The IIA’s 2013 International Conference in July was attended by more than 2,000 practitioners, representing 110 countries. Attending members of The IIA’s Audit Executive Center and select CAEs were invited to participate in a pre-conference forum on Sunday, July 14, which was sponsored by the Center for Audit Quality (CAQ). More than 90 CAEs from around the world, representing organizations of all sizes, participated in this two-part forum, discussing the topics of financial statement reporting fraud and the COSO 2013 Internal Control–Integrated Framework (Framework).

In the first part of the afternoon, Professor V.G. Narayanan of the Harvard Business School led the participants in an interactive discussion about the Hollate Manufacturing Case Study, a fictitious case study which examines a potential material fraud at a fictional manufacturing company. That session was followed by a panel discussion on the COSO 2013 Internal Control–Integrated Framework. The following summarizes highlights from this exclusive Audit Executive Center event.

**THE HOLLATE MANUFACTURING CASE STUDY**

**THE SITUATION:**
A week before fourth quarter financials were scheduled to be reported, Jack Brennahan, Hollate’s CEO, received a phone call from their external auditor and later their audit committee chair regarding some unusual journal entries. The entries appeared to increase inventory and reduce costs of goods sold during the 4th quarter. Additional inquiries to the controller and the CFO did not sufficiently explain the entries.

**THE BACKGROUND:**
- CEO Jack Brennahan had been promoted internally from his position as CFO and hired William Blackburt as the new CFO.
- Executives at Hollate had close professional and personal relationships, and two of the Board members had worked with Brennahan earlier in his career.
- The structure of compensation packages for both the CEO and the CFO made it unlikely for them to earn any bonuses if Hollate did not make acquisitions.
- To maintain a line of credit, their agreement with the bank included several stringent covenants, including revenue targets.
- The internal audit function was understaffed and mainly tested internal controls from an operational perspective, rather than testing financial reporting; they did not have a direct line of communication with the board’s audit committee.
- Formal accounting and control procedures were in place, but exceptions could be made for the good of the company.
- The company had a code of conduct, but it was poorly communicated as was the whistleblower hotline.
WHAT SHOULD THE CEO DO? In response to the first question, participants initially suggested several possible actions, which included contacting internal audit to investigate or requesting that the audit committee commission an investigation. As the discussion dynamic moved from opinion to collaboration, a consensus developed around the idea of launching an investigation performed by an independent party because the ethical culture of the company as described in the case study was questionable. Some participants also agreed that fourth-quarter financials should be delayed pending the investigation.

The proposed delay to the release of fourth-quarter financials would likely elicit speculation, so it became clear that the CEO needed to manage communication to stakeholders before the rumors damaged those relationships. Theoretically, even well-managed communication to stakeholders — banks, vendors, customers, employees, stock exchange — could affect lines of credit, buying power, sales, employee satisfaction, and stock value. “The consequences of not communicating,” Professor Narayanan reminded the group, “are worse because they are going to find out one way or another. If you are not doing the messaging, someone else is doing the messaging for you.” The participants considered the following points to be most important when communicating to stakeholders:

- Communicate what you know and your plans to determine the extent of the problem.
- Be transparent and direct.
- Utilize the established relationships you have with stakeholders.

Professor Narayanan emphasized that failing to manage this situation properly may create “a self-fulfilling prophecy” and lead to bankruptcy — not because of the original accounting issue, but how things were handled.

WHY DID THIS SITUATION HAPPEN? After participants discussed several situational factors in the scenario, they speculated that the root cause of the problem was the compensation structure for the CFO. As one attendant stated, “It was impossible for the CFO to earn a higher tier bonus if the company did not make any acquisitions. For him to make acquisitions, it was very important to maintain the line of credit. For him to have the line of credit, he had to keep all the terms in the covenant… that is the reason he would make the journal entries, to make sure the gross margin is high enough.”

The problem suggested here is that a conflict of interest arises when the individual entrusted with accurately reporting a company’s financials has a compensation package that is linked to a particular financial outcome.

SITUATIONAL FACTORS

Some of the factors in the case that created the opportunity for this to occur included:

- Internal audit was not only too small for the size and strategy of the company, but its resources were taxed by project work on acquisitions.
- The communication from internal audit to the audit committee was funneled through the CFO, impeding independence.
- The audit committee was not sufficiently knowledgeable about accounting rules.
- The code of conduct, issued by an outside consultant, was not reinforced by the behavior of management.
**SO WHO’S RESPONSIBLE?** To answer this question in terms of culpability, the evidence in the case points to the CFO, but the responsibility extends beyond blaming an individual. As one participant stated, “everyone was responsible, starting with the board.” Others pointed out that the CEO is ultimately the person directing strategy and the CFO took advantage. The board’s oversight responsibilities, it was noted, meant they should have put in place “a structure commensurate with the expanded activities of the organization.” There was some disagreement on whether the CAE was also responsible; some cited that he did not have the expertise or broad understanding of financial controls and responsibilities and others felt he had the capacity without the necessary independence.

**WHAT SHOULD BE DONE TO MITIGATE?** To address the question of mitigating risk, Professor Narayanan organized the conclusions using the fraud triangle—opportunity, motivation, and rationalization.

Opportunities included:

- The collegial culture and lack of professionalism within the company.
- An absence of internal controls.
- A very small internal audit department without sufficient experience.
- An internal audit department that lacks independence and direct access to the board of directors.

Motivation stemmed from:

- The bonus incentive in the compensation package for the CFO being tied to revenue targets.

Rationalization is represented in the case by:

- The attitude that actions can be justified for the greater good of the company.

To mitigate these factors, participants suggested removing the CFO and expanding the internal audit function with different expertise. The group also identified the need to look into the financial literacy of the board. One participant suggested that all the directors should be retrained. It was determined that a direct avenue for communication between the CAE and the audit committee was required in order to provide internal audit with the independence needed to be effective. Professor Narayanan mentioned balancing the compensation package, which acted as a motivator for the behavior, but he warned against taking pressure off performance. To address rationalization, Narayanan also suggested that the company should “take the time to point out what the organization adds to the greater society” and emphasize the values for which the organization stands. Reinforcing these values and employing a boundary system when actions are inconsistent with the code of conduct will work to create an environment that does not support the rationalization that was encountered in this situation.
COSO PREPAREDNESS AND POLLING RESULTS

PANEL DISCUSSION. Having worked closely on the revision, Soske discussed three areas that the changes in the COSO Framework sought to address: changes to business and operating environments that have occurred over the last 20 years; clarity around the use of the framework for purposes other than financial reporting; and articulation of 17 principles that are key aspects of each of the five original components of the 1992 framework (see Figure 2). A key point Soske made was that in COSO’s view of an effective system of internal control, these “17 principles need to be present and functioning and operating together.”

COSO FORUM PANEL

The panel discussion was facilitated by Georgia Pacific Vice President and Chief Audit Executive and incoming IIA Chairman Paul J. Sobel. The panel included:

- PricewaterhouseCoopers (PwC) Partner Stephen Soske
- COSO Board Chairman Robert Hirth
- United Airlines Managing Director of Corporate Audits Sharon Grant
- CAQ Executive Director Cindy Fornelli

Sobel led a discussion about COSO informed by the contribution of the panelists along with attendee responses to real-time polling questions.

UPDATE ARTICULATES PRINCIPLES OF EFFECTIVE INTERNAL CONTROL

Control Environment

1. Demonstrates commitment to integrity and ethical values
2. Exercises oversight responsibility
3. Establishes structure, authority and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability

Risk Assessment

6. Specifies suitable objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change

Control Activities

10. Selects and develops control activities
11. Selects and develops general controls over technology
12. Deploys through policies and procedures

Information & Communication

13. Uses relevant information
14. Communicates internally
15. Communicates externally

Monitoring Activities

16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies

Fig. 2. Adapted from 2013 REVISED COSO Internal Control—Integrated Framework — A Suitable Model for ALL, a presentation by Robert Hirth and Stephen Soske.
To address concerns relative to companies transitioning to COSO in the United States and internationally, Hirth described transitions to the revised framework as something that “will vary by organization and where customization will be required.” Hirth went on to state that “if organizations have monitored changes appropriately and revised their systems of internal control regularly and effectively to address internal and external changes, they should experience less than a significant effort when transitioning to a revised framework.” He also assured international participants who utilize the COSO 1992 framework, which represented 88 percent of the international audience in attendance (see Figure 3), that the 2013 COSO Framework is slated for translation into seven languages in the next year.

Discussing the transition to the revised framework, Grant emphasized the importance of examining the current process and educating the stakeholders before executing a transition plan. United is collaborating with external auditors in their examination of the current processes in relation to the 17 principles of the revised framework. The next step they see will be transparent communication to educate stakeholders about what needs to take place to align with the new framework and what it all means for the company.

Finally, communicating from the stakeholder perspective, CAQ’s Fornelli emphasized the flexibility created through a principles-based framework when she stated that “it gives them a roadmap, but again, allows it to be tailored to individual companies at that period in time…you’re always going to have to evolve and you’re always going to have to continuously improve. I think the framework with the principles allows that to happen.”

**Fig. 3.** In this chart, “Yes” accounts for polling results that indicated any of three options: 1) Yes, but we only use it for internal audit purposes 2) Yes, we use it for evaluation and reporting on internal control over financial reporting 3) Yes, we use it as a framework for our entire system of internal control.

**Polling Results — Familiarity with 2013 COSO Framework.** One notable comparison in the polling results was that 83 percent of the participants indicated that they currently use the 1992 COSO Framework for some part of their system of control, but 46 percent of the participants indicated that they had not read the 2013 COSO Framework at all and another 35 percent had read only the executive summary. These numbers suggest that there is an audience for information about the revised framework,
and this well-attended event serves as one example of seeking that information. Fornelli communicated that she did not find these results concerning because the framework is iterative, building off the five components in the 1992 Framework.

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<th>Polling Results — Concerns with Implementation</th>
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<td>Polling responses indicated that understanding the COSO 2013 Framework and educating stakeholders were among the highest concerns for participants.</td>
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<td>Reinforcing an earlier comment from COSO Board Chairman Robert Hirth, Soske stated that “if you understood the 1992 Framework and your systems of internal control have been keeping pace with changes in the business, it may be just a diagnostic assessment. It may not require significant change in processes and activities.”</td>
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<th>Polling Results — Benefits of COSO 2013</th>
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<td>As Figure 5 shows, respondents perceived the principles-based approach of COSO 2013 as the biggest benefit. While both COSO 1992 and COSO 2013 share the five overarching components, the principle-based design of the current revision serves the intention of making the framework more broadly applicable. Fornelli also noted that from a stakeholder’s perspective that “the additional emphasis on fraud in the revised framework could work to help mitigate issues related to tone at the top, compensation structure, and others identified in the Hollate case.”</td>
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<td>Polling results indicate that an overwhelming majority believe the biggest benefit of implementing COSO 2013 is that it is more principles-based. Participants were polled on this question after significant discussion about the revised framework.</td>
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CONTINUING THE CONVERSATION. This article encapsulates a discussion from The IIA’s Audit Executive Center CAE forum at the 2013 International Conference. This forum, sponsored by the CAQ in partnership with The IIA and The IIA’s Audit Executive Center, was designed to explore two pressing issues in internal audit: financial reporting fraud and COSO 2013. Attending CAEs gained greater insight into the factors at play in financial reporting fraud. They also learned about the essential changes in the COSO framework, shared their concerns, and discussed the benefits of the revised framework. This CAE forum is one of several exclusive Center benefits offered to member CAEs. The next Audit Executive Center CAE forum will be held as a General Audit Management pre-conference event in March 2014.

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