



American Institute of Certified Public Accountants

Fraud Prevention and Management Override of Controls

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Much has been said in recent years about internal control over financial reporting in a company - in fact, for publicly traded companies, the review of these controls both by management and the auditors is required by the Sarbanes-Oxley Act of 2002. But who really understands internal controls, how do they help to mitigate risk, and for that matter, who really knows about management override of internal controls?

Internal control is broadly defined as a program designed and implemented by management with the oversight of the board of directors, to provide reasonable assurance regarding the achievement of the objectives of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

A robust system of internal controls is imperative for all organizations, whether they are publicly-traded, privately-owned, not-for-profit or in the government sector. Management is responsible to establish and maintain the system of internal control in an organization, and the audit committee of the board of directors (or the full board if there is no audit committee) has responsibility to oversee these processes. Not only is internal controls good business, but they also mitigate the risk of fraud in the organization by providing a system of checks and balances to minimize the chance for defalcation or misappropriation to occur.

But what happens when management overrides internal control over financial reporting? Sometimes it's OK – a necessary action when the system does not provide for unusual transactions. The important thing to remember is that any management override of control be fully transparent to other members of management, to the internal audit team, to the audit committee if it involves an override of a control over the financial reporting system of the company, and to the full board if necessary. Certainly the Office of Corporate Compliance / Chief Compliance Officer should be advised of and oversee the evaluation of any management override of internal control, particularly over financial reporting.

Unfortunately, sometimes the management override of control is conducted for a nefarious purpose - to mask real financial results, or for the misappropriation of assets. The audit committee of the board of directors has a key role in combating management override of controls. An article in the August 2002 issue of Club Management reports that 49% of all frauds occur in organizations with less than 100 employees, and cause average losses of \$127,500 per fraud scheme - which is higher in smaller companies than in larger companies where the amount per fraud scheme is less than \$100,000. The article goes on to note that managers and executives perpetrated frauds that caused losses three and one-half times greater than that caused by regular employees. How many of these frauds occurred through management override of controls?

Following are some steps the audit committee should take to strengthen this effort, for if not, the price to be paid is one of financial and reputational risk.

Actions to Address the Risk of Management Override of Internal Controls

- Maintain Skepticism - Skepticism is an attitude that acknowledges that fraud risks, including the risks 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 discussions 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 controls, the audit

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committee should set aside any beliefs about the integrity of management because override is most often committed by "good executives gone bad." In fact, the Association of Certified Fraud Examiners (ACFE) in its 2004 Report to the Nation on Fraud, reports that the typical occupational fraud perpetrator is a first-time offender. Only 7 percent of occupational fraudsters in the ACFE study were known to have prior convictions for fraud-related offenses.

- Strengthen Committee Understanding of the Business - Today's audit committees need a solid knowledge of the industry and business to form the foundation for effective oversight. 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; however, when a business is unable to achieve desired results legitimately, the temptation to override internal controls to manipulate reports results can ensue. 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.
- Brainstorm to Identify Fraud Risk - Members of the audit committee can increase their effectiveness in dealing with the potential of management override of internal controls by discussing, among themselves, the potential for fraud. An exchange of ideas about how and where they believe the entity may be susceptible to fraud, what might motivate management to perpetrate fraud, how might management override controls to engage in and conceal fraudulent financial reporting, and how entity assets could be misappropriated can be useful for this purpose. Effectiveness of the brainstorming session can be increased if it is conducted, at least partially, in executive session without management present.
- Use the Code of Conduct to Assess Financial Reporting Culture - The mere existence of a code of conduct is not sufficient to reduce the likelihood of management override of controls. The audit committee should also use the code of conduct as a benchmark for assessing whether the culture or "tone at the top" and management's actions are those necessary and sufficient to maintain the highest levels of integrity when under pressure and faced with the opportunity to commit fraud.
- Cultivate a Vigorous Whistleblower Program - Respondents to a 2004 survey by ACFE revealed that various forms of fraud are detected 40% of the time by tips, which made this the leading method for detecting fraud. 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 relating to accounting, internal controls, and auditing.
- Develop a Broad Information Feedback Network - Identifying situations where management has overridden controls 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 can significantly increase the audit committee's ability to detect management override of internal controls. This network often includes internal auditors, independent auditors, compensation committee and key employees. The audit committee may consider meeting periodically with representatives of each of these groups to discuss matters affecting the financial reporting process. ACFE reports that among frauds committed by owners and executives, which tend to be the most costly, over half of all cases were identified by a tip.

This paper is based on a publication titled *Management Override of Controls: The Achilles' Heel of Fraud Prevention*, copyright © 2005 by American Institute of Certified Public Accountants. For a free download of the full document use this link: http://www.aicpa.org/audcommctr/spotlight/achilles_heel.htm



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