The Institute of Internal Auditors

TONE at the TOP

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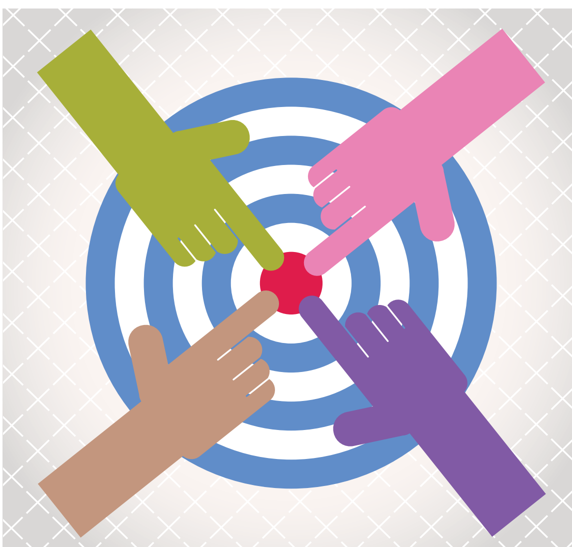
Providing senior management, boards of directors, and audit committees with concise information on governance-related topics.

All Hands on Deck: Partnering to Fight Fraud



Financial reporting fraud — it can wreck investor confidence and destroy shareholder value. The crippling monetary losses from the fraud itself are often just the tip of the iceberg. The discovery of fraud in a company's financial report is likely to cause a rippling effect, leading to unwanted media attention, devastating a company's reputation, and the public's confidence in the integrity of financial markets.

With so much at risk, how is it possible that financial reporting fraud can go undetected for years — as in the case of World Com, Adelphia, and Tyco — seemingly right under the noses of executives, independent auditors, and a watchful boards of directors?

Many blame the age-old problem known as the *expectation gap*. "We've been hearing about the expectation gap for decades, if not centuries," says Cindy Fornelli, executive director of the Center for Audit Quality (CAQ), who notes that the term has been found in literature dating as far back as the 1880s. The expectation gap refers to the differing points of view that investors and each of the four parties in the financial reporting supply chain (financial management, internal auditors, board and audit committee members, and external auditors) have in terms of who is responsible for deterring and detecting financial reporting fraud.

This issue of *Tone at the Top* explores what one group of industry leaders is doing to shed light on the subject, help close the expectation gap, and ultimately reduce the occurrence of financial reporting fraud and boost investor confidence.

Taking Action

Known as the Anti-Fraud Collaboration, the group was formed three years ago by four organizations that represent members of the financial reporting supply chain. Its mission is simply stated: to promote integrity in financial reporting. And it's taking action by developing a host of free resources, including case studies, a webinar series, and a financial literacy quiz.

The Anti-Fraud Collaboration's latest project tackles the expectation gap issue from all sides, and includes a survey of the four organizations' members, a lively roundtable discussion with all parties, and free 15-page summary report. "The project helps establish a benchmark for current expectations within each of the stakeholder groups," explains National Association of Corporate Directors (NACD) board member Michele Hooper. "It also gives us the opportunity to begin applying this knowledge to deter and detect fraud within our individual companies in order to narrow the expectation gap."

Anti-Fraud Collaboration Partners

1. Center for Audit Quality (CAQ) — representing external auditors.
2. Financial Executives International (FEI) — representing senior financial executives.
3. The Institute of Internal Auditors (IIA) — representing internal auditors.
4. National Association of Corporate Directors (NACD) — representing board and audit committee members.

www.antifraudcollaboration.org

Diverging Views

Survey results show a general consensus among all parties that financial executives have primary responsibility for deterring financial reporting fraud. However, the party responsible for *detecting* fraud isn't so clear. Although a slight majority of respondents say it's the financial executives, a sizeable minority place the onus on internal auditors. And nearly a quarter of board members believe it's the external auditors who should catch financial reporting fraud — a finding that surprises Hooper given external auditors' position at the end of the reporting process. "I would have expected that percentage to be lower," she says.

"Although remote, financial reporting fraud carries with it a material risk for any organization. It's a huge burden for any one group to think they can sufficiently deter or detect it single-handedly," notes The Institute of Internal Auditors' (IIA's) President and CEO Richard Chambers, explaining the divergence and pointing to another part of the survey in which each party indicated how *reasonable* it is for them to detect fraud. "Some of the most notorious financial reporting frauds had been going on for long periods of time, and had required involvement at the highest levels of the organization, such that detection almost demands tenacity among members of the financial reporting supply chain."

WHO HAS THE PRIMARY ROLE IN *DETECTING* FINANCIAL REPORTING FRAUD?

External Auditors	Financial Executives	Internal Auditors	Boards/Audit Committees
12%	52%	31%	6%

Marie Hollein, president and CEO of Financial Executives International, agrees that a collaborative effort is needed to improve the integrity of financial reporting. "While it is primarily the financial executives' responsibility to both deter and detect financial reporting fraud, it is *everyone's* responsibility, collectively, to improve our abilities in this area," she says.

Closing the Gap

Although roundtable participants stopped short of defining specific roles each party should play, they ultimately concluded that the various professionals can work collaboratively to narrow the expectation gap and reduce financial reporting fraud by: (1) strengthening governance, (2) improving communication, and (3) exercising healthy skepticism.

"It starts with governance and tone at the top," says Chambers. "The audit committee of the board has to take a lead in establishing clear expectations of each party in deterring and detecting financial reporting fraud."

The NACD's Hooper agrees. "The board of directors and audit committee are responsible for setting the tone at the top," she says. "We hire the CEO, who establishes the culture that permeates our organizations, so we're essentially endorsing the cultural style of that executive."

Secondly, continuous, open, and candid communication across all stakeholders is necessary to ensure a holistic approach to improving the integrity of financial reporting, say roundtable participants. "Of course, they can each carry out their jobs effectively in a silo, but when they talk to one another, internal auditors, external auditors, management, and the board of directors are that much more powerful," notes the CAQ's Fornelli.

"Keeping the lines of communication open is key throughout the year, not only at the end of the reporting period," adds FEI's Hollein, who believes financial executives could be more proactive in reaching out to their audit committee members, as well as internal and external audit leaders. "By maintaining regular, open communications, hopefully questions will be raised earlier in the reporting process."

Finally, and arguably most importantly, all four parties must work collaboratively to ensure skepticism is being exercised. "Objectivity, independence, and skepticism are important cornerstones of effective auditing as well as important tools in detecting financial reporting fraud," explains Fornelli, who says it's everybody's responsibility to ask appropriate questions in a deliberate, but tactful way.

Survey results seem to corroborate that viewpoint. An overwhelming majority (86 percent) of respondents from all four groups agreed that they should exercise skepticism when preparing or reviewing financial statements.

The key is for stakeholders to balance trust with skepticism. However, that may be easier said than done. Only 46 percent of internal auditors and 58 percent of financial management believe that they are striking an appropriate balance between the two.

"Stakeholders would do well to live by the motto, 'trust but verify,'" advises NACD's Hooper.

"All parties can help each other promote healthy skepticism — and avoid creating an atmosphere of distrust — by being receptive to probing questions, expecting those type of questions, and being ready with honest, robust answers," explains Fornelli.

TRUST VS. SKEPTICISM: APPROPRIATE BALANCE

External Auditors	Financial Executives	Internal Auditors	Boards/Audit Committees
70%	58%	46%	79%

Setting the Course

In the end, each party in the financial reporting chain can improve its chances of deterring and detecting fraud by working collaboratively with the others. "We need to look across lines and be more supportive of how we integrate our expectations and how we rely on each other to reduce fraud within our own organizations," says Hooper.

"We have to ensure that we're not 'ships passing in the night,' each thinking the other is looking at the key risks creating an environment conducive to financial reporting fraud, and nobody truly knowing what the other is doing," adds The IIA's Chambers. "Financial reporting fraud can be elusive. If everybody isn't pre-aligned in terms of what each one's looking at, a financial reporting fraud could become quite material before it is even suspected."

Quick Poll Question

How well do your organization's financial executives, internal auditors, external auditors, and board members communicate with one another?

Visit www.theiia.org/goto/quickpoll to answer the question and see how others are responding.

About The IIA

The Institute of Internal Auditors Inc. (IIA) is a global professional association with 180,000 members in 190 countries. The IIA serves as the internal audit profession's chief advocate, international standard-setter, and principal researcher and educator. www.globaliia.org

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Kenton J. Sicchitano

The Institute of Internal Auditors
TONE at the TOP

247 Maitland Ave.
Altamonte Springs, FL 32701-4201 USA

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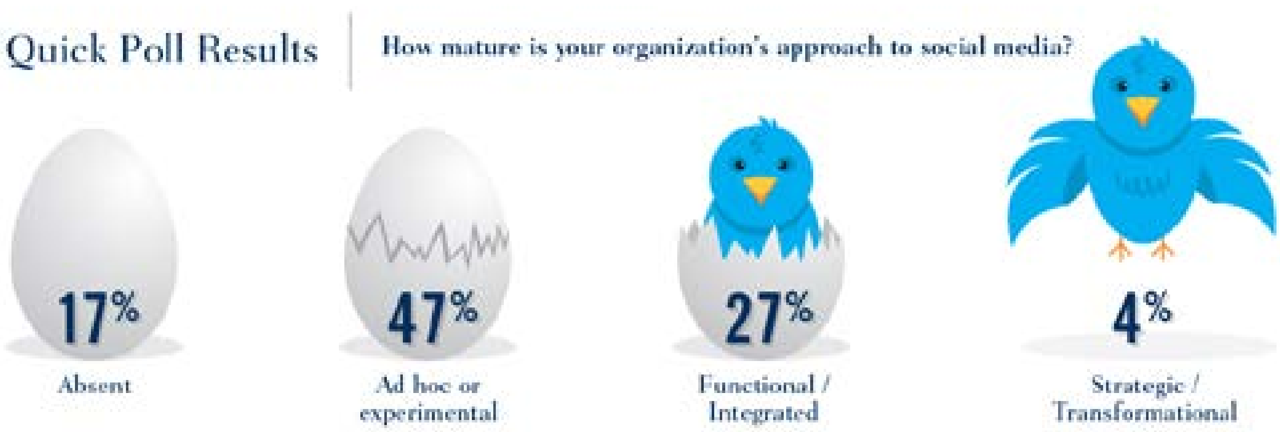

*Based on 547 responses. Respondents could only choose a single response.