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Audit Committee Excellence Series

Achieving excellence: The audit committee's role in deterring fraud

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PwC's Audit Committee Excellence Series (ACES) provides practical and actionable insights, perspectives, and ideas to help audit committees maximize performance. This edition addresses the audit committee's role in deterring fraud.

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This ACES module discusses key considerations related to deterring fraud, including:

1. Why deterring fraud is critical to audit committees

2. The US Federal Sentencing Guidelines - the baseline standard

3. The impact of the Dodd-Frank "whistleblower rules" on the current fraud environment

4. The committee's impact on "tone at the top" and deterring fraud

5. Other specific areas to consider:
   - Bribery and corruption
   - Trends in insider trading enforcement
   - The importance of the company's code of conduct

1. Why deterring fraud is critical to audit committees

Economic fraud is pervasive and comes in many varieties—from bribery, corruption, and money laundering to insider trading and financial reporting fraud. Each type of fraud has its own distinct characteristics and consequences. Over the last two years, there has been an uptick in reported incidents. On average, 45% of US organizations report they have suffered some type of fraud over that period[1]. And technological advancements have changed the landscape, increasing the number of opportunities to commit fraud, and creating innovative new ways to perpetrate it.

In the US and around the globe, enforcement has ramped up considerably. The SEC filed a record 755 enforcement actions in their 2014 fiscal year, covering a wide range of misconduct, and obtained orders totaling $4.16 billion in disgorgement and penalties.[2] Additionally, the SEC has adopted a "broken windows" approach to securities enforcement—prosecuting minor violations of the federal securities laws in order to encourage enhanced internal controls, and to dissuade potential wrongdoers from engaging in more egregious conduct. The US Department of Justice (DOJ) also continues to identify Foreign Corrupt Practices Act (FCPA) enforcement and anti-corruption measures as key priorities for 2015. In total, the DOJ recovered $1.56 billion in fines and settlements related to bribery and corruption cases during their 2014 fiscal year.[3] Enforcement agencies globally are also committing to more robust action going forward. For example, the UK Serious Fraud Office (SFO) intends to increase enforcement of the UK Bribery Act.

Within this context of increased fraud incidents and record enforcement, directors—and audit committees in particular—are faced with considerable challenges. While it's clear that the CEO and senior management play the essential role in setting ethical expectations of the company's employees and third-parties, directors can also have a significant impact on deterring fraud and ensuring appropriate "tone at the top." Such responsibilities typically fall to the audit committee, as they are closely related to the committee's oversight responsibilities in the areas of financial reporting and regulatory compliance. This edition of ACES addresses the role audit committees can play in helping to deter fraud.

[1] PwC's 2014 *Global Economic Crime Survey*
[2] US Securities and Exchange Commission. *SEC's FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases*, October 2014.

2. The US Federal Sentencing Guidelines - the baseline standard

The standard in the US for effective ethics and compliance programs is set out in the Federal Sentencing Guidelines. The guidelines require companies' compliance programs to promote a "culture that encourages ethical conduct and a commitment to compliance with the law." The guidelines also promote comprehensive compliance procedures and careful monitoring by requiring directors to be knowledgeable about compliance programs and to be informed by those with day-to-day responsibility over compliance. An effective compliance program monitored by the board may be a mitigating factor in a prosecutor's decision to charge a company with wrongdoing—and may reduce the amount of any fines the company may face due to criminal action on the part of employees or third-party providers. As such, the audit committee should meet regularly with the company's General Counsel to monitor compliance with legal and regulatory requirements and oversee an annual review of the company's compliance programs and reporting systems.

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3. The impact of the Dodd-Frank whistleblower rules on the current fraud environment

There are a number of external factors that impact the environment for fraud deterrence, including the Dodd-Frank whistleblower rules—which have added a new set of dynamics to deterring fraud and caused many companies to rethink their approach to handling internal allegations of wrongdoing. The whistleblower rules provide significant monetary incentives for reporting securities violations directly to the SEC, as well as strong protections for doing so. As a result, companies are adopting many new best practice protocols that committees may want to look into:

- Have a written response plan to deal with allegations;

[3] US Department of Justice 2014 *FCPA Related Enforcement Actions,* 2014.

- Understand management's efforts to raise employees' awareness of their rights and responsibilities for reporting of allegations;
- Assess whether the volume of hotline complaints is excessive, or so low it suggests the company culture does not support employee reporting of concerns;
- Embed adherence to laws and regulations into employee performance plans;
- Review the structure of employment agreements and confidentiality agreements for language that may preclude an employee from reporting concerns directly to the SEC;
- "Widen the net" of individuals to whom employees can report issues—providing them with more options for reporting concerns; and
- Discuss whether anti-retaliation provisions need to be clarified in the company's code of conduct, as the Dodd-Frank whistleblower rules provide specificity about what constitutes "retaliation."

When it comes to investigating an allegation, equal treatment of all employees is essential. Any sense that certain individuals are given preferential treatment regarding allegations of impropriety, or that all infractions are not dealt with the same way, will undermine corporate culture—and may make employees less likely to report concerns in the future. Best practices include:

- Investigate all allegations and handle infractions consistently and in accordance with established company policy, regardless of the level of the individual involved;
- Understand that all complainants can become external whistleblowers, so every issue should be addressed and related actions and conclusions should be thoroughly documented;
- Recognize that issues involving senior executives will likely mean audit committee involvement in any investigation;
- Provide the audit committee with periodic communications regarding significant allegations;
- Set thresholds for whistleblower reporting to the audit committee; and
- Consider whether any information regarding an investigation should be communicated to the company's stakeholders.

Audit committee considerations:

- *Ensure management performs robust annual reviews of the company's compliance programs and reporting systems.*
- *Request periodic updates on the external enforcement environment and the company's fraud training and prevention programs.*
- *Be familiar with the US Federal Sentencing Guidelines requirements for effective compliance programs.*
- *Understand the nature and volume of allegations reported to the company's whistleblower hotline.*
- *Ensure management provides the audit committee with periodic information about reported allegations.*
- *Understand the company's response to the Dodd-Frank whistleblower rules and whether additional measures should be taken.*

4. The committee's impact on "tone at the top" and deterring fraud

The importance of "tone at the top" in deterring fraud cannot be overstated. And numerous academic studies have shown that the most powerful driver of tone is the behavior of the CEO—which has a "trickle-down effect" to managers and employees. If the tone set by senior management upholds values like integrity, honesty, and fairness, employees will be more inclined to uphold the same values. Simply put, employees tend to follow the examples of their immediate supervisors—even when supervisors' actions may be inconsistent with formal company policy. And while many companies have hotlines for employees to report wrongdoing or concerns, most employees report misconduct to their immediate supervisor. So it's imperative that employees trust the CEO's and management's commitment to ensuring the company operates ethically.

One of the key ways that audit committees can help deter fraud is to not underestimate the role they can play in ensuring the company's "tone at the top" reflects a strong focus on ethical behavior. However, since tone is not tangible or quantifiable, evaluating and influencing it can be difficult. That said, we have observed astute audit committee members take a number of specific approaches to evaluating and impacting company culture. Many of these approaches have become more prevalent over the last few years in response to expectations regarding the board's performance. They include:

Talk explicitly about ethics, culture, and tone. The clearest way to signal the importance of ethics, culture, and tone to senior management—and influence their behavior—is by allocating meaningful time and focus to discussing the company's culture at audit committee or board meetings. Through specific dialogue about these areas, the audit committee is setting expectations about this topic's importance. Asking questions lets management know that these areas are "top of mind" to directors. This type of dialogue can serve to drive CEOs to take positive action relative to establishing exemplary culture and tone. In this regard, directors have made considerable progress; 68% now say their boards have discussed "tone at the top" in the last year, compared to only 46% who did so in 2012[4].

Observe management's interactions with the audit committee. The nuances in executives' behavior can indicate many things about the company's "tone at the top." Over the course of time, audit committee members will interact with executives in a variety of forums—from formal committee meetings and offsite strategy retreats, to social events and board dinners. Committee members will want to pay close attention to how executives interact in each of these environments, and particularly in one-on-one situations. Is the conversation frank, candid, and balanced? In addition, audit committees should take note of how rehearsed or scripted management's presentations are at formal meetings. Excessively controlled communications or reluctance by the C-suite to have spontaneous discussions can indicate a potential concern.

Meeting employees outside of the C-suite. Directors have significantly more direct contact with company employees outside of the C-suite than they did only three years ago (57% meet with such individuals now, compared to only 31% in 2012[5]). This is progress, as meetings and discussions with a broader group of employees can help inform committee members and give them a different perspective on tone at the company. Many committee members visit the company's divisions or subsidiaries to gain additional perspectives regarding the company's culture.

Review CEO communications to employees. The audit committee will want to be comfortable that management is fostering an atmosphere that makes ethics and compliance part of the everyday dialogue. To this end, the extent of the CEOs communications to employees concerning ethics and compliance can be revealing. The tone of such communications should stress the importance of ethics and compliance and encourage employees to speak up with any concerns. Audit committees can consider the robustness and spirit of such communications to help them assess the extent of explicit or implicit messages the CEO is sending.

Leverage internal and external auditors. The company's internal and external auditors are invaluable assets in helping the audit committee assess tone. Internal and external auditors spend a great deal of time focused on the company's internal controls and ethics and compliance programs. These parties' respective views on the credibility of the company's practices can be critical. In particular, audit committees should ask auditors probing questions about the accounting areas requiring the greatest degree of management estimation and judgment. These areas provide the most latitude for manipulation—for example, certain revenue transactions, loan losses, and asset valuations. Inquiring about the accounting areas that take the most time and are most subject to recurring problems or disagreements is also a good approach. Committees should also leverage one-on-one meetings with auditors and ensure the effective use of private sessions to understand sensitive issues. Regarding the internal audit group, the audit committee (and particularly its Chair) can go a long way to empower that organization through visible endorsement of the function. For example, attending the internal audit group's annual planning meetings can send a strong signal to the entire organization that the audit committee places great importance on the role of internal audit.

Delving into employee and customer surveys, exit interviews, and upward feedback. There are many different tools that audit committees can use to help assess and influence culture. For example, employee satisfaction survey results and turnover data, if reviewed, can highlight red flags that warrant further discussion. The committee can also gain insight into how management handles relationships with major customers through the results of customer surveys. In addition, the results of exit interviews with departing executives, particularly those in the finance department, can shine light on underlying issues of which the audit committee may otherwise not be aware. Carefully crafted questions in these surveys that address not only job satisfaction but perspectives on the ethics of immediate supervisors can be revealing. Over 90% of directors are receiving and reviewing employee satisfaction/values survey information.[6]

The audit committee can also ask about the results of the upward/peer feedback of senior executives; one-quarter of directors now say they do this, up from 20% three years ago[7]. Such a process can provide unique information about culture.

[4] PwC 2015 Annual Corporate Directors Survey
[5] PwC 2015 Annual Corporate Directors Survey
[6] PwC 2014 Annual Corporate Directors Survey
[7] PwC 2015 Annual Corporate Directors Survey

Spend time discussing the risks embedded in compensation plans. The psychology of incentives dictates that employees will consistently do what they are paid to do, in which case some features of compensation plans can create incremental financial reporting risk. Perhaps that's why 42% of directors say they have increased the time spent discussing the risks embedded in compensation plans over the last year[8]. Some boards have cross-committee membership between the audit and compensation committees—allowing at least one audit committee member the opportunity for a deep dive into compensation accelerators, bonuses and targets.

In looking at compensation plans, audit committees will want to examine whether there are structural elements that could drive inappropriate management behaviors. In particular, committees need to understand the extent to which executives are being driven to meet challenging targets as key performance measures and expectations—which could potentially affect financial reporting decision-making. At the same time, they should understand the sensitivity of the company's share price and level of precision applied by the market to hitting or missing specific consensus or guidance estimates. A high-pressure operating environment, coupled with distinct market sensitivity to earnings has the potential to result in inappropriate management behavior. In many organizations that experienced financial reporting fraud, corporate culture played a contributing factor in that subordinates were not comfortable challenging their supervisors' behavior. In some cases, CEOs set unrealistic profit targets and demanded subordinates meet them, putting managers under pressure to postpone losses or accelerate sales. In this regard, it is useful for committee members to understand the amount of pretax profit and after-tax net income needed to drive a one cent change in reported earnings per share.

Fraud at international locations

Many frauds go undetected for years. This can be particularly true at international locations where the business unit leadership, including the CFO, have been in place for an extended number of years. A fraud covering an extended period is often detected only when new leadership or finance personnel are rotated into the business unit. As a consequence, committees may want to ask about the rotation of CFOs at international locations. It is not necessarily practical to do so, but a "fresh set of financial eyes" can go a long way in stemming potential problems. In addition, remote locations may not have the same level of controls as the parent, if simply due to having fewer employees.

The importance of "tone at the top" in deterring fraud cannot be overstated.

Audit committee considerations

- *Consider whether the committee has a robust approach for evaluating "tone at the top."*
- *Consider whether the committee is influencing company culture through the questions they ask and the information they request.*
- *Assess whether the tone of management communications stresses the importance of ethics and compliance and encourages employees to speak up with any concerns.*
- *Leverage one-on-one meetings with internal and external auditors and ensure the effective use of private sessions to understand sensitive issues.*
- *Take into account the data from employee satisfaction surveys, exit interviews, and upward and peer feedback.*
- *Evaluate how rehearsed and scripted interactions with management are.*
- *Understand the extent to which executives are being driven to meet challenging targets as key performance expectations.*
- *Assess the feasibility of rotation of CFOs at international operations.*
- *Evaluate whether committee members have a sufficient understanding of the sensitivity of the market to reported earnings and the dollar amount that impacts earnings per share by one cent.*

5. Other specific fraud areas to consider

Bribery and corruption

Addressing the risk of bribery and corruption can be a real challenge. Bribery is a prevalent practice in many areas of the world and local culture often supports gift-

[8] PwC 2015 Annual Corporate Directors Survey

giving as an acceptable business practice. Further, what constitutes a “legal facilitation” payment versus an illegal bribe is not well defined. And when an issue is identified, it is difficult to understand or convince regulators that the issue is isolated as opposed to systemic in the company’s culture and operations.

The scale and complexity of today’s supply chains and distribution channels have increased the risks in third-party relationships. And the US FCPA and UK Bribery Act extend companies’ responsibility—and liability—for bribery and corruption to activities conducted on their behalf by their agents, resellers, and distributors. Yet third-party providers are outside of the organization’s direct controls. Less than 30% of US companies monitor their third-party vendors, suppliers, and agents to prevent corruption, fraud, and other compliance risks[9]. In light of these factors, many audit committees have increased their focus on bribery and corruption globally. In fact, nearly two out of five directors say their boards have had specific discussions about bribery and corruption concerns in the last year[10].

Audit committees should commit the time to understanding the high-risk locations in which the company does business, particularly questioning the rationale for the use of “middle men” or intermediaries in such “hot spots.” They should also ask management to review the adequacy of third-party contracts and policies—many of which may have been in place for some time, and not recently reviewed. If not currently doing so, the audit committee might suggest that the company adopt supplier/distributor codes of conduct that require suppliers to follow minimum standards of expected practice. And the committee may also wish to understand whether the company’s whistle-blower hotline is extended to third parties—and how those third parties train their employees about ethics and compliance issues.

Companies need to focus attention on personnel differently in non-US territories if there are different cultural expectations about reporting violations, which may require targeted training. Further, committees will want to ensure appropriate levels of due diligence and compliance certifications in acquisitions and new third-party agreements, as well as the inclusion of “right to audit” provisions in third-party contracts and whether those rights are actually being exercised.

Trends in insider trading enforcement

Since 2010, 168 actions have been filed against nearly 400 individuals and entities regarding insider trading.[11] And while the most high-profile insider trading allegations have historically been made against individuals, more recently, the focus has shifted. As explained below, pension funds and other investors have been critical of the specific provisions of company’s 10b5-1 plans and the SEC and DOJ are increasingly focused on “expert networks.”

10b5-1 plans allow insiders to sell a predetermined number of shares at a predetermined time. By removing the discretionary component, trade may take place despite insiders having visibility at certain times into material non-public information. These plans can provide corporate insiders with a strong defense to illegal insider trading—if they were established in good faith, adopted when the insider was unaware of material non-public information, and the insider did not exercise subsequent influence over the trades. But some investors and others have criticized these plans because the specific terms of these arrangements are not publicly disclosed.

In addition, regulators and investors have recently expressed concern about company employee participation in “expert networks” (research consulting firms that provide data and analysis to the investment community). At issue is whether the employees are sharing insider information with analysts and hedge funds. These investigations resulted in dozens of people associated with expert networks being charged with insider-trading.[12] Company policies about employee use of, or participation in, “expert networks” should be considered. Many companies ban such employee participation or require pre-approval by the legal department.

In light of such developments, board discussions of controls to prevent insider trading violations have become more prevalent; 44% of directors now say they had such conversations in the last year, compared to only 27% three years ago[13].

Audit committees should ensure they understand insider trading controls. Best practices can include requiring the General Counsel to approve all insider trades, allowing insider sales only through a company designated broker, and adoption of 10b5-1 plans only during appropriate trading windows. Audit committees should know whether a company has 10b5-1 plans and if so, should understand whether the plans have features that could be subject to criticism, such as the ability to easily terminate or amend the plans, or allowing for the adoption of multiple, overlapping plans. Plans that do not have an adequate “stand-off period” of 30 or 60 days

[9] NAVEX Global, *2013 Third-Party Risk in a Global Environment*, September 2013

[10] PwC 2015 Annual Corporate Directors Survey

[11] US Securities and Exchange Commission. “Year-by-Year SEC Enforcement Statistics,” Accessed August 12, 2015 http://www.sec.gov/news/newsroom/images/enfstats.pdf

[12] US Securities and Exchange Commission. “SEC Enforcement Actions: Insider Trading Cases,” Accessed August 12, 2015 http://www.sec.gov/spotlight/insidertrading/cases.shtml

[13] PwC 2015 Annual Corporate Directors Survey

before trading can occur after plan adoption can also be scrutinized.

The importance of the company's code of conduct

The code of conduct articulates the company's core values and behavioral expectations of employees and others. Management needs to ensure employees understand the code of conduct and the penalties for violations. The company should make the code readily available on its website and in employment manuals, cover it in employee education programs, and feature it in regular communications to reinforce its importance and relevance. Some companies also require a periodic acknowledgement of the code by employees and third-party providers. The audit committee should periodically review the company's code of conduct and receive regular information from management on how its content is communicated to employees and third parties.

Audit committee considerations

- *Consider whether the company's whistleblower hotline should be made available to key third-party providers.*
- *Understand whether the company tenders for long-term contracts and whether the committee has a basic understanding of bribery issues.*
- *Evaluate whether the company is performing adequate due diligence relative to bribery and corruption controls on acquisitions, mergers, and new third-party contracts.*
- *Inquire whether the company is enforcing its right to audit third-party compliance and obtaining compliance certificates from third-party providers.*
- *Ensure the company has clear compliance policies about insider trading that articulate what constitutes "material non-public information."*
- *Understand whether the company's employee policies address participation in "expert networks."*
- *Evaluate features of the company's 10b5-1 plans that could be scrutinized.*
- *Periodically review the company's code of conduct and receive regular information from management on how the code is communicated to employees and third parties.*

How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or one of the individual's noted below:

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Other topics

Other "Audit Committee Excellence Series" topics include:

- Assessing the company's forward-looking guidance practices and the potential risks of consensus estimates (March 2014)
- Financial reporting oversight (May 2014)
- Overseeing internal audit (July 2014)
- Overseeing external auditors (September 2014)
- Overseeing accounting changes—including the new revenue recognition standard (February 2015)
- Role, composition, and performance (May 2015)
- Dealing with investigations (June 2015)

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