



Fraud and the Responsibilities of the Audit Committee: An Overview

PURPOSE OF THIS TOOL: An audit committee should take an active role in the prevention and deterrence of fraud, as well as an effective ethics and compliance program. The audit committee should constantly challenge management and the auditors to ensure that the organization has appropriate antifraud programs and controls in place to identify potential fraud and ensure that investigations are undertaken if fraud is detected. The audit committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This tool is intended to make audit committee members aware of their responsibilities as they undertake this important role. This tool highlights areas of activity that may require additional scrutiny by the audit committee.

Fraud can be very costly to all types of organizations, including not-for-profit organizations. According to the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose an estimated 7 percent of annual revenues to fraud.¹ Their research also indicates that there is anecdotal evidence that fraud at not-for-profit organizations may be even higher. This is due to the fact that not-for-profit organizations are not implementing the most effective fraud controls, such as whistle-blower hotlines and management review of financial statements, and are focusing their resources on the least effective fraud controls.² The cost of fraud not only includes the financial cost, but also costs such as damage to the organization's reputation, potential loss of donors or other resource providers, loss of management and board expertise, and many other nonfinancial costs.

Definition and Categories of Fraud

An understanding of fraud is essential for the audit committee to carry out its responsibilities. The term *fraud* is defined in Black's Law Dictionary (Sixth Edition, 1990) as

An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury ... A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.

¹ Association of Certified Fraud Examiners (ACFE), *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 8.

² ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 40.

The ACFE defines *occupational fraud* as

The use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets³

The audit committee also needs to be aware that fraud affecting the organization often falls within one of the following three categories:

- *Management fraud*, which involves senior management's intentional misrepresentation of financial statements, or theft or improper use of an organization's resources.
- *Employee fraud*, which involves nonsenior employee theft or improper use of an organization's resources.
- *External fraud*, which involves theft or improper use of resources by people who are neither management, nor employees of the firm.

This categorization of fraud is useful, but not absolute. Middle management employees may intentionally misrepresent financial statement transactions, for example, to improve their apparent performance, or outside individuals may collude with organization management or employees.

Roles of the Audit Committee in the Prevention, Deterrence, Investigation, and Discovery or Detection of Fraud

The members of the audit committee should understand their role of ensuring that the organization has antifraud programs and controls in place to help prevent fraud, and aid in its discovery if it does occur, to properly fulfill their fiduciary duties of the following:

1. Monitoring the financial reporting process
2. Monitoring the internal control system
3. Overseeing the external audit and internal audit functions
4. Reporting findings to the board of directors
5. Monitoring and overseeing the whistle-blower policy and hotline

Guidance to boards of directors and trustees, audit committees, and management to help prevent, deter, and detect fraud is contained in the AICPA's Antifraud & Corporate Responsibility Resource Center available at www.aicpa.org/antifraud/homepage.htm. The information contained in the center can be viewed from different user perspectives for a personalized focus on the issues.

Not-for-profit organizations can use the specific requirements for audit committees as outlined in the Sarbanes-Oxley Act and the Securities and Exchange Commission rules as a guide. The requirements can be obtained from the AICPA Web site at www.aicpa.org/sarbanes/index.asp.

The audit committee should ensure that the organization has implemented an effective ethics and compliance program, and that it is periodically tested. Because the occurrence of significant frauds can frequently be attributed to an override of internal controls, the audit committee plays an important role to ensure that internal controls address the appropriate risk areas and are functioning as designed.

³ ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 6.

Internal auditors and external auditors can serve a vital role in aiding in fraud prevention and deterrence. Internal audit staff and external auditors that are experienced and trained in fraud prevention and deterrence can help to provide assurance that (1) risks are effectively identified and monitored, (2) organizational processes are effectively controlled and tested periodically, and (3) appropriate follow-up action is taken to address control weaknesses. The audit committee needs to ensure that internal and external auditors are carrying out their responsibilities in connection with potential fraud.

Whistle-Blowers

According to the ACFE, the most effective method for detection of fraud has historically been tips.⁴ In many cases, these tips are obtained through the use of whistle-blower policies and hotlines. Not-for-profit organizations must establish procedures for the receipt, retention, and treatment of complaints received by the organization regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the organization of concerns regarding questionable accounting or auditing matters (see Sarbanes-Oxley Act of 2002, Title III, Section 301.) In many organizations, the audit committee is significantly involved monitoring the whistle-blower process. The audit committee chair or the entire committee may be involved in the primary investigation and review of the whistle-blower complaints and reporting. In addition, some organizations have designated the audit committee chair or an audit committee member as the individual who initially receives whistle-blower reports. See also the “Sample Whistle-Blower Tracking Report” in this toolkit.

When Fraud Is Discovered

Fraud can be discovered through many sources, namely, internal or external auditors, forensic accounting consultants, employees, vendors, and others. Establishing a confidential hotline can also be an important source of information leading to fraud discovery, as part of an organization’s overall ethics, compliance, and fraud prevention program. Although a confidential hotline is something that could be accomplished internally, a variety of outside service providers can be engaged to provide this service for the organization.

If fraud or improprieties are asserted or discovered, the audit committee—through the external auditors, internal auditors, or forensic accounting consultants, as appropriate—should investigate, and, if necessary, retain legal counsel to assert claims on the organization’s behalf. Forensic accounting consultants, in particular, may be needed to provide the depth of skills necessary to conduct a fraud investigation and, if it is desirable, to get an external assessment.

If fraud is discovered or there is a reasonable basis to believe that fraud may have occurred, the audit committee is responsible for ensuring that an investigation is undertaken. Criteria should be in place describing the audit committee’s level of involvement, based on the severity of the offense. Most audit committees will also want to obtain information about all violations of the law and the organization’s policies.

Forensic accounting consultants can also frequently provide audit committees with other related advisory services, namely, (1) evaluations of controls designs and operating effectiveness through compliance verification, (2) creation of special investigations units, (3) incident management committees, (4) disclosure risk controls, (5) ethics hotlines, (6) code of conduct, and other antifraud measures.

The audit committee can engage the audit firm to carry out a forensic or fraud investigation. If CPA forensic accountants are engaged by the organization’s general counsel, rather than the audit committee, they may potentially attain attorney-client privilege status, not otherwise available under normal circumstances.

⁴ ACFE, *2008 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2008, p 20.

Expertise of Forensic Accounting Consultants

In some situations, it may be necessary for an organization to look beyond the external audit team for expertise in the fraud area. In such cases, forensic accounting consultants can provide additional assurance or advanced expertise because they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting consultants may also provide fresh insights into the organization's operations, control systems, and risks. The work of forensic accounting consultants may also provide comfort for the organization's CEO and CFO. Forensic accounting consultants, however, cannot act as an insurer to prevent or detect fraud.

Many forensic accountants have obtained specific training in the identification and detection of fraud and may have additional designations such as certified fraud examiner. More information about certified fraud examiners may be located at the Web site for the ACFE at www.acfe.com

Conclusion

The public is demanding greater vigilance from all parties involved in organizational governance, thus increasing the need to fight fraud. Audit committees are required to play a pivotal role in the prevention and deterrence of fraud, and to take appropriate action in the discovery of fraud. External public accountants, hired by audit committees, and internal auditors will continue to play an important part in the process. Forensic accounting consultants have emerged, however, as vital, newly recognized allies. Qualified forensic accounting consultants have the education, training, and experience to provide additional assistance to audit committees so they may better carry out their fiduciary responsibilities in the fight against fraud.