MANAGEMENT OVERRIDE OF INTERNAL CONTROL:

The Achilles' Heel of Fraud Prevention

The Audit Committee and Oversight of Financial Reporting

American Institute of Certified Public Accountants

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2005 Antifraud Programs and Controls Task Force

Ronald L. Durkin, *Chair*
Mark Beasley
Toby J.F. Bishop
David Cotton
George P. Fritz
Dan L. Goldwasser
Ronald B. Norris
Zoe-Vonna Palmrose
Thomas M. Stemlar

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AICPA Staff

Charles E. Landes
Vice President—Professional Standards

Michael P. Glynn
Senior Technical Manager
Audit and Attest Standards

Andrew Mrakovcic
Technical Manager
Audit and Attest Standards

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NOTICE TO READERS

Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention was originally published in 2005. This 2016 update makes relatively minor revisions to the original publication to align the earlier document with more recent technical guidance, pronouncements, and professional standards.

The purpose of this best practices document is to offer guidance to audit committees in addressing the risk of fraud through management override of internal control over financial reporting. By effectively overseeing management and addressing the risk of management override, audit committees increase the likelihood of preventing, deterring, and detecting fraudulent financial reporting. The guidance in this document is applicable, in various degrees, to audit committees of publicly traded companies; nonpublic companies; not-for-profit organizations; federal, state, and local government entities; and other entities.

This document is meant to help facilitate the audit committee's consideration of the risk of management override of internal control. If the reader would like to learn more about management antifraud programs and controls, please see the document titled *Fraud Risk Management Guide*, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the Association of Certified Fraud Examiners (ACFE).

This document represents the views of the members of the AICPA's Antifraud Programs and Controls Task Force and has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA. This document has no authoritative status. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate.

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The risks of fraud and management's ability to override internal control are present in *every* entity.

Section A: Management Override and the Audit Committee's Responsibilities

The chair of the audit committee of ControlCo was stunned. Company counsel had just advised him that the prior year's revenue and earnings may have been overstated. "But how could that happen? We have good internal control, and management and the auditors both signed off that they were effective!" he said. Ultimately, the chair learned of the "Achilles' heel" of any system of fraud prevention: Those who design and implement internal control—management—can also override or bypass those controls. The chair began to wonder, What might we have done differently? How can an audit committee prevent management from overriding internal control? *A few weeks later, as the fraud became public, the chair felt even worse when reading the headline in the local newspaper: "Where Was the Audit Committee?"*

Then, regulators and class action lawyers began to ask:

- *Was the audit committee sufficiently involved, or were the members simply listeners? Did the audit committee's actions demonstrate an appropriate level of skepticism?*
- *Did the individual members of the audit committee carefully read the quarterly financial statements? Did they understand the correct key performance indicators?*
- *Was the audit committee alert to financial statement fraud risk factors? Did the audit committee members focus on the potential for manipulation of financial statements?*
- *Were the entity's code of conduct and whistleblowing processes really important to the entity, or was it simply an effort to comply with regulatory requirements?*
- *Was the audit committee making best use of the entity's internal auditors and independent auditors?*

Even though internal control over financial reporting (hereinafter referred to as *internal control* or simply as *controls*) may appear to be well-designed and effective, controls that are otherwise effective can be overridden by management in every entity. Many financial statement frauds have been perpetrated by intentional override by senior management of what might otherwise appear to be effective internal control. Indeed, with very few exceptions, most of the major fraud cases in the past 50 years that had catastrophic results for the organization were perpetrated by senior members of management circumventing or overriding seemingly sound systems of internal control. Audit committees may reduce the risk of material misstatement in the financial statements due to fraud by addressing the risk of management override of internal control as part of their oversight of the financial reporting process. This document provides guidance to audit committees in considering the risk of management override of internal control—the Achilles' heel of fraud prevention.

Because management is primarily responsible for the design, implementation, and maintenance of internal control, the entity is always exposed to the danger of management override of controls, whether the entity is publicly held, private, not-for-profit, or governmental. When the opportunity to override internal control is combined with powerful incentives to meet accounting objectives, senior management may engage in fraudulent financial reporting. Thus, otherwise

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effective internal control cannot be relied upon to prevent, detect, or deter fraudulent financial reporting perpetrated by senior management.

Management may override controls to intentionally misstate the nature and timing of revenue or other transactions by (1) recording fictitious business events or transactions or changing the timing of recognition of legitimate transactions, particularly those recorded close to the end of an accounting period; (2) establishing or reversing reserves to manipulate results, including intentionally biasing assumptions and judgments used to estimate account balances; and (3) altering records and terms related to significant or unusual transactions.

The board[1] of directors and its audit committee are responsible for overseeing the actions of management. Corporate directors can no longer argue that they acted diligently in carrying out their responsibilities if they have failed to design a strong audit committee charter and timely perform all the functions specified therein. With respect to audit committee members, this includes the duty to inquire into the adequacy of their organization's internal control, both in theory and in practice, and to take actions, such as those described in this document, to minimize the possibility that internal control are overridden by management, thereby resulting in undetected fraud.

An appropriate tone at the top (set by the board of directors), implementation of a code of conduct or ethics, training programs, expanded auditing and public reporting on the effectiveness of internal control as required by the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act), and enhanced criminal penalties under the act all may be helpful fraud deterrents, but their mere existence will seldom provide assurance that management override can be prevented or timely detected.

> The COSO *Internal Control—Integrated Framework* (2013) states that an "Internal control system is … able to provide reasonable assurance—but not absolute assurance, to an entity's senior management and board of directors…. While internal control provides reasonable assurance of achieving the entity's objectives, limitations do exist…. Limitations may result from the … ability of management to override internal control."

A diligent audit committee will evaluate whether oversight mechanisms are in place and functioning that will prevent, deter, or detect management override of internal control. Furthermore, the U.S. Federal Sentencing Commission's Federal Sentencing Guidelines (Federal Sentencing Guidelines) increase expectations for antifraud programs and controls and can serve as one useful tool in assessing the entity's antifraud programs and controls.

> The Federal Sentencing Guidelines) "offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical

[1] Throughout this publication, the terms *board* and *board of directors* refer to the governing or oversight body or those charged with governance of the organization.

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conduct and in complying fully with all applicable laws." [Footnote: 2014 Guidelines Manual, Chapter 8, Introductory Comments.]

The U.S. Federal Sentencing Commission first promulgated organizational sentencing guidelines in 1991. The sentencing guidelines apply to almost all types of organizations, including corporations, partnerships, unions, not-for-profit organizations, and trusts. One significant aspect of the sentencing guidelines is that each organization is responsible for the wrongful acts of its employees as long as the employees were acting in their official capacity—even if the organization did not know or approve of the employees' actions. The compliance program component has been a vital part of the sentencing guidelines since that time. Included in the sentencing guidelines are seven minimum requirements to be used to test the effectiveness of a compliance program. Those seven elements are as follows:

1. Establish policies, procedures, and controls
2. Exercise effective compliance and ethics oversight
3. Exercise due diligence to avoid delegation of authority to unethical individuals
4. Communicate and educate employees on compliance and ethics programs
5. Monitor and audit compliance and ethics programs for effectiveness
6. Ensure consistent enforcement and discipline of violations
7. Respond appropriately to incidents and take steps to prevent future incidents

Section B: Actions to Address the Risk of Management Override of Internal Control

Management override is very difficult to detect. However, an audit committee can take actions to address the risk of management override of controls. This section outlines several actions: maintaining an appropriate level of skepticism, strengthening committee understanding of the business, brainstorming about fraud risks, using the code of conduct to assess financial reporting culture, ensuring the entity cultivates a vigorous whistleblower program, and developing a broad information and feedback network.

Maintaining Skepticism

An effective starting point for the audit committee in assessing fraud risk is the exercise of an appropriate level of skepticism when considering the risk of management override of internal

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control. Skepticism is an attitude that acknowledges that fraud risks, including the risk of management override, exist in every entity. An appropriate level of audit committee skepticism requires alertness to potential fraud risk factors and a willingness to ask sometimes difficult and perhaps even embarrassing questions. It also requires an environment that encourages open and candid discussion among audit committee members and sufficient time to think and consider "what if" scenarios related to the possibilities of fraud at the entity. In considering the risk of management override of internal control, the audit committee will set aside any beliefs about the integrity of management because override is most often committed by "good executives gone bad," rather than consistently dishonest people.

Appropriate skepticism by audit committee members is essential to their assessment of the risk of management override of internal control. With an appropriate attitude about the ever-present risk of management override, audit committee members can use their knowledge of the business and related financial statement risks to explicitly oversee the risk of management override of controls. Additionally, an open display of skepticism, in itself, can be a deterrent to management override of controls.

Strengthening Committee Understanding of the Business

Audit committees need a solid knowledge of the industry and business to form the foundation for effective oversight. Because financial reporting to stakeholders should reflect the economic activity of the entity, industry and entity knowledge is critical for determining whether the entity's financial reporting is sufficient for its users. That knowledge also helps the audit committee identify and understand business and financial risks that may increase the likelihood of fraud.

Most businesses plan legitimate reactions to variances from expected financial performance. Those reactions may include either new or additional transactions, or the cancellation, reduction, or postponement of transactions otherwise planned. For example, a business that is not meeting its earnings goals may accelerate or delay incurring expenses. It may decide on more or fewer new employees than planned, or it may change the pattern or timing of research and development or marketing efforts. An entity facing a profit shortfall may attempt to increase sales through a variety of means, including reducing prices, offering incentives, or expanding its sales force. Conversely, an entity surpassing its budgeted revenues may decide to slow sales by not filling orders for a short time to minimize overtime costs and balance customer inventory levels. These are usually legitimate, transaction-oriented means of "managing" operations.

When a business is unable to achieve desired results legitimately, the temptation to override internal control to manipulate reported results can ensue. The distinction between what is legitimate and not legitimate is not always clear, particularly when estimates are involved or when the accounting depends on a management decision. Understanding key earnings drivers and management's planned reactions to variations from expected performance increases the audit committee's ability to identify situations in which management's actions may have crossed the line and may no longer be legitimate. Audit committees will consider whether transactions make sense in the context of legitimate business purposes.

Management controls the key sources of revenue and earnings volatility through the management of the company's underlying business, operations, credit, and market risks. Management also is responsible for the numerous estimates and judgments underlying reported results. These sources include judgments on asset values, estimated liabilities, and contingencies, to name only a few. In some cases, nonfinancial data, such as subscribers or customers, or units sold, can be critical drivers of earnings and revenue. An audit committee that does not understand the key drivers of earnings and revenue and fails to focus on related

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key performance indicators may not be able to properly monitor management and may not have a reasonable chance of identifying fraud risk factors in advance of a crisis.

The identification of fraud-related incentives or pressures, opportunities, and attitudes or rationalizations begins with each audit committee member obtaining a solid and complete understanding of the business. This understanding can be used to assess fraud risk as the audit committee evaluates press releases, analysts' forecasts and reports, and financial reports to shareholders. Understanding the nature of the entity's core lines of business and management's compensation package may help the audit committee identify significant incentives or opportunities for fraud. Historically, technology, telecommunication, and service entities have been particularly vulnerable to these risks. In addition, certain industries or business operations are subject to accounting and financial reporting issues that are grounded in subjective determinations. These provide an opportunity for management to perpetrate a financial fraud.

Fraud-related incentives or pressures, opportunities, and attitudes or rationalizations constitute the "fraud triangle." According to auditing standards generally accepted in the United States of America (paragraph .A1 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* [AICPA, *Professional Standards*]):

Fraud, whether fraudulent financial reporting or misappropriation of assets, involves incentive or pressure to commit fraud, a perceived opportunity to do so, and some rationalization of the act, as follows:

- Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps, unrealistic) earnings target or financial outcome—particularly because the consequences to management for failing to meet financial goals can be significant. Similarly, individuals may have an incentive to misappropriate assets (for example, because the individuals are living beyond their means).

- A perceived opportunity to commit fraud may exist when an individual believes internal control can be overridden (for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control).

- Individuals may be able to rationalize committing a fraudulent act. Some individuals possess an attitude, character, or set of ethical values that allow them knowingly and intentionally to commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

A next step in identifying fraud risks involves the audit committee's understanding of what may threaten management's ability to accomplish its objectives and strategies. Those threats or risks include competition, capital constraints, major customer or vendor loss, production issues, economic downturn, or regulatory change. They too may create incentives or pressures for engaging in fraud.

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It is important for the audit committee to understand the financial reporting environment (for example, attitudes, ethics, motives, and pressures) affecting the CEO, CFO, and others who are involved in the entity's financial reporting. The internal reporting process between key segments of the business (across lines of business, divisions, and geographic segments) and senior management may also be important and worthy of audit committee inquiry. Unrealistic performance expectations, real or perceived, have too often been the catalyst for financial statement fraud at remote or relatively small business units. Information obtained by the audit committee about differences in the financial reporting cultures across different units may signal areas within the company where fraud risks may be heightened.

It is useful to understand the process of developing, reviewing, and revising budgets, as well as the company's budget "mentality." Because the operating budget can establish the earnings that the company hopes to report, it may prompt management to manage earnings when operations are not in line with expectations. For example, a budget that is intended as an incentive to divisions and subsidiaries to reach their highest potential can create pressures on managers to falsify reported results. An early challenge to an unrealistic budget by a well-informed audit committee can be an effective deterrent against management override of controls to reach unrealistic targets.

Finally, it is always important for the audit committee to have a thorough understanding of the incentives and pressures management personnel face due to the entity's incentive compensation programs. The ability to exercise stock options when the stock price reaches predetermined levels and financial performance-related bonuses can be strong motivators for positive change but can also place intense pressure on management to "manage" earnings improperly.

Brainstorming to Identify Fraud Risks

Members of the audit committee can increase their effectiveness in dealing with the potential of management override of internal control by discussing, among themselves, the potential for fraud. An exchange of ideas or "brainstorming" about how and where they believe the entity may be susceptible to fraud, what might motivate management to perpetrate fraud, how management might override controls to engage in and conceal fraudulent financial reporting, and how entity assets could be misappropriated can be useful for this purpose. The brainstorming session's effectiveness is increased if conducted, at least partially, in closed or executive session without management present.

The brainstorming session includes a consideration of known external and internal factors affecting the entity that might (1) create incentives or pressures for management and others to commit fraud, (2) provide the opportunity for fraud to be perpetrated, and (3) indicate a culture or environment that enables management to rationalize committing fraud. An attitude that includes a questioning mind, as described previously and, for this purpose, setting aside any prior positive beliefs regarding the honesty and integrity of management increases the usefulness of the discussion.

Audit committee discussions with internal auditors, independent auditors, counsel, the compensation committee, human resources, the compliance officer, marketing and sales, and business unit leadership may provide important input to the brainstorming session. Guidance as to the substance of those discussions is provided later in this document.

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Considering schemes used to perpetrate management fraud at other entities and the degrees to which such schemes might occur at this entity may also increase the effectiveness of the session. An antifraud specialist, working with the audit committee, can often enhance the effectiveness of the brainstorming session. The appendix to this document discusses fraud schemes and items the audit committee may consider when brainstorming to identify fraud risks.

Some initiatives that are especially important for having an effective brainstorming session include advance preparation by participants and efforts to ensure an open and frank discussion by all participants. A tendency in many brainstorming sessions is for the group to be overly influenced by initial ideas of a dominant personality. As such, the group will include ideas from all participants before determining which are most helpful. Once several fraud risks are identified, a prioritization by the combined likelihood of occurrence and the magnitude of impact can help focus the committee's efforts.

Possible brainstorming agenda items include the results of whistleblower hotline calls, fraud risk assessments performed by the company's independent auditors, fraud risk assessments performed as part of the entity's fraud risk management process, and other fraud risk factors or concerns identified by audit committee members.

Using the Code of Conduct to Assess Financial Reporting Culture

Most organizations have a code of conduct. The mere existence of a code, however, is not sufficient to reduce the likelihood of management override of controls.[2] The audit committee can use the code of conduct as a benchmark for assessing whether the culture or tone at the top and management's actions are those required to maintain the highest levels of integrity under pressure and opportunity to commit fraud. The code also facilitates the reporting of inappropriate conduct by delineating the types of conduct the organization deems unacceptable.

The audit committee will be routinely furnished with the results of any surveys of employees regarding corporate behavior and similar information received from external parties, such as customers and vendors. These can be excellent sources of information for the audit committee about the culture or tone at the top. Perceptions of management's commitment to uphold the code influence the degree to which employees and other parties follow the code and report violations of the code. The extent to which management is perceived to be committed to conduct sanctioned by the code will influence the audit committee's ability to deter, prevent, or detect management override of internal control. Equally important, an evaluation by the audit committee of how management communicates information about the code and motivates employees to comply with the code also provides information reflecting the culture or attitudes about ethical behavior within the organization. Employee awareness and training about the code may signal information about management's commitment to the code and indicate the likelihood that employees will report management code violations. Conversely, a lack of awareness by employees may signal management's lack of commitment to ethical conduct.

Cultivating a Vigorous Whistleblower Program

A key defense against management override of internal control is a whistleblowing process that typically incorporates either a telephone or web-based hotline, or a combination of both. The Association of Certified Fraud Examiners (ACFE) biennial fraud surveys consistently

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[2] As a result of the Sarbanes-Oxley Act of 2002, Section 406, the SEC set rules requiring registrants to disclose whether the issuer has adopted a code of ethics for its senior executive officers and, if not, why.

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reveal that various forms of fraud are detected more than 40 percent of the time by tips from employees of the victim organization. Thus, this is the leading method for detecting fraud.[3] Although the Sarbanes-Oxley Act[4] requires that confidential reporting mechanisms be made available only to employees, opening the system to suppliers, customers, and others can increase the number of reports by approximately 50 percent.[5]

The audit committee can assist in creating strong antifraud controls by encouraging the development of a culture in which employees view whistleblowing as a valuable contribution to an attractive workplace of integrity and their own futures. The reporting mechanisms must demonstrate confidentiality so potential whistleblowers are assured that their concerns will be properly considered and that they will not be subjected to retribution. Successful whistleblowing procedures require strong leadership from the audit committee, the board of directors, and management.

For the audit committee to effectively monitor the risk of management override of internal control, the automatic and direct submission to the audit committee of all complaints involving senior management (without filtering by management or other entity personnel) is essential. The audit committee's primary interest is complaints related to accounting, internal control, and auditing.

By engaging internal auditors to periodically evaluate the design and operating effectiveness of the hotline, the audit committee can ensure that the hotline reflects changes in the company's operations and in best practices and indicate satisfactory support from management, employees, and other participants. Tests and evaluations by internal auditors of whether protocols established for forwarding information to the audit committee have been followed are important.

Developing a Broad Information and Feedback Network

Identifying situations when management has overridden internal control is difficult because those actions are not obvious and are not expected of a trusted management team. To respond to that challenge, the development of an extensive information network that extends beyond senior management may significantly increase the audit committee's ability to detect management override of internal control. In addition to the financial reporting process, the network often includes the following:

- Internal auditors
- Independent auditors
- Compensation committee
- Key employees

The audit committee may consider meeting periodically with representatives from each of the above groups to discuss matters affecting the financial reporting process, including significant

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[3] See Association of Certified Fraud Examiners, various *Reports to the Nations on Occupational Fraud and Abuse* (Austin, TX: ACFE), www.acfe.net.

[4] A whistleblowing hotline is the *statutory responsibility of the audit committee* and cannot simply be delegated to entity officials. Section 301 of the Sarbanes-Oxley Act of 2002 requires that audit committees establish effective "whistleblowing" procedures.

[5] See Association of Certified Fraud Examiners, various *Reports to the Nations on Occupational Fraud and Abuse* (Austin, TX: ACFE), www.acfe.net.

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estimates, fraud risks, key internal controls, and any other items of concern. Inconsistencies in information obtained from these sources may signal that management override of internal control is present. The information obtained from these sources may be useful to the audit committee in its brainstorming session about the risk of management override of internal control.

Communications With Internal Auditors

First and foremost, the internal audit department will understand that its responsibilities are primarily to the audit committee. A strong internal audit function may also include audit committee oversight of the internal audit group's budget approval process and its policies regarding hiring, evaluation, training, and termination of internal audit staff. Terminating or transferring high level internal audit personnel will be ultimately determined by the audit committee.

Executive sessions with the head of the internal audit function at every audit committee meeting provide the audit committee a unique opportunity to engage in candid discussions with him or her about the possible risk of management override of internal control and any indications of improper conduct by senior management.

The audit committee, by understanding and assisting in developing the internal auditors' annual audit plan, will influence the internal auditors' agenda by directing the plan's emphasis to areas of particular interest to the audit committee. These areas might include fraud risks—particularly matters that surfaced during the brainstorming session—and controls over judgments and estimates and key information processes. A properly directed internal audit staff can serve as the "eyes and ears" of the audit committee.

Specific inquiries might include the following:

1. What fraud risks are being monitored by the internal audit team on a periodic or regular basis? How does internal audit address the continuous auditing of these critical risks, in particular, with respect to the use of data analytics?
2. What specific procedures does internal audit perform to address management override of internal control?
3. Has anything occurred that would lead internal audit to change its assessment of the risk of management override of internal control?

Communications With Independent Auditors

The Sarbanes-Oxley Act requires that the independent auditors be appointed by the audit committee. As a best practice, all audit committees—even those not subject to the Sarbanes-Oxley Act—may consider being responsible for the appointment of the independent auditors. In this way, the audit committee can ensure that the independent auditors report directly to the committee. A strong and candid relationship, including an open dialogue between the independent auditors and the audit committee, can provide a useful foundation for the audit committee's assessment of fraud risk, including the risk of management override of internal control.

Specific inquiries might include the following:

1. What fraud risks are independent auditors addressing through audit procedures, in particular, risks related to management override of internal control?

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2. What other matters were discussed in the audit team brainstorming session on fraud risk?
3. What were the results of the independent auditors' inquiries of management about fraud? Did those inquiries result in the identification of specific processes, transactions, or people that were the subject of concerns regarding higher fraud risk?
4. What are the results of audit procedures designed to address the risk of management override of internal control?

Additionally, the audit committee will be aware that the independent auditors are required to address the risk of management override of controls apart from any conclusions regarding the existence of other risks.[6] The audit committee members will recognize that the independent auditors have given extensive consideration to the risk of financial statement fraud and use the work performed by the independent auditors to the greatest extent possible.

> Paragraph .15 of AU-C section 240 states that AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), requires a discussion among the key engagement team members, including the engagement partner, and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. Paragraph .15 of AU-C section 240 also requires that this discussion should include an exchange of ideas or brainstorming among the engagement team members about how and where the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated.

Communications With the Compensation Committee

The compensation committee of the board approves programs for executive compensation and broad-based incentive plans. The audit committee's understanding of these plans is important when the plans may result in a heightened risk of fraudulent financial reporting primarily through creating excessive incentives or pressures to meet the plans' targets.

In addition to reviewing the minutes of compensation committee meetings, it is important for the audit committee to understand the performance incentives and possible unintended consequences that could lead to fraudulent financial reporting. For example, if company-wide earnings-per-share is a major factor affecting compensation, or if stock or option awards are a significant element of compensation, management's integrity can be put under stress if the company has difficulty meeting earnings targets. Additionally, when the compensation committee evaluates management's performance, best practices might include the compensation committee seeking the audit committee's assessment of the entity's internal control environment, including the tone at the top.

Communications With Key Employees

[6] See paragraph .32 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).

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The development of an information network with other key entity employees can be very beneficial. Focal points to consider include the general counsel, compliance or security director, human resources department, marketing or sales department, and business unit leaders.

The entity's general counsel may be aware of potential violations of laws and regulations, violations of the entity's code of conduct, or pressures that management may be experiencing. Typically, the audit committee's inquiry of the general counsel about any known pressures to structure significant or unusual transactions designed to achieve financial targets may signal the possibilities of fraud. Additionally, the general counsel generally would be asked about major legal risks that the entity may be facing, which may create significant pressures to engage in fraud. Specific questions to the general counsel can be structured by the audit committee based on the environment and can be focused, as appropriate, on issues potentially affecting management integrity. Additionally, as a best practice, the audit committee may consider having a dialogue with the entity's external counsel. If such a dialogue is established, the audit committee may ask about any inquiries that management may have made to the external counsel.

The human resources department may also play a key role in the audit committee's information network. Pre-employment screening, monitoring, and employee discipline are all part of the entity's antifraud program. The exit interview process and resignation letters with respect to employees in the accounting and finance function, employee surveys, and whistleblower hotline reports about human resources issues may be valuable sources of information regarding management integrity and the tone at the top.

The audit committee will want to establish an open and comfortable reporting relationship with the entity employee who has responsibility for compliance with laws and regulations and physical security. Frequent violations of laws or regulations may indicate a cavalier attitude by management regarding rules and an increased risk of management override of internal control.

Revenue recognition is almost always a fraud risk. Periodic conversations with the appropriate marketing and sales personnel about company policies and controls over selling activities may reveal pressures to meet revenue targets and possible inappropriate behavior. Marketing personnel may not fully appreciate the accounting significance of certain types of contract provisions—formal or informal. Interaction with the audit committee can help send an important message and further strengthen a tone at the top across the broader organization. Additionally, sales-related activities have been the focal point of numerous financial statement frauds relating to distorted revenue or sales transactions. This type of risk is higher in certain industries and often can simply involve aggressive marketing rather than fraud. Nonetheless, the misstatement of the financial statements can be significant. Therefore, the audit committee may often find it beneficial to meet with appropriate marketing and sales personnel to determine whether any revenue recognition issues exist and how management override could result in fraudulent revenue recognition.

Leaders of business units within an enterprise may face significant incentives or pressures imposed by senior management to meet internal targets or other performance metrics. When business unit leaders perceive these incentives or pressures to be extreme, they may be motivated to engage in activities that may include the override of internal control to fraudulently report financial results related to business unit operations. Business unit leaders may also be aware of senior management activities to override internal control performed at the business unit level for purposes of fraudulently reporting financial results at the consolidated level.

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Dialogue with business unit leaders about performance-based incentives and management-imposed pressures may provide the audit committee with effective information about the risk of potential management override of internal control to fraudulently distort financial performance. For example, periodic inquiry of key business unit leaders about their perceptions of senior management pressure to meet performance targets and whether business unit leaders have been asked by senior management to engage in questionable activities to meet those targets may provide insightful information to the audit committee about the potential presence of management override of internal control.

Additionally, the layer of management below senior management may be the most likely to be aware of management override and, therefore, establishing an open line of communication with members of management one or two levels below senior management is important.

To identify information about potential financial statement fraud, the audit committee will need to establish a confidential dialogue with key employees. For example, an audit committee member who avails himself or herself of an opportunity to interact with key employees during company meetings or functions may get a sense of employee attitudes toward the company. The audit committee member may also learn about the tone at the top, employee knowledge of antifraud programs and controls, including the whistleblower program, and other information that employees may be reluctant to communicate through the whistleblower program. Whenever audit committee members are "out and about," it may be beneficial to take advantage of the opportunity to talk to entity leaders. The important, and sometimes difficult, task is to do so without damaging relations with management by sending a strong message of mistrust.

Conclusion

The risk of management override of internal control is present in every entity. Although the best practices guidance provided in this document cannot guarantee that the audit committee will prevent, deter, or detect fraud through management override of internal control, the implementation of these suggestions will result in more effective audit committee oversight of management. Perhaps most importantly, this guidance may prevent the nightmare scenario of ControlCo (see page 1) and the subsequent question, "Where was the audit committee?"

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Appendix: Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks

As an audit committee addresses fraud risk in general and risk of management override in particular, it is useful to consider frequently occurring fraud schemes and ask, "Can they happen here?" Evidence from fraud-related research may be helpful in this regard.[1]

Research has found that the most frequent type of fraud is asset misappropriation (about 80 percent to 85 percent of reported cases). Financial statement frauds (usually perpetrated by senior members of management) account for about 8 percent to 10 percent of reported cases. Although financial statement or managerial frauds are less frequent, such frauds can have catastrophic results. The median loss caused by asset misappropriation is about $120,000 to $130,000. The median loss caused by financial statement fraud is about $1 million.

Frauds perpetrated by owners and executives account for only about 19 percent of reported cases (whereas frauds perpetrated by employees account for about 41 percent of reported cases). But, the median loss due to owner and executive frauds was more than $700,000 (whereas the median loss due to employee frauds was about $65,000).

Discovered frauds perpetrated by employees took a median of 12 months to detect. Discovered frauds perpetrated by owners and executives, however, took a median of 24 months to detect.

Although management is primarily responsible for designing, implementing, and maintaining controls for preventing employee fraud, management cannot be relied upon for preventing financial statement or management fraud. That is a key responsibility of the audit committee.

As the audit committee evaluates the entity and entity management, it can be helpful to ponder the questions in this appendix related to the three elements of the "fraud triangle:" incentives or pressures, opportunities, and attitudes or rationalizations. These queries can be particularly helpful in structuring an effective brainstorming session. Answers to these questions can also provide focus for planning additional steps designed to control the risk of management override of internal control. Some of these additional steps can be undertaken by the audit committee. Other follow-up assessment steps can be delegated to internal or external auditors. A positive answer to any of the following questions does not necessarily imply that fraud has occurred. Rather, a positive answer indicates that a heightened risk of fraud may exist, and further evaluation by the audit committee may be prudent.

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[1] These statistics are based on research conducted by the Association of Certified Fraud Examiners. See Association of Certified Fraud Examiners, various *Reports to the Nations on Occupational Fraud and Abuse* (Austin, TX: ACFE). www.acfe.net.

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Incentives or Pressures on Management

1. Is the entity's financial stability or profitability threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following?
   - High degree of competition or market saturation, accompanied by declining margins
   - High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates
   - Significant declines in customer demand and increasing business failures in either the industry or overall economy
   - Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent
   - Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth
   - Rapid growth or unusual profitability, especially compared to that of other companies in the same industry
   - New accounting, statutory, or regulatory requirements

2. Does excessive pressure exist for management to meet the requirements or expectations of third parties due to the following?
   - Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages
   - Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures
   - Marginal ability to meet debt repayment or other debt covenant requirements
   - Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards

3. Is management's personal financial situation threatened by the entity's financial performance arising from the following?
   - Significant financial interests in the entity
   - Significant portions of compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow (Note: Management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.)
   - Personal guarantees of debts of the entity

4. Is there excessive pressure on management or operating personnel to meet financial targets set by the board of directors or management, including sales or profitability incentive goals, budgets, or publicized forecasts or projections?

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5. Are earnings expected to be "managed" at the subsidiary or division level, creating pressures on lower-level managers to meet higher-level management expectations?

6. Is there a perception of adverse consequences on lower-level managers if subsidiaries or divisions fail to exceed or fall short of budgeted, projected, or forecasted results?

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Opportunities Management Can Exploit

1. Does the nature of the industry or the entity's operations provide opportunities to engage in fraudulent financial reporting that can arise from the following?
   - Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm
   - A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
   - Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
   - Significant, unusual, or highly complex transactions, especially those close to year end that pose difficult "substance over form" questions
   - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist
   - Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification
   - Significant accounting system changes, particularly the implementation of new, complex systems or where control effectiveness was not adequately considered
   - Major structural changes, such as acquisitions or spin-offs, that might have affected internal control creating the likelihood of financial statement error

2. Are significant estimates used in the annual or quarterly financial reporting process unrealistic or inconsistent with actual historical results or with the performance of other entities in the same industry?

3. Is there ineffective monitoring of management as a result of the following?
   - Domination of management by a single person or small group (in a non-owner managed business) without compensating internal control
   - Ineffective oversight over the financial reporting process and internal control

4. Is there a complex or unstable organizational structure as evidenced by the following?
   - Difficulty in determining the organization or individuals that have controlling interest in the entity
   - Overly complex organizational structure involving unusual legal entities or managerial lines of authority
   - High turnover of senior management, counsel, or board members

5. Are internal control components deficient as a result of the following?
   - Inadequate monitoring of internal control, including automated controls and controls over interim financial reporting (where external reporting is required)?

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- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems, including situations involving reportable conditions

6. Are there indications that the qualifications and capabilities of the finance or accounting organizations and key personnel need significant improvement?

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Attitudes or Rationalizations Exhibited by Management

1. Is there any evidence of ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards?

2. Is there any evidence of nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates?

3. Is there a known history of violations of securities laws or other laws and regulations, or claims against the entity or its senior management, alleging fraud or violations of laws and regulations?

4. Is there excessive interest by management in maintaining or increasing the entity's stock price or earnings trend?

5. Is there a practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts?

6. Has management failed to correct known reportable conditions on a timely basis in the past or during the current year's audit?

7. Has management exhibited an interest in employing inappropriate means to minimize reported earnings for tax-motivated reasons?

8. Have there been attempts by management to justify marginal or inappropriate accounting on the basis of materiality?

9. Is the relationship between management and the current or predecessor auditor strained, as exhibited by the following?
   - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
   - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
   - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee
   - Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement

10. Has management failed to identify business risks on a timely basis or failed to adequately monitor identified risks?

11. Has management been unwilling to address, on a timely basis, issues that could result in significant financial statement adjustments or adverse disclosures?

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12. Have management, internal auditors, or the independent auditors exhibited a less-than-diligent attitude regarding the entity's antifraud programs and controls?

13. Are disclosures and other information in Management's Discussion and Analysis of Financial Condition and Results of Operations overly optimistic or inconsistent with the audit committee's knowledge of operations, the industry, or the entity's performance?

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