Securities Litigation Alert

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What Audit Committees Can Do to Prevent Accounting Fraud in Uncertain Times

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Key Takeaways:

- The COVID-19 crisis creates heightened risk of improper financial reporting.
- Audit committees can and should take steps to help prevent such frauds.
- Audit Committees should maintain the appropriate tone at the top, understand changes to internal controls in light of COVID-19, and scrutinize unusual financial reporting items.

COVID-19 is taking an immense toll on people and the economies on which they depend. In the midst of such disconcerting circumstances, companies are confronting urgent business needs on multiple fronts: supporting employees, maintaining business operations, conserving liquidity, and making adjustments to both short-term and long-term corporate strategy. Such chaotic conditions, unfortunately, can become fertile ground for another concern: fraud. While corporate management and others play a significant role in ensuring that a company does not resort to accounting schemes, audit committees can and should provide an important counterweight to the risk of improper accounting practices. Below, we identify certain financial reporting pitfalls audit committees should look out for and explain what audit committees can do to avoid them. As regulators have reminded us recently, in this crisis "investors and other stakeholders need high quality financial information more than ever,"[1] and audit committees serve a crucial role in delivering that information.

The Snowball Effect

A vast majority of companies operate with high integrity. But even sound companies can encounter the occasional case of a well intentioned accounting workaround gone awry, or a bad apple who engages in purposeful financial reporting misconduct. Historically, many accounting and disclosure schemes began with relatively small accounting indiscretions, which snowballed into larger financial reporting meltdowns.

To stop that snowball from forming, audit committees should sharpen their focus on certain financial reporting items. First, in the course of completing their annual audits and quarterly reviews, auditors may communicate to the audit committee uncorrected misstatements, i.e., waived accounting adjustments. The audit committee should have

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a robust dialogue with both management and the outside auditor about the nature of these adjustments, including why the adjustments are viewed as immaterial, both quantitatively and qualitatively.

Similarly, management or the outside auditor may communicate to the audit committee matters related to certain accounting policies and practices, estimates and significant unusual transactions. Audit committees should be particularly attentive to the substance of these communications, taking time to understand the explanation and rationale for each item. Audit committees should use their interactions with their external auditors to ask pointed questions about possible areas for fraud: What material modifications have been made to corporate agreements and arrangements in this environment? Are assets being impaired properly? Has working remotely adversely impacted the auditor's review or access to information? Is the subsequent events disclosure sensible? Have risk factor disclosures been updated to reflect COVID-19-related risks?

Internal Controls Likely Will Morph

The crisis may also disrupt a company's internal control over financial reporting and the auditor's ability to rely on those controls in their audit. Companies may need to temporarily replace or modify existing controls due to Covid-19-related changes in business operations and staffing. Management and external auditors, in turn, will each have to adjust to these changes. Audit committees should stay abreast of management and the auditor's progress in adapting to this new control environment. At the same time, audit committees should seek updates on the remediation of previously discovered internal control issues. Given all of the other demands on a company's resources, remediation efforts may not progress as quickly as the audit committee may expect. Nevertheless, certain weaknesses in entity level controls may deserve higher priority. A crisis also is an opportunity for the audit committee to engage with its internal auditors to determine if they should reprioritize their projects for the rest of the year to address the unique financial reporting and internal control risks the crisis presents.

Tone at the Top Becomes Even More Important During a Crisis

As companies ask managers to meet cost cutting targets, some managers may be tempted to look for improper accounting entries to make costs appear lower than they are. For instance, if the company agrees to modify a debt arrangement, a lease or a sales contract, has the modification been recorded properly? If the company is expecting an insurance recovery, has the company recognized the proper amount at the proper time? Is a contingent loss or a disruption in the company's supply chain being acknowledged and disclosed? To the extent that cost cutting involves reductions in personnel, is there appropriate succession planning in place to maintain a robust control environment?

Audit committees generally will not have a voice in deciding how much or where a company will cut costs. But they certainly can influence the messaging that accompanies those cuts. Audit committees should work with management to send a clear message to the company's employees that the economic stresses of the moment are opportunities to demonstrate the company's strong ethics, not its sleight of hand. In addition, audit committees should inquire about the operational soundness of the

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company's whistleblowing/complaint systems, which become all the more critical during a crisis.

Not All Anomalies Are the Same

One line of defense for detecting fraud is the monitoring and review of transactions. Data analysis and other technology tools can assist in identifying anomalies, trends and risk indicators within large populations of transactions. Using these tools, the company may identify certain anomalous financial reporting items which raise questions about the nature and substance of the transactions. The audit committee should meet regularly, and more often than quarterly while the COVID-19 pandemic ensues, and ask management to explain the facts and circumstances for any out of the ordinary metrics. Management may offer legitimate explanations based on current circumstances. Audit committees, however, have a duty to understand and scrutinize management's rationales for transactions or metrics during the current crisis and how they may differ from those offered in prior periods.

By considering the scenarios we have outlined here and employing appropriate responses, audit committees can not only fulfill their critical role of overseeing their companies' financial reporting, but also put themselves on a stronger footing as their companies emerge out of this crisis.

[1] Securities and Exchange Commission, Public Statement of Sagar Teotia, Statement on the Importance of High Quality Financial Reporting in Light of the Significant Impacts of COVID-19 (Apr. 3, 2020). Link.

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