Closing the Expectation Gap in Deterring and Detecting Financial Statement Fraud: A Roundtable Summary

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Introduction –

Closing the Expectation Gap in Deterring and Detecting Financial Statement Fraud: A Roundtable Summary

On April 24, 2013, a roundtable was held on the subject of the "expectation gap." The objective of this program was to bring together the key players in the financial reporting supply chain (corporate directors, financial executives, external auditors, and internal auditors) to discuss each group's expectations of the roles of the various players in the deterrence and detection of financial reporting fraud.

The roundtable was convened by the Anti-Fraud Collaboration, which includes the Center for Audit Quality (CAQ), Financial Executives International (FEI), The Institute of Internal Auditors (IIA), and the National Association of Corporate Directors (NACD).

The April 24 roundtable, Stakeholder Discussions: Closing the Expectation Gap in Deterring and Detecting Financial Statement Fraud, hosted by The IIA, included an opening panel discussion led by IIA Vice President of Professional Practices Hal Garyn, with CAQ Executive Director Cynthia Fornelli, NACD Managing Director and CFO Peter Gleason, and FEI President and CEO Marie Hollein. The panel discussion was followed by a breakout session with participants including members from each organization. Discussion also took place around an initial survey of members of the four organizations coordinated by The IIA in the fall of 2012 on this subject.

The roundtable discussions produced the following key takeaways:

- ☐ A large majority of survey respondents believe that financial management has primary responsibility in *deterring* financial reporting fraud, with a smaller majority believing financial management is responsible for *detecting* financial statement reporting fraud.
- ☐ Expectations vary widely on the responsibility of external and internal audit in the deterrence and detection of material fraud in financial reporting.
- ☐ Audit committees are expected to have the financial expertise to ask the right questions.
- ☐ There is a need for open and honest communication across all groups, in particular between the audit committee and the auditors, both internal and external.

The April 24 roundtable provided an opportunity to bring together all players in the financial reporting supply chain to discuss an essential matter: their expectations of each other with respect to deterring and detecting financial reporting fraud. Within this discussion, participants worked to identify gaps in their expectations, the roles each party should play, and actionable items that can reduce any expectation gap therein. The following roundtable summary represents a starting point in this dialogue.

SURVEY FINDINGS ON THE EXPECTATION GAP

During the event, The IIA's Garyn presented the results of the fall 2012 survey on closing the expectation gap in the financial reporting supply chain.[1] While the vast majority of survey respondents indicated that financial executives had primary responsibility for *deterring* financial reporting fraud, external auditors were more likely than the other financial reporting supply chain members to suggest that boards and audit committees bore primary responsibility. When it came to *detecting* fraud, respondents were more likely to identify financial management as having the primary role, but these results were not as resounding as they were for the fraud deterrence questions. Several survey respondents cited internal auditors as having primary responsibility. Audit committee members and internal auditors were more likely than the other two groups to place primary responsibility for fraud detection on the external auditor.

The expectation gap was also exemplified by the survey finding that board members are confident or highly confident that management, internal audit, and external audit will be able to identify a material misstatement due to fraud. They also had a fairly high level of confidence in their own ability to identify a material misstatement; this level of confidence was not shared by the other financial reporting supply chain members. Internal auditors expressed somewhat less confidence than the external auditors and financial management in management's ability to identify a material fraud.

Another interesting finding from this survey was related to the issue of skepticism versus trust. Although both external and internal auditors identify skepticism as key to performing their functions, internal auditors were less likely than external auditors to say that they exercise the appropriate balance between trust and skepticism. Rather, internal auditors were as likely to say that there is more trust than skepticism in their company.

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[1] *The survey results are presented in the Appendix.*

OPENING PANEL

Following the survey presentation by Garyn, the panelists responded to the results. FEI's Hollein commented that there are takeaways from the survey for each role that can strengthen one's ability to deter and detect fraud. Rather than attributing primary responsibility to one role, she emphasized, "It's everyone's role to be part of deterring and detecting financial reporting fraud, and how you carry that out depends on where you sit and your experience." NACD's Gleason remarked that "a key learning point is that the responses reveal that audit committee members place more trust in management than management places in them." He posed the question: "What do we need to do to engage all these groups differently, so they understand the skepticism with which we all need to look at things to be able to identify early and later stage frauds?" CAQ's Fornelli discussed trust versus skepticism, asking, "How do you work with people on a daily basis, but maintain a questioning mind-set? How do we achieve that balance?"

HIGHLIGHTS OF ROUNDTABLE DISCUSSION

During the remainder of the roundtable, participants discussed questions surrounding what the expectations are of and between each party: financial management, external audit, internal audit, and the audit committee. Discussions within each group initially sought to define the roles with specific levels of responsibility, but conversations evolved to explore the concept of a holistic approach to fraud detection and deterrence. Thematic within all conversation was the need for effective communication across the financial reporting supply chain.

FINANCIAL MANAGEMENT'S ROLE

In general, financial management was perceived as having the primary responsibility in deterring and detecting financial reporting fraud, but concern was raised that when fraud occurs, management is often involved. This concern points to the importance of the relationship between parties. When there is an effective oversight function and active communications, the audit committee (through internal audit) can be made aware of concerns around fraud and management's potential involvement. As one participant described it, internal audit "can be the eyes and ears the audit committee needs."

A holistic view of management's role emphasizes the responsibility of financial managers to have controls in place and operating effectively. Or as one group phrased it, "Management's role is to design, implement, and execute effective controls that address the risk of financial reporting fraud." Similarly, another group of participants proposed an approach with a series of levels in place for fraud detection and deterrence. At every level, each group — financial management, audit committee, external audit, and internal audit — has a role to play. In this approach, management is responsible for designing processes and procedures and monitoring their effectiveness in developing accurate and complete financial statements with reasonable assurance of deterring and detecting potential fraud that is material to the financial statements.

ROLES OF EXTERNAL AND INTERNAL AUDITORS

Expectations for external and internal auditors varied widely. Some audit committee representatives had no expectation that internal or external auditors would detect fraud, while others defined their roles in fraud detection as essential. The role of internal audit, it was acknowledged, depends on how the company utilizes it, so there was little consensus on its role in fraud detection. Internal audit can have a broad scope in an organization that extends beyond financial reporting controls. As one participant stated, some internal audit functions "may perform mostly financial reporting controls testing and others may dedicate their internal auditing teams to operational and compliance testing." As in the case with internal auditors, external audit approaches vary based on a risk assessment. Some believed that external auditors were best equipped to identify material financial statement fraud because of their financial reporting audit procedures.

Participants emphasized the importance of objectivity for internal and external audit in order to provide unbiased information to the audit committee, but some also acknowledged potential or perceived conflicts of interest in this area. One representative from internal audit expressed concern over the practice of awarding stock options to internal audit as a portion of their compensation because of the possibility that this incentive could influence someone to delay disclosure of negative results. Likewise, some believe that external audit's independence can be undermined by the need to try to ensure continued retention of the audit engagement.

When reviewing the roles of internal and external audit, participants attributed primary responsibility for testing the design and effectiveness of controls over financial reporting to auditing, both internal and external. Internal auditors' activities could be viewed as a deterrent simply by creating the awareness that they continuously evaluate the effectiveness of fraud controls and review the results of their execution.

THE AUDIT COMMITTEE'S ROLE

When looking at how audit committee members affect the deterrence and detection of financial statement reporting fraud, there was a consensus that the governance role they play makes all groups aware of expectations and sets the tone at the top. The most frequently stated expectation for this role was that audit committee members should have financial literacy. Current requirements for public company audit committees are that at least one member should be an "audit committee financial expert" as defined by the U. S. Securities and Exchange Commission. Participants also voiced the expectation that audit committee members should utilize this expertise in asking challenging questions of management when reviewing financial statements. This does not mean that every audit committee member must be a CPA; even within financial literacy, there can be diversity of backgrounds. "For a strong audit committee," one participant offered, "there must be diversity of professional backgrounds. A good committee might include someone with a private equity background, a CFO, and someone from an investment house, for example." Another expectation was that audit committee members should be required to have knowledge of the industry and business processes. Some participants also suggested that the audit committee should engage management several layers down.

Developing these relationships could help the audit committee better assess if the internal audit function and the financial reporting team members are qualified and able to help deter and detect fraud and deliver on reporting transparency objectives, and if the external auditors are qualified and effective at detecting financial reporting fraud.

COMMUNICATION BETWEEN PARTIES

Separate breakout discussions at the roundtable voiced a common theme of the need for communication across all members of the financial reporting supply chain.

Audit committee representatives conveyed that an open and honest dialogue with both external and internal auditors is essential to help them determine whether management is doing the right thing. Both audit committee representatives and internal and external auditors emphasized the importance of candid conversation outside of formal meetings. Through this dialogue, audit committees can seek information from internal and external auditors about their true areas of concern.

What remains a challenge, though, is closing the gap between what the audit committee expects and what is realistic in terms of internal and external auditors' ability to deter and detect fraud. In many cases, this topic is not a primary focus of boards and senior management; however, participants believe that it would be beneficial to have more frequent and robust conversations with the audit committee on fraud deterrence and detection. It is only through clear communication about their various roles that the players in the financial reporting supply chain can operate well together to achieve their common objective: to deter and detect fraud in financial statement reporting.

As participants in the roundtable worked to define the roles of each player, an additional suggestion was made to provide key information to the audit committee members to allow them to ask probing questions about critical accounting estimates and judgments. It could also be beneficial to have not only the CFO, but additional staff members responsible for preparation of the financial reports attend the audit committee meetings.

Another suggestion made was to have audit committee members not only "talk the talk" with the CFO, CEO, and lead engagement partner of the company audit, but to periodically "walk the walk" through the company and speak to company staff about what they were doing and why.

CONCLUSION

The objective of this program was to bring together the key players in the financial reporting supply chain (corporate directors, financial executives, external auditors, and internal auditors) to discuss each group's expectations in the deterrence and detection of financial reporting fraud. While the roundtable dialogue made progress in understanding the expectation gap, the participants did not attempt to define who should take primary responsibility. Such definitions would be arbitrary at best and counterproductive at worst, as they could reinforce diffusion of responsibility.

However, as participants shifted the conversation to a more holistic approach, responsibilities were viewed as complementary parts working together to design, operate, and monitor controls that mitigate the risk of material misstatements related to financial reporting fraud. Assigning primary responsibility became less important as the group described a more interconnected approach as one where "each player in the financial supply chain is clear about their role and performs it well to effectively deter and detect fraud." For the roles to operate well together, communication is critical.

This recurring theme of communication suggests an avenue to address the expectation gap among financial reporting participants: open and candid conversation among the internal and external audit functions, financial management, and the audit committee, allowing for audit committees to perform their governance role with necessary transparency and realistic expectations that will help achieve effective risk management. This would go a long way toward addressing the larger expectation gap between the financial reporting participants and the investing public — a gap that will surely narrow as financial reporting participants work together even more effectively to improve the deterrence and detection of financial reporting fraud.

The outcome of the roundtable discussions can serve as a catalyst for continued dialogue among the financial reporting supply chain participants, the investing public, and other interested parties on the efforts that are undertaken in public companies to deter and detect financial fraud.

HISTORY AND PURPOSE OF THE ANTI-FRAUD COLLABORATION

During 2009 and in early 2010, the CAQ led a project that brought together audit partners, academics, CEOs, CFOs, board members, audit committees, and regulators to discuss deterring and detecting material financial reporting fraud. In October 2010, in a document titled Deterring and Detecting Financial Reporting Fraud: A Platform for Action (www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf), the CAQ published three key findings from this project:

1. An ethical culture, as exhibited by the tone at the top of the organization, as well as the mood in the middle and the buzz at the bottom, is the primary line of defense in financial reporting fraud. The positive tone related to fraud detection and deterrence should not stay at the top; it needs to be reinforced with clear policies and messaging through the entire organization.
2. Everybody needs to have a questioning mind-set. All players in the financial reporting supply chain need to employ skepticism even as they maintain an effective working relationship.
3. Strong communication and active collaboration among all players are essential to effectively deter and detect fraud.

The project led to the formation of the Anti-Fraud Collaboration, which comprises members of the CAQ, FEI, The IIA, and NACD and represents four key groups: external audit, senior financial executives, internal audit, and board/audit committee members. Several collaborative projects have been delivered by this partnership. The Stakeholder Discussions: Closing the Expectation Gap on Deterring and Detecting Financial Statement Reporting Fraud roundtable is one such project.

Find more resources from the Anti-Fraud Collaboration at:
www.antifraudcollaboration.org

Appendix –

Closing the Expectation Gap in Deterring and Detecting Financial Statement Fraud: Survey Results

SURVEY DEMOGRAPHICS

- Survey was open from 10/3/12 to 11/14/12
- Total responses – 432, with people identifying themselves as most affiliated with:
    - 32% – The IIA
    - 31% – FEI
    - 26% – CAQ
    - 12% – NACD
- Organization (or primary clientele):
    - 48% publicly traded
    - 31% privately held
    - 10% non-profit
    - 7% public sector

WHO HAS THE <u>PRIMARY</u> ROLE IN *DETERRING* FINANCIAL REPORTING FRAUD?

	All	CAQ	FEI	IIA	NACD
Execs	87%	78%	90%	90%	90%
BoD/AC	10%	20%	6%	8%	6%
Int Audit	2%	2%	4%	2%	2%
Ext Audit	1%	1%	0%	0%	2%

WHO HAS THE <u>PRIMARY</u> ROLE IN *DETECTING* FINANCIAL REPORTING FRAUD?

	All	CAQ	FEI	IIA	NACD
Execs	52%	56%	52%	51%	46%
BoD/AC	6%	9%	6%	4%	2%
Int Audit	31%	32%	33%	28%	29%
Ext Audit	12%	4%	9%	18%	23%

HOW REASONABLE IS IT FOR US TO *DETER/DETECT* FINANCIAL REPORTING FRAUD?

	CAQ	FEI	IIA	NACD
Ext Audit	2.3 / 2.9			
Financial Execs		4.2 / 3.7		
Int Audit			3.0 / 3.3	
BoD				3.0 / 2.3

Scale: 5 = Very reasonable
1 = Not reasonable at all

LEVEL OF CONFIDENCE IN IDENTIFYING A POTENTIAL MATERIAL MISSTATEMENT DUE TO FRAUD.

% Confident or Highly Confident

	All	CAQ	FEI	IIA	NACD
Execs	84%	85%	86%	76%	96%
BoD/AC	48%	46%	54%	36%	75%
Int Audit	86%	81%	88%	86%	92%
Ext Audit	81%	82%	73%	82%	90%

IN PREPARING OR REVIEWING FINANCIAL STATEMENTS, ONE SHOULD EXERCISE SKEPTICISM.

% Agree or Strongly Agree

All	CAQ	FEI	IIA	NACD
86%	91%	82%	82%	90%

% Disagree or Strongly Disagree

All	CAQ	FEI	IIA	NACD
13%	8%	15%	16%	10%

LEVEL OF CONFIDENCE THAT EACH PARTY EXERCISES A SUFFICIENT LEVEL OF SKEPTICISM.

% Confident or Highly Confident

	All	CAQ	FEI	IIA	NACD
Execs	82%	73%	89%	76%	96%
BoD/AC	76%	74%	80%	66%	94%
Int Audit	90%	82%	91%	94%	98%
Ext Audit	94%	98%	90%	93%	98%

TRUST VS. SKEPTICISM.

	All	CAQ	FEI	IIA	NACD
More trust than skepticism	31%	22%	31%	42%	21%
More skepticism than trust	6%	5%	9%	7%	0%
Appropriate balance	60%	70%	58%	46%	79%

EFFECTIVENESS OF METHODS TO DETER/DETECT FINANCIAL REPORTING FRAUD.

	All	CAQ	FEI	IIA	NACD
Communicating code of conduct and corporate values	4.5	4.1	4.5	4.7	4.6
Ethics training	4.3	4.1	4.1	4.5	4.3
Employee hotlines	4.3	4.3	4.1	4.6	4.4
Employee surveys	3.9	3.9	3.7	4.1	4.1

Scale: 5 = Strongly Agree
3 = Neutral
1 = Strongly Disagree

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