatory requirements that could impair the financial stability or profitability of the entity.
- High degree of competition or market saturation, accompanied by declining margins.
- Declining industry with increasing business failures.
- Rapid changes in the industry, such as significant declines in customer demand, high vulnerability to rapidly changing technology, or rapid product obsolescence.
- A high level of complaints from customers, suppliers, or regulatory authorities.
- Excessive pressure to meet financial sales targets and analysts expectations.

Risk factors relating to operating characteristics and financial stability

- Incomplete or incorrect accounting records e.g. large suspense accounts or reconciliations with many outstanding items.
- Significant number of journal entries close to year-end.
- Excessive use of Special Purpose Vehicles or acquisition accounting and the excessive use of business combinations.
- Frequent changes in accounting policies.
- Overly optimistic news releases or shareholder communications, with the CEO acting as champion to convince investors of future potential growth.
- Financial results that seem “too good to be true” or significantly better than competitors – without substantive differences in operations.
- Widely dispersed business locations with decentralised management and a poor internal reporting system.
- Significant pressure to obtain additional capital necessary to stay competitive considering the financial position of the entity - including need for funds to finance major research and development or capital expenditures.
- Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive effect on the entity, such as ultimate collectibility of receivables, timing of revenue recognition, realisability of financial instruments based on the highly subjective valuation of collateral of difficult-to-assess repayment sources or significant deferral of costs.
- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm.
- Significant, unusual or highly complex transactions close to year-end that pose difficult “substance over form” questions or large last-minute transactions that result in significant impact on results in half yearly or annual reports.
- Accounting principles/practices that appear to favour form over substance or accounting principles/practices at variance with industry norms.
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
- Overly complex organisational structure involving numerous or unusual legal entities, managerial lines of authority, or contractual and business arrangements without any apparent business or practical purpose and not well understood.
- Difficulty in determining the organisation or individual(s) that control(s) the entity.
- Especially high vulnerability to changes in interest rates.

- Unusually high dependence on debt or marginal ability to meet debt repayment requirements. Debt covenants that are difficult to maintain.
- Unrealistically aggressive sales or profitability incentive programmes.
- Threat of imminent bankruptcy or foreclosure.
- Adverse consequences of significant pending transactions, such as a business combination or contract award, if poor financial results are reported.
- Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.
- Inability to generate cash flows from operations while reporting earnings and earnings growth.
- Apparent inconsistencies between the facts underlying the financial statements and the Chairman's statement (e.g. the CEO report presents a "rosier" picture than the financial statements warrant).
- A consistently close or exact match between reported results and planned results, for example, results that are always exactly on budget, or managers who always achieve 100 percent of bonus opportunities.
- A pattern of delivering most of the month's or quarter's sales in the last week or last day.
- Unusual balance sheet changes or changes in trends or important financial statement relationships, for example receivables growing faster than revenues, or accounts payable that keep getting delayed.
- Unusual accounting policies, particularly for revenue recognition and cost deferrals, for example recognising revenues before products have been delivered (bill and hold) or deferring items that normally are expensed as incurred.
- Numerous and/or recurring unrecorded or 'waived' adjustments raised in connection with the annual audit.
- Use of provisions/reserves to smooth out earnings which are subsequently reversed in a later period or frequent and significant changes in estimates for no apparent reason, increasing or decreasing reported earnings.
- Differences between accounting and tax profits.

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