DETERRING and DETECTING FINANCIAL REPORTING FRAUD

A Platform for Action

October 2010

CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets
Affiliated with the American Institute of CPAs

THE CENTER FOR AUDIT QUALITY AND ITS VISION

The Center for Audit Quality (CAQ) is dedicated to enhancing investor confidence and public trust in the global capital markets by:

- Fostering high-quality performance by public company auditors
- Convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention
- Advocating policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions

The CAQ is an autonomous public policy organization based in Washington, D.C. It is governed by a board comprised of leaders from the public company audit firms, the American Institute of Certified Public Accountants (AICPA), and three individuals independent of the profession. The organization is affiliated with the AICPA.

ABOUT THIS REPORT

This report focuses on financial reporting fraud at publicly-traded companies of all sizes, and its recommendations are intended to be scalable to different situations. While the report addresses specific structures, such as an internal audit function or a formal fraud risk management program, it is not intended to suggest that one size fits all, or to be limited to any single implementation approach. It is important that each company consider the concepts presented and tailor them to its particular characteristics. While not the specific focus of this report, many of the points may be applicable to other types of organizations, such as privately-owned companies, not-for-profit organizations, and governmental entities.

ACKNOWLEDGEMENTS

We would like to thank all those who participated in the discussions and interviews, and the drafting of this document; this report would not have been possible without you. We appreciate the wisdom shared throughout this process. While there are too many who contributed to name, we would like to mention one — Elizabeth Rader, director at Deloitte LLP — for her immense contribution in reviewing the material and drafting this report.

On behalf of the Center for Audit Quality (CAQ), we are pleased to present this report on *Deterring and Detecting Financial Reporting Fraud—A Platform for Action.* Financial reporting fraud—defined for this report as "a material misrepresentation resulting from an intentional failure to report financial information in accordance with generally accepted accounting principles"—is a serious concern for investors and other capital market stakeholders. There is no way to predict who will commit fraud. Moreover, because fraud is intentionally concealed by the perpetrators, it often is difficult to detect for some time. Multiple cases of financial reporting fraud have undermined confidence in the U.S. capital markets in the past few decades.

The CAQ is committed to enhancing investor confidence and public trust in the capital markets. We advocate policies and standards that foster the highest-quality performance by public company auditors, and we act as a convener and collaborator with other stakeholders to foster informed discussions on issues pertaining to the integrity of financial reporting.

During 2009 and early 2010, the CAQ sponsored a series of discussions and in-depth interviews to obtain perspectives on fraud deterrence and detection measures that have worked, and on ideas for new approaches. The participants included the full spectrum of stakeholders with an interest in the integrity of financial reports of publicly-traded companies: corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, investors, regulators, academics, and others.

This report is the result of those discussions and interviews, considered in light of related research and guidance on the topic. The report contains numerous ideas for mitigating the risk of financial reporting fraud, as well as points to ponder. Notably, discussion participants strongly believe that ongoing collaboration and the collective sharing of ideas and resources would greatly advance efforts to mitigate financial reporting fraud.

Accordingly, this report represents a first step in longer-term initiatives and collaborations for the deterrence and detection of financial reporting fraud, to benefit investors and other participants in the capital markets. The CAQ plans to play a leadership role in encouraging collaborative action to advance the understanding of conditions that contribute to fraud and develop enhanced deterrence and detection techniques and tools for all participants in the financial reporting process, including management, boards of directors, audit committees, internal auditors, and external auditors. We intend these efforts to complement the activities of the Public Company Accounting Oversight Board's (PCAOB) Financial Reporting Fraud Resource Center, and look forward to opportunities for collaboration with the Center.

We are delighted to announce that Financial Executives International, The Institute of Internal Auditors, and the National Association of Corporate Directors, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud, plan to collaborate with the CAQ on these initiatives.

We hope this report provides food for thought and spurs stakeholders to leverage our resources to advance the deterrence and detection of financial reporting fraud. We look forward to working with all interested parties in the future.

Michele J. Hooper
Michele J. Hooper
Co-Vice Chair, Governing Board
Center for Audit Quality

Cynthia M. Fornelli
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Executive Director
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Executive Summary

On a number of occasions over the past few decades, major public companies have experienced financial reporting fraud, resulting in turmoil in the U.S. capital markets, a loss of shareholder value, and, in some cases, the bankruptcy of the company itself. The Sarbanes-Oxley Act of 2002 has done much to improve corporate governance and deter fraud; however, financial reporting fraud—an intentional, material misrepresentation of a company's financial statements—remains a serious concern for investors and other capital markets stakeholders.

In 2009, the Center for Audit Quality (CAQ), which is committed to enhancing investor confidence and public trust in the capital markets, convened five roundtable discussions (four in the United States, one in London) with more than 100 participants, followed by more than 20 in-depth interviews, in order to capture perspectives on fraud deterrence and detection measures that have worked and ideas for new approaches. The participants included corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, investors, regulators, academics, and others.

The observations in this report are derived from those discussions and interviews, considered in light of related research and guidance on the topic. The report contains ideas for mitigating the risk of financial reporting fraud, as well as related points to ponder. It represents a first step in advancing longer-term initiatives and collaborations for the deterrence and detection of financial reporting fraud, to benefit investors and other participants in the capital markets.

Understanding the Landscape

The Fraud Triangle. Theoretically, anyone has the potential to engage in financial reporting fraud; indeed, some individuals who commit fraud had previous reputations for high integrity. Three factors, referred to as the "fraud triangle," often combine to lead individuals to commit fraud: pressure or an incentive to engage in fraud; a perceived opportunity; and the ability to rationalize fraudulent behavior.

Participants in the CAQ discussions identified the top three pressures for fraud as personal gain (including maximizing performance bonuses and stock-based compensation); the need to meet short-term financial expectations; and a desire to hide bad news. Opportunities for fraud usually are greatest when the tone at the top is lax or controls are ineffective, although even the best controls cannot completely eliminate the risk of fraud. Finally, individuals who commit financial reporting fraud must be able to justify or explain away their fraudulent actions.

Typically, financial misstatement or manipulation starts small, intended as "just a little adjustment" to improve results. But as the need to maintain the deception continues, one misstatement leads to another until the perpetrator is locked in, loses objectivity, and heads down the "slippery slope" to commit major fraud.

Historically, most major financial statement frauds have involved senior management, who are in a unique position to perpetrate fraud by overriding controls and acting in collusion with other employees. When fraud occurs at lower levels in an organization, individuals may not initially realize that they are committing fraud; they may see themselves as simply doing what is expected to "make their numbers."

The Financial Reporting Supply Chain. Management, boards of directors, audit committees, internal auditors, and external auditors make up the public company financial reporting process or "supply chain" and have complementary and interconnected roles in delivering high-quality financial reporting to the investing public, including the deterrence and detection of fraud.

Management has primary responsibility for the financial reporting process and for implementing controls to deter and detect financial reporting fraud. Boards of directors and audit committees are responsible for oversight of the business and the control environment. The audit committee oversees the financial reporting process, the internal audit function, and the company's external auditors.

Internal auditors play a key role in a company's internal control structure and have a professional responsibility to evaluate the potential for the occurrence of fraud and how the organization manages fraud risk. External auditors must be independent of the company they audit and provide a public report on the entity's annual financial statements, including—for U.S. public companies with $75 million or more in market capitalization—an opinion on the effectiveness of the entity's internal control over financial reporting.

Fraud Deterrence and Detection

How can those in the financial reporting supply chain individually and collaboratively mitigate the risk of financial reporting fraud? While there is no "silver bullet," the CAQ discussion participants consistently identified three themes:

- A strong, highly ethical tone at the top that permeates the corporate culture (an effective fraud risk management program is a key component of the tone at the top)
- Skepticism, a questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain
- Strong communication among supply chain participants

Tone at the top. A strong ethical culture starts at the top with a company's most senior leaders and cascades through the entire organization to create, in the words of a CAQ discussion participant, a "mood in the middle" and a "buzz at the bottom" that reflect and reinforce the tone at the top.

Corporate culture influences all three sides of the fraud triangle. A strong ethical culture creates an expectation to "do the right thing" and counteracts pressure and incentives to commit fraud. An ethical culture also supports well-designed, effective controls that diminish opportunities for fraud and increase the likelihood that fraud will be detected quickly. In addition, a culture of honesty and integrity severely limits an individual's ability to rationalize fraudulent actions.

CAQ discussion participants agreed that management plays the most critical role in building a strong ethical culture. They emphasized that, to do so, senior management must clearly communicate ethical expectations and visibly live by them. Importantly, employees need to hear the same messages from their immediate supervisors, because they have the most powerful and direct influence on the ethical judgments of their employees.

Tone at the top is reinforced through the establishment of a comprehensive fraud risk management program with a readily accessible confidential whistleblower program. In fact, studies show that fraud most often is detected through tips. In multinational organizations, it is critical that ethics and fraud deterrence programs also account for cultural differences.

Boards and audit committees support and reinforce the tone at the top in part by choosing the right management team. Audit committees oversee the financial reporting process, including monitoring fraud risk and the risk of management override of controls. Boards, through the compensation and audit committees, also reinforce the company's ethical values by reviewing compensation plans, especially those for senior management, for unintentional incentives to commit financial reporting fraud.

The internal audit function tests and monitors the design and effectiveness of fraud programs and internal control over financial reporting. According to The Institute of Internal Auditors (The IIA), internal audit should operate with organizational independence, which commonly includes direct reporting to the audit committee and unrestricted access to the board and audit committee should matters of concern arise. External auditors have the responsibility to plan and perform an audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud.

Skepticism. Skepticism involves the validation of information through probing questions, the critical assessment of evidence, and attention to inconsistencies. Skepticism is not an end in itself and is not meant to encourage a hostile atmosphere or micro-management; it is an essential element of the professional objectivity required of all participants in the financial reporting supply chain. Skepticism throughout the supply chain increases not only the *likelihood* that fraud will be detected, but also the *perception* that fraud will be detected, which reduces the risk that fraud will be attempted.

CAQ discussion participants noted that management exercises skepticism by periodically testing assumptions about financial reporting processes and controls, and remaining cognizant of the potential for fraud, particularly if the organization is under financial pressure. They emphasized the importance of having boards and audit committees employ a skeptical approach in discharging their oversight responsibilities. To exercise skepticism effectively, board and audit committee members need a thorough knowledge of the company's business (especially the drivers of its revenue and profitability), its industry and competitive environment, and key risks.

For both internal and external auditors, skepticism is an integral part of the conduct of their professional duties, including the consideration of the risk of management override of controls. Internal and external auditors can also provide insight into the company's ethical culture and the effectiveness of its internal controls to assist board and audit committee members in exercising skepticism.

Communication Across the Financial Reporting Supply Chain. Participants in the CAQ discussions stressed that financial reporting supply chain participants should leverage their complementary and interconnected responsibilities through frequent and robust communications to share insights and eliminate gaps in their collective efforts.

The audit committee is a hub for many of these communications because it has direct reporting lines from management, the internal auditor, and the external auditor. In addition to regular communications with these groups, executive sessions with each of them, as well as with selected key employees, can be a valuable tool for boards and audit committees to obtain a broad perspective on the company's financial reporting environment. Also, regular communication among management, the internal auditor, and the external auditor is integral to the accomplishment of each party's responsibilities.

Together, these communications enable the sharing of information, perspectives, and concerns that provide a view into the company that is "greater than the sum of its parts." Open and robust exchanges that consciously strive to avoid minimalist, compliance-oriented discussions will yield maximum benefits for all parties.

The Case for Collaboration: Increasing Effectiveness Across the Financial Reporting Supply Chain

CAQ discussion participants agreed that while supply chain participants work to deter and detect financial reporting fraud one company at a time, the collective sharing of ideas and resources would greatly advance efforts to mitigate financial reporting fraud.

The CAQ believes that such collaboration would indeed enhance the ability of participants in the financial reporting supply chain to deter and detect financial reporting fraud and thereby sustain and enhance confidence in the capital markets over the long term. In addition to the discussion participants, the CAQ sought input on this report from Financial Executives International (FEI), the National Association of Corporate Directors (NACD), and The IIA, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud. Each of these organizations provided significant support and insights, and expressed interest in further collaboration.

In light of the positive reception this effort has received and the importance of this issue to investor confidence, the CAQ plans to play a leadership role by encouraging continued collaboration with these key stakeholders (and other professional organizations where appropriate) to leverage existing resources, share ideas, and prioritize future activities to advance the deterrence and detection of financial reporting fraud. We will focus our initial efforts in four areas:

- Advance the understanding of conditions that contribute to fraud
- Promote additional efforts to increase skepticism
- Moderate the risks of focusing only on short-term results
- Explore the role of information technology in facilitating the deterrence and detection of fraudulent financial reporting

These areas represent the beginning of a focused and coordinated effort to mitigate the risk of financial reporting fraud and the damage it can cause to individual companies and the capital markets.


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100,610
(41,033)
5,751
(1,252)

Financial Reporting Fraud

What It Is and Why the Center for Audit Quality Cares

Over the past few decades, multiple headline-grabbing cases of financial reporting fraud at public companies have rocked the capital markets. These frauds have a negative impact on the capital markets and erode the trust of the investing public. Financial reporting fraud can also have a devastating impact on a company's reputation, to the point of jeopardizing its existence.

The Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "the Act") was enacted in response to the corporate scandals of the late 1990s and early 2000s, which resulted in major losses for investors and a precipitous decline in investor confidence in the U.S. capital markets. The requirements of the Sarbanes-Oxley Act were intended to strengthen public companies' internal controls over financial reporting and have served to sharpen the focus of senior management, boards of directors, audit committees, internal audit departments, and external auditors on their responsibilities for reliable financial reporting. Although it is generally accepted that the Sarbanes-Oxley Act has improved corporate governance and decreased the incidence of fraud, recent studies and surveys indicate that investors and management continue to have concerns about financial statement fraud. For example:

- The Association of Certified Fraud Examiners' (ACFE) *2010 Report to the Nations on Occupational Fraud and Abuse* found that financial statement fraud, while representing less than five percent of the cases of fraud in its report, was by far the most costly, with a median loss of $1.7 million per incident.

- *Fraudulent Financial Reporting: 1998–2007* from the Committee of Sponsoring Organizations of the Treadway Commission (the *2010 COSO Fraud Report*), analyzed 347 frauds investigated by the U.S. Securities and Exchange Commission (SEC) from 1998 to 2007 and found that the median dollar amount of each instance of fraud had increased three times from the level in a similar 1999 study, from a median of $4.1 million in the 1999 study to $12 million. In addition, the median size of the company involved in fraudulent financial reporting increased approximately six-fold, from $16 million to $93 million in total assets and from $13 million to $72 million in revenues.

- A 2009 KPMG survey of 204 executives of U.S. companies with annual revenues of $250 million or more found that 65 percent of the respondents considered fraud to be a significant risk to their organizations in the next year, and more than one-third of those identified financial reporting fraud as one of the highest risks.[1]

- Fifty-six percent of the approximately 2,100 business professionals surveyed during a Deloitte Forensic Center webcast about reducing fraud risk predicted that more financial statement fraud would be uncovered in 2010 and 2011 as compared to the previous three years. Almost half of those surveyed (46 percent) pointed to the recession as the reason for this increase.[2]

Because fraud can have such a devastating impact, the CAQ, consistent with its mission, convened five roundtable discussions in 2009. Representatives of all stakeholders affected by fraud were able to share perspectives, experiences, successful anti-fraud measures, and ideas for new approaches. The participants in these discussions included, among others, corporate executives, members of boards of directors and audit committees, internal auditors, external auditors, fraud specialists, investors, regulators, and academics. In order to facilitate a free flow of ideas, the roundtable discussions were conducted with no public attribution of comments to individual participants. These discussions were followed in early 2010 by in-depth interviews with more than 20 of the roundtable participants conducted by an independent research firm. The interviews delved further into the insights and observations of individual participants in the discussion groups, and participants agreed to be quoted in this report. The discussions and interviews focused on a particular subset of frauds, those that are material and involve a public company's financial reports. Other types of fraud, such as the misappropriation of assets, were outside the scope of the discussions.

The observations and areas of focus in this report are derived from these discussions and interviews. Throughout this report, where observations indicate that participants agreed on a particular point, it is meant to indicate general consensus, not necessarily that there was unanimity. The insights from the discussions were considered in light of related research, and they include both specific ideas for consideration by individual stakeholder groups, as well as several longer-term proposals for collaboration among all stakeholders. Together, these proposals represent the beginning of a long-term effort to advance the deterrence and detection of financial reporting fraud, with the ultimate goal of benefiting investors, other users of financial reports, and participants in the capital markets. This report and the ideas generated from it are intended to serve as a springboard for ongoing collaboration among all stakeholders to diminish the risk of financial reporting fraud.

The Sarbanes-Oxley Act—Legislation for Strong Governance and Accountability

The Sarbanes-Oxley Act of 2002 was enacted in response to the corporate scandals of the late 1990s and early 2000s. The Act mandated significant reforms to public companies' governance structures and the oversight of public company accounting firms. Many of its requirements were intended to raise the standard of corporate governance and mitigate the risk of fraudulent financial reporting. In particular, the Act:

- Reinforces the responsibility of corporate officers for the accuracy and completeness of corporate financial reports, and adds a requirement for the public certification of each periodic report filed with the SEC that includes financial statements. The chief executive officer and chief financial officer must certify that each such periodic report complies with the requirements of the Securities Exchange Act of 1934 and that the financial statements are fairly presented
- Establishes criminal penalties for a willful and knowing untrue certification
- Provides for the disgorgement of the bonuses and profits of executives involved in fraudulent financial reporting
- Requires evaluations and increased disclosures of a company's internal control over financial reporting by management, and a related report by the external auditor for certain companies
- Requires other enhanced disclosures, including whether the company has a code of ethics for senior financial officers
- Enhances the role of the audit committee, including requirements for financial expertise and responsibility for oversight of the company's external auditor
- Requires companies to establish whistleblower programs, and makes retaliation against whistleblowers unlawful

These provisions are generally held to have helped reduce financial reporting fraud and to serve as an ongoing deterrent to such fraud. Several CAQ discussion participants emphasized the deterrent effect of the criminal penalties for untrue certifications by the CEO or CFO.

CHAPTER 1

Understanding the Landscape

Why Commit Fraud—The Seductive Triangle

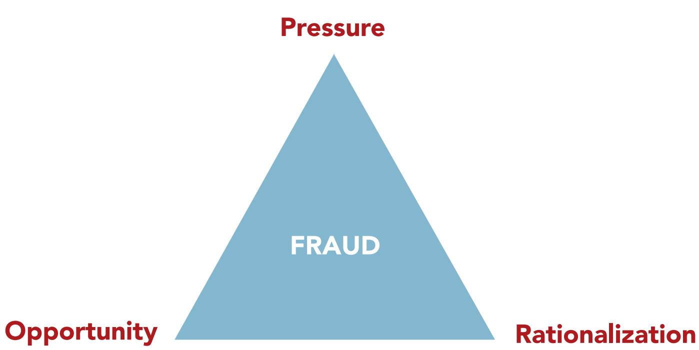
Three conditions typically are present when individuals commit fraud: pressure or an incentive to engage in fraud, a perceived opportunity, and the ability to rationalize fraudulent behavior. This "fraud triangle" was first developed by noted twentieth century criminologist Donald Cressey.[3] These three conditions may exist whether the economy is strong or weak, and, accordingly, fraud can be committed in both good times and bad. How then do these factors motivate fraud?

> There is a pressure at an individual level which I think is significantly associated with compensation arrangements in the organization. There is also pressure at a corporate level, when there is a negative economic environment that makes targets much harder to achieve. Both can create powerful incentives for financial statement fraud.
>
> **Ian Ball,** Chief Executive Officer, International Federation of Accountants

Pressure to commit fraud. Pressure can be either a positive or a negative force. When goals are achievable, pressure contributes to creativity, efficiency, and competitiveness. However, temptations for misconduct arise when goals do not appear to be attainable by normal means, yet pressure continues unabated, with career advancement, compensation, and even continued employment at risk. When pressure is transformed into an obsessive determination to achieve goals no matter what the cost, it becomes unbalanced and potentially destructive. That is when individuals are most likely to resort to questionable activities that may lead to fraud.

Participants in the CAQ roundtable discussions and interviews identified the top three motivators for fraud as *personal gain* (including maximizing performance bonuses and the value of stock-based compensation); *achieving short-term financial goals* (either internal targets or external analyst expectations); and *hiding bad news* from investors and the capital markets. Similarly, the *2010 COSO Fraud Report* found that the most commonly cited motivations for financial statement fraud were "the need to meet internal or external earnings ex-

The Fraud Triangle



pectations, an attempt to conceal the company's deteriorating financial condition, the need to increase the stock price, the need to bolster financial performance for pending equity or debt financing, or the desire to increase management compensation based on financial results." Interestingly, academic research indicates that the desire to recoup or avoid losses is much more likely to motivate an individual to engage in activities that could lead to fraud than the desire for personal gain.[4]

> **I think most people who come unstuck in this context of accounting misstatement are basically honest people who get caught up and then they get desperate.**
>
> **Jonathan Fisher QC,** Barrister, 23 Essex Street Chambers; Trustee, Fraud Advisory Panel

Other research has found that executives and mid-level managers feel that they face continual pressure to meet business objectives as well as the short-term financial goals of analysts and investors. In the KPMG 2008–2009 *Integrity Survey,* 59 percent of managers and employees acknowledged feeling pressure to do whatever it takes to meet business targets; 52 percent believed that they would be rewarded based on results rather than the means used to achieve them; and 49 percent feared losing their jobs if they missed their targets. Consistent with comments from multiple CAQ discussion participants, several recent academic studies have found that executives at companies accused of financial reporting fraud face greater financial incentives to increase stock price, in the form of stock or option holdings, than executives at companies where fraud was not found. The studies indicate that the motivation for fraud is often to increase or prevent a decrease in stock price.[5]

> **When we are talking about material financial statement fraud, it is likely that senior management either knows about it or has caused it by putting so much pressure on employees.**
>
> **Scott Taub,** Managing Director, Financial Reporting Advisors

Financial misstatement or manipulation often starts small, intended as "just a little adjustment" to meet earnings targets or give the company time to improve results. Initially, the individual involved may not even consider what is done to be unacceptable or fraudulent. But as the need to maintain the deception continues, one adjustment leads to another and the scope of the fraud expands until the perpetrator is locked in and headed down the "slippery slope" to major fraud.

Opportunity for fraud. Even when pressure is extreme, financial reporting fraud cannot occur unless an opportunity is present. Opportunity has two aspects: the inherent susceptibility of the company's accounting to manipulation, and the conditions within the company that may allow a fraud to occur. The nature of the company's business and accounting can provide sources of opportunity for fraud in the form of significant related-party transactions outside the ordinary course of business; a large volume of estimates of assets, liabilities, revenues, or expenses that are subjective or difficult to corroborate; and isolated, large transactions. Some large transactions, especially those close to period-end, can pose complex "substance over form" questions that provide opportunities for management to engage in fraudulent reporting.[6]

The opportunity for fraud is also affected by a company's internal environment, which is largely influenced by the entity's culture and the effectiveness of its internal controls. Strong controls can significantly limit possibilities for the manipulation of results or for fraudulent transactions. It is important to maintain a sharp focus on controls in both good and bad economic times. When results are strong and markets are up, there can be a tendency toward complacency, with diminished focus on internal controls and reduced scrutiny of results. In tough economic times, companies trying to do more with less may cut budgets in areas that compromise the effectiveness of internal controls. Both the

Perceived Root Causes of Misconduct (a survey of 5,065 working adults)

Pressure to do "whatever it takes" to meet business targets	**59%**
Believe will be rewarded for results, not means	**52%**
Believe code of conduct not taken seriously	**51%**
Lack familiarity with standards for their jobs	**51%**
Lack resources to get job done without cutting corners	**50%**
Fear losing job if miss targets	**49%**
Believe policies easy to bypass or override	**47%**
Seek to bend rules for personal gain	**34%**

KPMG LLP (U.S.) *Integrity Survey 2008–2009*

PricewaterhouseCoopers *2009 Global Economic Crime Study* and the Ernst & Young *2009 European Fraud Survey* indicated that staff reductions were likely to lead to inattention to normal financial control procedures and thus result in a greater risk of fraud.

Rationalization of fraud. Individuals who commit financial reporting fraud possess a particular mindset that allows them to justify or excuse their fraudulent actions. CAQ discussion participants emphasized that personal integrity is critical in determining whether an individual will be prone to rationalize fraud. However, as the pressure or incentive increases, individuals may be more likely to construct some rationalization for fraudulent actions. For instance, in an environment of extreme pressure to meet corporate financial goals, members of management or other employees may conclude that they have no choice but to resort to fraud to save their own jobs or the jobs of others, or simply to keep the company alive "until the turnaround comes."

> **The greatest risk of manipulation of financials is when management creates an impression that [the manipulation] is needed or expected . . . Most of the people committing fraud are not doing it for personal gain. They are doing it because they feel it is necessary and appropriate.**
>
> **Norman Marks,** Vice President, Governance, Risk and Compliance, SAP BusinessObjects

Where the motivation for fraud is more altruistic than personal—to save jobs or keep the company afloat—the pressure to commit fraud also can become the rationalization for it. The process of rationalization, like the slippery slope to fraud, often starts with justifying a small nudge to the boundaries of acceptable behavior but then deteriorates into a wholesale loss of objectivity. However, discussion participants noted that if employees understand that violations of the company's ethical standards will not be tolerated and if they see senior management living by strict ethical standards and consistently demonstrating high integrity, fraudulent behavior becomes difficult to rationalize.

> **The presence of a process to deter fraud doesn't eliminate the threat of people acting fraudulently.**
>
> **Charles M. Elson, JD,** Edgar S. Woolard, Jr. Chair, Professor of Law and Director of the John L. Weinberg Center for Corporate Governance, University of Delaware

Who Commits Fraud

The three sides of the fraud triangle are interrelated. Pressure can cause someone to actively seek opportunity, and pressure and opportunity can encourage rationalization. At the same time, none of these factors, alone or together, necessarily cause an individual to engage in activities that could lead to fraud. So what exactly is the profile of the person who commits fraud?

Theoretically, anyone has the potential to engage in fraud, and in fact some individuals who commit fraud previously had reputations for high integrity and strong ethical values. When pressures make individuals desperate and opportunity is present, financial reporting fraud becomes a real possibility. As one of the CAQ discussion participants observed, most people who commit fraud do not start with a conscious desire to do so: "They end up there because the world they are operating in has led them to a challenge beyond their capabilities."

Participants in the CAQ roundtable discussions also underscored that the greatest risk of financial reporting fraud relates to what has been called the "Achilles' heel" of fraud—the possibility of management override of controls.[7] Management is in a unique position to perpetrate fraud because it possesses the power to override controls, manipulate records, and facilitate collusion by applying pressure to employees and either enlisting or requiring their assistance.

In some situations, senior leaders do not perpetrate a fraud directly, but instead are indirectly responsible because they put inordinate pressure on subordinates to achieve results that are impossible without "cooking the books." At lower levels in the organization, individuals may not initially realize that they are committing fraud, but instead see themselves as simply doing what is expected to "make their numbers" or responding to the request of a supervisor.

POINT TO PONDER

Even under extreme pressure, only a small percentage of senior management actually commits fraud. Why do some buckle under pressure, and others not? Why and how do good people start down the slippery slope to fraud? Is it a function of circumstances? Or is it a fundamental character flaw?

Participants in the Financial Reporting Supply Chain and Their Roles in Mitigating the Risk of Financial Reporting Fraud

Management, boards of directors, audit committees, internal auditors, and external auditors are all key players in the public company financial reporting process, or "supply chain,"[8] with complementary and interconnected roles in delivering high-quality financial reporting, including the deterrence and detection of fraud.

Management

Members of management have the foremost role in the financial reporting process, with primary responsibility for the deterrence and detection of financial reporting fraud. They are responsible for the maintenance of accurate books and records and the design and implementation of an effective system of internal control over financial reporting. They are also responsible for evaluating and managing the company's business risks, including the risk of financial reporting fraud, and then implementing and monitoring compliance with appropriate internal controls to mitigate those risks to an acceptable level.

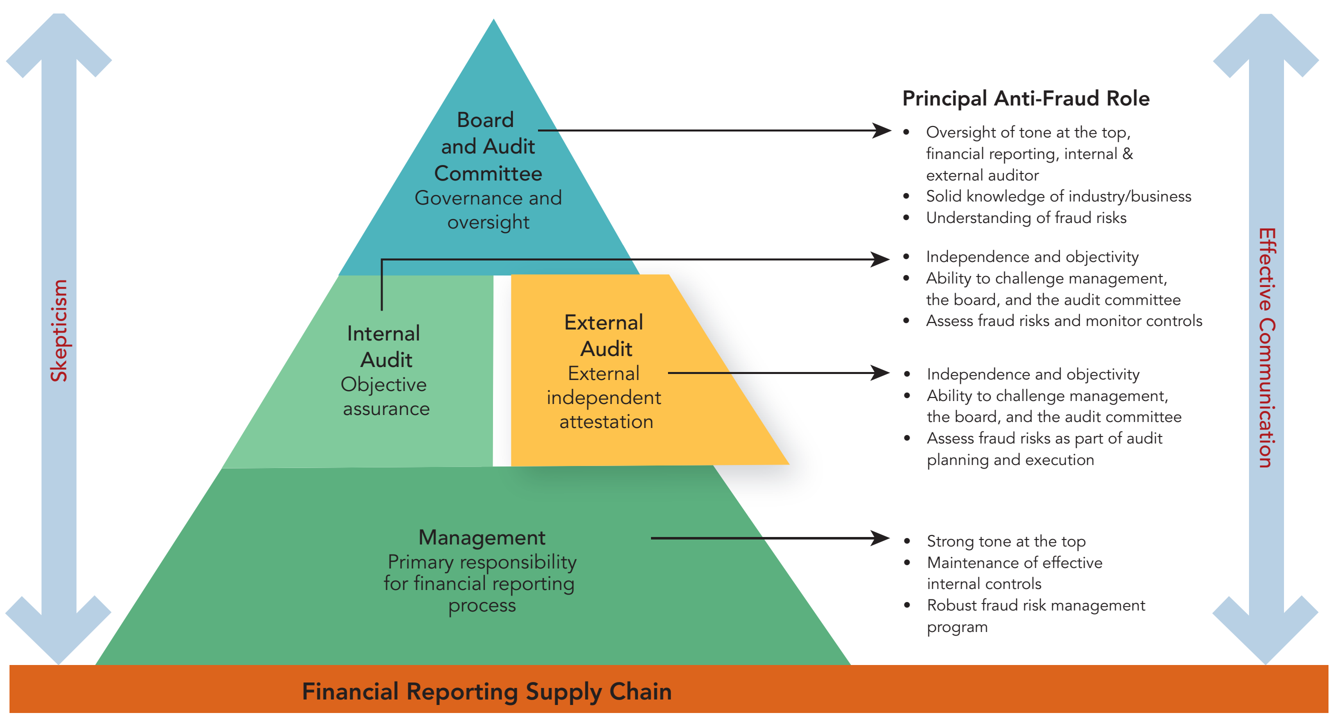
In the case of financial reporting fraud, critical controls start with the ethical tone at the top of the organization and include a strong code of ethics, fraud awareness training, hotline reporting mechanisms, monitoring tools, and processes to investigate, evaluate, and, where necessary, punish wrongdoing.

Senior management reports to the board of directors, with specific reporting to the audit committee on matters related to financial reporting and the risk of financial reporting fraud. While members of management have the foremost role in preventing and detecting fraud, they typically are involved when material financial reporting fraud does occur. According to CAQ discussion participants, in these situations, management is usually found ignoring the company's code of conduct and overriding internal controls. As a consequence, the roles of other parties in the financial reporting supply chain are critical in adequately addressing the risk of financial reporting fraud.

Boards of Directors and Audit Committees

As discussed in detail in several publications from the NACD,[9] the board of directors and audit committee of a public company have ultimate responsibility for oversight of the

Shared Responsibility to the Investing Public for Mitigating the Risk of Financial Reporting Fraud



business, including risk management and the financial reporting process.

The report of the NACD *Blue Ribbon Commission on Risk Governance,* like the Internal Control Framework developed by COSO, recognizes that the foundation for effective governance is board members who are objective, capable, and inquisitive, with a solid knowledge of the company's industry, business, and control environment. CAQ discussion participants stressed that audit committee members should have industry and entity knowledge, including a strong understanding of the economics of the business, in order to identify and understand business and financial risks that may increase the likelihood of fraud.

Most financial statement fraud involves senior management of the company—either directly, because they are the perpetrators, or indirectly, because they have imposed difficult-to-reach performance goals.

Michael Oxley, Former Member of Congress; currently Of Counsel, Baker & Hostetler LLP

The audit committee is responsible for overseeing the financial reporting process and controls, the internal audit function, and the external auditors, including the appointment of the company's external auditor. It oversees management's implementation of policies that are intended to foster an ethical environment and mitigate financial reporting risks. In this process, the audit committee has the responsibility to see that management designs, documents, and operates effective controls to reduce the risk of financial reporting fraud to an acceptable level. The Sarbanes-Oxley Act also makes the audit committee responsible for establishing mechanisms for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or audit matters, and confidential, anonymous submissions by employees of concerns regarding questionable accounting and auditing matters (generally referred to as the ethics or whistleblower program).

In addition, it is increasingly common for the audit committee to have a link with the compensation committee through overlapping members, joint meetings, or attendance of the audit committee chair at certain compensation committee meetings. The objective of this process is to satisfy both committees that the executive compensation structure provides sound incentives for achieving corporate strategies without unintentionally providing motivations for fraud or other unethical behavior. The focus on compensation structures will likely increase as a result of legislation and regulatory rules regarding corporate compensation policies and practices.

Internal Audit

Not all public companies have an internal audit function. However, where companies have an internal audit department, that group is described by The IIA as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations."[10] According to IIA standards, internal auditors should be independent of the activities they audit and free from interference in the conduct of their activities, and should exercise due professional care. Functionally, the chief audit executive commonly reports to the audit committee, with administrative reporting most often to the chief executive officer, general counsel, or chief financial officer.

Under IIA standards, internal audit is responsible, among other things, for evaluating the effectiveness of the company's risk management, control, and governance processes. CAQ discussion participants noted that internal auditors with such responsibilities should have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization.

Internal auditors also are responsible for evaluating risk exposures related to the reliability and integrity of financial information, and specifically "the potential for the occurrence of fraud and how the organization manages fraud risk." In this process, internal audit's role typically includes communicating to the board, audit committee, and management that internal controls, including controls to deter and detect fraud, are sufficient for the identified risks, and verifying that the controls are functioning effectively.[11] Internal audit also may assist management in identifying and assessing risks and the control environment.

In addition to these duties, internal audit may be involved in monitoring the whistleblower program, assessing compliance with the entity's code of ethics, and other activities in support of the organization's ethical culture.

External Audit

External auditors are independent of the organization they audit and provide a public report on the company's annual financial statements. Generally, for U.S. listed companies with $75 million or more in capitalization, the audit also includes an opinion on the effectiveness of the internal controls over financial reporting that management has implemented to address the risk of material misstatements in financial statements.

External auditors report directly to the audit committee, which engages them and oversees the conduct of the audit. Under PCAOB auditing standards, an audit is a detection mechanism specifically designed to assess fraud risk and detect *material* fraud: "An [external] auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."[12]

Due professional care and skepticism are fundamental principles in everything an external auditor does. As part of their professional responsibilities, external auditors are required to discuss with the audit committee, as applicable, matters such as, but not limited to, those that may enter into the evaluation of the risk of financial reporting fraud, the adjustments that resulted from the audit, the auditor's judgment on the quality of the entity's accounting principles, significant accounting estimates, material weaknesses or significant deficiencies in internal controls identified during the audit, and disagreements with management, if any.[13] Because of their experience with a variety of companies, external auditors also are often in a position to provide useful perspectives on best practices in financial reporting and controls, including the mitigation of fraud risks.

> **It's quite plausible for senior management to rationalize fraudulent behavior: "We are not hurting anybody, we are not spending any money, we are protecting jobs, we think the business is going to turn around next year. We are just making sure that we are still here next year when the turnaround comes."**
>
> **David Alexander,** Director of Forensic Services, Smith and Williamson

Themes Related to Deterrence and Detection

The participants at the CAQ roundtable discussions and in-depth interviews agreed that pressure, opportunity, and rationalization are indeed key catalysts for financial reporting fraud. They also agreed that senior management has the primary responsibility for deterring and detecting fraud, working in concert with the board of directors and audit committee and the internal and external auditors.

A fundamental underpinning of any company's efforts to deter and detect fraud is a robust system of internal control. All key players in the financial reporting supply chain have some responsibility with respect to internal control systems. However, the risk of management override of internal controls and other factors means it is not enough to focus only on the design of a company's system of internal control. Thus, the crucial question is how the key players in the financial reporting supply chain, both individually and collectively, can effectively mitigate the risk that the three forces in the fraud triangle will lead to financial statement fraud.

Three themes or categories of fraud deterrence and detection measures emerged from the CAQ's discussions and

Deterring and Detecting Financial Reporting Fraud

Because of the inherent limitations on the effectiveness of controls and the possibility for the override of controls, the risk of fraud can be mitigated but not completely eliminated. Therefore, companies typically employ two strategies to mitigate fraud risks: controls that focus primarily on deterring potential fraud and controls to detect fraudulent activity.

Controls to deter fraud, such as a strong ethical tone at the top and a proactive fraud management program, are highly visible in the organization and are designed to ascertain and mitigate the forces that can enable fraud.

Detective controls generally operate in the background and focus on the timely identification of fraud that has occurred. Examples of detective controls include:

- Process controls such as reconciliations and physical count
- Technology tools to identify anomalies in accounting entries or activity
- Regular management or internal audit reviews of areas of activity (such as accounting estimates) susceptible to manipulation

Some controls, such as a whistleblower program, both deter fraud by their presence and help detect incidents of fraud.

interviews. These themes highlight the actions some companies already are taking to address the risk of financial reporting fraud and stimulate thinking about other potential approaches that may counter one or more of the motivators in the fraud triangle. These same themes are also reflected in recent research on the deterrence and detection of financial reporting fraud.

- First, the tone at the top, as it is reflected throughout a company's culture, is the primary line of defense and one of the most effective weapons to deter fraud
- Second, skepticism, or a questioning mindset on the part of all key participants in the financial reporting process, is a vital tool in evaluating fraud risk and in deterring and detecting potential financial reporting fraud
- Third, strong communication and active collaboration among all key participants are essential to a thorough understanding of the risks of financial reporting fraud and to an effective anti-fraud program

In developing specific next steps to advance efforts to deter and detect financial reporting fraud, it is instructive to focus on how each of the key groups in the financial reporting supply chain can embrace these themes in order to help mitigate the risk of financial reporting fraud. The following chapters discuss each of the themes and the related responsibilities of each stakeholder group—management, boards and audit committees, internal auditors, and external auditors.

2 CHAPTER

Tone at the Top

The Power of Corporate Culture

In both the CAQ's roundtable discussions and in-depth interviews, participants were unanimous that an organization's ethical culture is a decisive factor in mitigating the risk of fraudulent financial reporting, and that the corporate culture can either deter financial reporting fraud or implicitly condone it. Similarly, the PricewaterhouseCoopers *U.S. Supplement to the 2009 Global Economic Crime Survey* found that 72 percent of the responding executives identified issues relating to corporate culture as the root cause of increased economic crime.

A strong ethical culture starts with an organization's most senior leaders (thus the phrase "tone at the top") and cascades down through the entire organization to create—in the words of several participants in the CAQ roundtables and interviews—a "mood in the middle" and a "buzz at the bottom" that reflects and reinforces the company's operating values. Boards and audit committees, along with internal auditors, play vital roles in building and sustaining the organization's ethical culture.

Corporate culture influences all three sides of the fraud triangle. A strong ethical culture creates an expectation of doing the right thing and counteracts pressures to push the envelope to meet short-term goals. Likewise, an ethical culture typically supports well-designed and effective controls that diminish opportunities for fraud and increase the likelihood that fraud will be detected quickly. A culture of honesty and integrity can severely limit an individual's ability to rationalize fraudulent actions. However, if an employee is motivated by personal reasons such as greed or financial need, he or she may be impervious to the influence of corporate culture.

Tone at the Top Does Matter

The *Integrity Survey 2008–2009*, conducted by KPMG LLP, found that among companies with a comprehensive ethics and compliance program, 90 percent of the respondents described the environment as one where people feel motivated and empowered to do the right thing. In companies without a comprehensive ethics and compliance program, only 43 percent gave that response.

Tone at the top is a level of commitment to integrity, to doing the right thing at all costs despite the consequences such action may have on financial performance. Actions speak louder than words. Observing how leaders make decisions and act on a day-to-day basis is the most convincing evidence about the cultural reality at a company.

Mark S. Beasley, Ph.D.,
Deloitte Professor of Enterprise Risk Management and ERM Initiative Director, North Carolina State University

Culture and Management

Of all the groups with a role in the financial reporting supply chain, management has the most critical role, because it is responsible for setting the tone at the top and establishing the culture and designing the systems that drive the organization. In the opinion of CAQ discussion participants, companies successful in building an ethical culture that deters fraud do so through a dual approach. First, they clearly state their ethical standards, and second, senior management visibly lives by those standards every day and reinforces them through the entire organization with appropriate systems and processes. The processes and criteria by which management makes decisions are crucial as they signal to the organization what is truly valued.

CAQ discussion participants stressed that an organization's tone at the top reflects its commitment to deterring and detecting fraud. If employees understand the organization's ethical expectations, believe that misconduct will not be tolerated, and see their senior leaders adhering strictly to the code of conduct, they are less likely to succumb to temptations to commit fraud and are more likely to report fraud if they see it. It's all about the example set by leadership, at all levels. In other words, the key is to walk the talk.

The Talk—Clear Policies and Messaging. According to CAQ discussion participants, to be effective, a company's ethical policies and standards should be unambiguously clear throughout all levels of the organization and in all geographic locations. It is senior leadership's responsibility to communicate these messages and continually reinforce them in a way that permeates through the entire organization. Employees need to hear the same messages not only from top leaders but also from their direct supervisors. As several participants in the CAQ roundtables and interviews pointed out, first-line supervisors have the most powerful and direct influence on the ethical judgments of employees. It is vital that the mood in the middle among these supervisors echo the company's talk on ethical values, so that the values become part of the daily conversation and the buzz at the bottom. Messages should emphasize each employee's duty to report questionable behavior, and performance goals and compensation plans should reinforce the primacy of ethical conduct.

The following steps can strengthen an organization's messaging related to ethics and fraud deterrence:

- Ongoing, consistently branded corporate communications that are rolled out across multiple forms of media and:
  - Communicate clear messages about specific objectives
  - Make an emotional appeal
  - Are customized to different employee groups, geographies, and cultures
  - Are regularly assessed and updated
- Periodic ethics training for employees, tailored to the level and needs of different employee groups
- Fraud awareness training that educates employees on the characteristics of fraud and the behaviors and other red flags that may suggest fraudulent conduct
- Regular reviews of ethics policies to identify gaps and incorporate best practices

In addition, management (particularly senior management) should be sensitive to the pressures placed on employees. For example, management needs to consider the impact of compensation plans and performance expectations for employees, particularly in high-pressure situations. To avoid creating unintended pressure to falsify results, managers should be mindful of the stresses that their employees may feel in trying to "make the numbers," and try to design goals that are realistic and achievable. If the economic environment or other assumptions for original goals change, managers should consider modifying such goals accordingly.

> The choices the top makes are going to define what's acceptable ethically.
>
> **David Larcker, Ph.D.,** James Irvin Miller Professor of Accounting, Stanford University Graduate School of Business

> If we tell people we expect you to hit this number next quarter, and your bonus depends on it, that provides an incentive to meet it or to lie about meeting it.
>
> **Nell Minow,** Editor and Co-Founder, The Corporate Library

The Walk—Actions Speak Louder Than Words. The "talk" about ethical behavior is important, but what really matters, according to CAQ discussion participants, is the example set by senior managers in their business and personal lives. A classic example is Enron, which at one time was lauded for its code of conduct and corporate governance programs, but which lacked leadership commitment to its principles. Moreover, the same standards of

Effective Codes of Conduct Are Based on Principles

"Exhaustively detailed codes of conduct encourage acquiescence and bureaucracy but fail to inspire employees with the spirit of ethical behavior. The most effective codes of conduct function not as rulebooks but as constitutions that detail the fundamental principles, values, and framework for action within an organization."

—LRN, *Ethics and Compliance Risk Management*, 2007 behavior should be applied to all levels of management, from first-level supervisors through the most senior ranks.

To integrate ethical behavior into the fabric of the company's culture, senior management's operating policies and decisions should reflect an unwavering commitment to the company's ethical values. Senior management should hold itself and all company personnel strictly accountable for compliance with ethical standards, and consequences for violations need to be consistently applied and clearly communicated.

> **Number one is talk the talk and number two is walk the talk by continuing to reinforce values in the discussions with the company personnel. Whether it's letters to the employees, letters to management, it's an ongoing process, not something where you paste something on the wall and walk away from it.**
>
> **John Trakselis, CPA,** Past President, Financial Executives International—Chicago Chapter

Annual employee surveys are excellent tools to obtain feedback on employees' understanding and perspective on ethics and compliance programs. As suggested by the consulting organization LRN, an effective employee survey should include questions that go beyond direct ethical issues and also ask about working conditions and overall job satisfaction, which often have significant ethical implications. The key is to craft questions that lead employees to comment on the organization's ethical culture. For example, a question might ask, do management and supervisors provide information and keep commitments? Responses may indicate whether management strictly abides by the rules or tends to push the limits of acceptable behavior.[14]

Fraud Risk Management Programs. In order to effectively deter and detect financial reporting fraud, management's activities also need to include a comprehensive fraud risk management program. Since the foundation for such a program is strong risk governance, many participants suggested that an appropriate member of senior management such as the chief risk officer, the ethics and compliance officer, or the general counsel should have explicit responsibility for the program, with audit committee oversight and ongoing monitoring of all of its aspects.

An effectively designed fraud risk management program starts with a formal assessment of fraud risk, which is tailored to the company, is updated annually, and evaluates incentives and opportunities to commit fraud. It also includes internal controls specifically designed to deter and detect financial reporting fraud.

The whistleblower program is one such control. Others include fraud awareness training for employees and robust controls over the financial reporting process. The program should also include a clear process for prompt investigation of allegations of fraud, along with swift corrective action if fraud is identified. The organization's response to fraud should send a clear signal that fraud will not be tolerated, at any time, in any place, or by any level of employee.[15]

The 2010 ACFE *Report to the Nations on Occupational Fraud and Abuse* found that, on average, the frauds in the study continued for two years from the point they began to the point they were detected, with some running consider-

Elements of Effective Fraud Risk Management

- A formal fraud risk management program that includes a code of ethics supported by the tone at the top; clear roles and responsibilities for the board, the audit committee, management, and internal audit; and fraud awareness and reporting training for all employees
- A comprehensive fraud risk assessment that addresses incentives and opportunities to commit fraud and the likelihood and significance of each potential fraud risk, including the risk of management override of controls
- Activities and controls to deter and detect fraud, including the consideration of fraud risk in the development of the annual internal audit plan and in the execution of internal audit engagements
- Processes for the investigation of potential frauds and for corrective action when necessary

Summarized from *Managing the Business Risk of Fraud: A Practical Guide*, by American Institute of Certified Public Accountants, Association of Certified Fraud Examiners, and and The Institute of Internal Auditors, 2008.

ably longer. Companies need to make continuous improvements in order to increase the likelihood that fraud is detected on a timely basis. The *Fraud Risk Checklist* published in 2008 by the Financial Executives Research Foundation provides an example of a structured approach for management to identify and mitigate potential risk factors for fraudulent financial reporting.[16]

Whistleblower Programs. Many CAQ discussion participants underscored the importance of a readily accessible whistleblower reporting mechanism, such as a hotline, to receive reports of concerns about ethics violations or potential fraud. The 2010 Institute of Internal Auditors Knowledge Alert on *Emerging Trends in Fraud Risks* identified a tool for confidential reporting as one of the key components of a fraud management program.

The Sarbanes-Oxley Act makes the audit committee specifically responsible for establishing and overseeing a confidential reporting mechanism. To promote its use, the Act requires that the procedures allow for reports to be submitted confidentially and anonymously. In order for the program to be effective, it is also important that there be a clear record of non-retaliation. Participants emphasized that allegations involving senior management and/or financial irregularities should be escalated to the audit committee immediately. In addition, for the whistleblower program to have credibility, reported matters should be investigated promptly, and meaningful penalties should be imposed when violations are confirmed. Numerous surveys reveal that many employees still fail to report fraud or other misconduct because they either fear retaliation or do not believe that management will do anything to stop the unethical behavior.[17] For that reason, some CAQ discussion participants suggested that companies consider sharing a summary of information about hotline reports and their disposition within the organization.

Boards and audit committees should set a culture in the organization of highly ethical behavior and communicate to those within the organization that if there is a problem, a vehicle exists for those inside the organization to report it in an anonymous way so that they don't feel jeopardized.

Michael A. Moran, Vice President, Global Markets Institute, The Goldman Sachs Group, Inc.

While the participants in the roundtable discussions noted that a large majority of calls to hotlines relate to relatively minor human resources matters, a meaningful percentage of reports identify serious misconduct or fraud. According to both the 2010 ACFE *Report to the Nations on Occupational Fraud and Abuse* and the 2009 PricewaterhouseCoopers survey, *Economic Crime in a Downturn,* fraud was much more likely to be detected by tips than by any other method. The ACFE study reported that "approximately half of fraud tips came through a hotline when that

Features of a Well-Designed Whistleblower Program

- Option for anonymity
- Organization-wide (global) and available 24/7, ideally by telephone, with professionally-trained interviewers in all local languages
- Single hotline for all ethics-related issues
- Dual dissemination of the information received so that no single person controls the information, with criteria for immediate escalation where warranted, and for notification of the audit committee when financial irregularities or senior management are involved
- Case management protocols, including processes for the timely investigation of hotline reports and documentation of the results
- Management analysis of trends and comparison to norms
- Data security and retention policies and procedures
- Customization to comply with the laws of foreign jurisdictions and to address cultural differences
- Ongoing messaging to motivate everyone in the organization, as well as vendors, to use the hotline

Summarized from *Best Practices in Ethics Hotlines,* T. Malone and R. Childs, The Network, 2009 mechanism was available, and . . . 63 percent of the hotline reports involved fraud by a manager or executive." The PricewaterhouseCoopers report found that 48 percent of frauds were discovered as a result of tips or hotline reports and concluded: "Whistle blowing is a tangible example of a benefit that companies can realize from building a culture where fraud is not tolerated and those that report it have no fear of retaliation."

POINT TO PONDER

The Dodd-Frank Act of 2010 directs the SEC to reward whistleblowers. Because tips are an effective means for identifying misconduct, should companies consider a reward system for tips leading to discovery of fraud?

Challenges of Cross-Cultural Differences. Public companies are increasingly global in scope, and multinational corporations face special challenges in trying to foster a consistent level of ethics across different countries and cultures. Instilling a consistent standard of ethical behavior is much more complex than just translating an ethics code or fraud deterrence program into different local languages. It requires capturing the nuances of meaning in the local language and tailoring policies to local customs, as well as determining that controls are implemented and compliance consistently monitored despite geographic distance. Creating a uniform ethical culture also means evaluating cultural differences that may create pressures, opportunities, or rationalizations for fraud that are different from those typical in the United States.

For example, it may be necessary to explain how the organization's policies are more restrictive than the law or common practice in a particular country. Certain expectations for behavior, such as a prohibition on "facilitation payments," may be more restrictive in the United States than what is normally acceptable in another jurisdiction. As one CAQ discussion participant pointed out, "Process bridges cultures. Checks and balances, transparency, and process will be more successful than any speech on ethics."

> **The audit committee needs to set the tone at the top. It should make it clear to management and the auditors that there is only one standard for how we do things, and that is the right way—and that doesn't mean the right way only if it's material."**
>
> **J. Michael Cook,** Audit Committee Chair, Comcast Corporation

Culture and Boards and Audit Committees

Under the Sarbanes-Oxley Act, audit committee members must be independent of management and must have a designated financial expert or explain why they do not. In addition, the audit committee is responsible for oversight of the confidential whistleblower program and for engaging and overseeing the external auditors. These responsibilities, along with the role of the board and audit committee in overseeing risk management, give boards and audit committees a central role in an organization's efforts to discourage and uncover fraud.

Among other things, boards and audit committees play a key role in reinforcing an appropriate tone at the top for both corporate conduct and risk management by making ethical conduct an overriding priority, including establishing a code of ethics specifically for the board that is consistent with the corporate code. CAQ discussion participants emphasized that the board and audit committee should make themselves visible in the organization as proponents of high ethical standards. Most importantly, the board and the audit committee support the tone at the top by putting the right senior management team in place as their representatives to the organization.

Boards and audit committees have the responsibility to assess the integrity of senior management on an ongoing basis. In particular, audit committees should be aware of and monitor the risk of management override of internal controls as a part of their oversight of the financial reporting process. Audit committees should pay specific attention to leveraging the internal audit function. According to 45 percent of the respondents to the *2009 Global Integrity Survey* by *Compliance Week* and Integrity Interactive Corporation, internal audit plays an essential role in gauging the overall level of integrity and ethics within a company. Another 33 percent indicated that internal audit contributes to this effort.

Executive compensation. Boards (through their compensation and audit committees) should evaluate whether incentive compensation plans—especially those for senior management—are aligned with the company's ethical values and long-term business goals. However, the *2009 Global Integrity Survey* noted that "half of the respondents said they don't tie integrity to executive compensation." Because incentive structures can influence the ethical environment within organizations, several of the CAQ discussion participants stated that links between compensation and audit committees should be strengthened. Additionally, the audit committee may consider evaluating the performance and compensation of the chief audit executive as well as employment or termination decisions for both the chief financial officer and chief audit executive.

Compensation goals are good when they balance short-term and long-term goals and objectives, and they look at the behavior that someone who is striving to achieve that goal is going to exhibit. Overemphasis on short-term goals can create incentives that do not foster ethical behavior.

Kathy Swain, Vice President, Internal Audit, The Allstate Corporation

POINT TO PONDER

How can the board and audit committee identify when a previously strong tone at the top starts to shift and morph into something more receptive to inappropriate risk-taking or behavior?

Culture and Internal Audit

The internal audit function has a key role in communicating, reinforcing, and evaluating the ethical culture of an organization, including testing compliance with anti-fraud programs and other controls. Internal auditors can be extremely valuable as "eyes and ears" for management as well as for the board and audit committee. The more substantive and visible their activities to support ethical standards and assess the risk of fraud, the greater their impact will be.

According to The IIA, a best practice for internal audit departments is to have a direct line of reporting to the audit committee. Along those lines, it is encouraging that 84 percent of respondents to a 2009 survey by the global internal auditor community AuditNet indicated that the chief audit executive had unrestricted direct access to the audit committee.[18]

To be effective, the internal audit staff should be knowledgeable and experienced, with the necessary expertise and tools, including fraud detection training and fraud specialists on staff, where possible. Moreover, the ability of internal audit to support the deterrence and detection of financial reporting fraud depends on the board and senior management sending a clear message on the importance of internal audit activities (for instance, by requiring all levels of management to respond to internal audit inquiries and findings).

Ten Principles for Effective Board Oversight of Risk

The 2009 report of the NACD *Blue Ribbon Commission on Risk Governance* identifies the following ten principles for effective board oversight of a company's risk management system. These principles are intended to serve as a foundation for a comprehensive risk management system tailored to the specific characteristics and needs of each individual company:

1. Understand the company's key drivers of success.
2. Assess the risk in the company's strategy.
3. Define the role of the full board and its standing committees with regard to risk oversight.
4. Consider whether the company's risk management system is appropriate and has sufficient resources.
5. Work with management to understand and agree on the types of risk information the board requires.
6. Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions.
7. Closely monitor the potential risks in the company's culture and its incentive structure.
8. Monitor critical alignments of strategy, risks, controls, compliance, incentives, and people.
9. Consider emerging and interrelated risks to help prepare for what's around the corner.
10. Periodically assess the board's risk oversight processes.

One of internal audit's roles is to challenge the design of a company's internal controls and to monitor their effectiveness, particularly in major risk areas. In some organizations, internal audit is tasked with managing the compliance and ethics program. Whether or not they manage the program directly, internal audit should consider issues raised through the program in the context of their role related to financial reporting fraud. Commonly, internal audit is charged with working with the audit committee in administering the program and determining that any response is rapid and appropriate.

Beyond these specific responsibilities, The IIA's Research Foundation, in a recent book by James Roth, *Best Practices: Evaluating the Corporate Culture,* has suggested that the greatest value that internal audit can provide is in the evaluation of "soft controls," which are "the informal, intangible levers of control such as tone at the top, the organization's ethical climate, and management's philosophy and operating style" that, taken together, constitute the corporate culture. The particular focus should be on identifying any gaps between the company's stated ethical and cultural values and the way the company actually operates. Roth presents various case studies to support his conclusion that root cause analysis of major frauds and business failures "leads inevitably to the culture of the organization," and that serious weaknesses in formal or "hard" controls usually have a soft control weakness as the underlying root cause. The evaluation of soft controls hinges on gathering employee perceptions and confirming whether they are accurate.

POINT TO PONDER

If internal audit is expected to assess and challenge the tone at the top of a company, is the function structured properly to maintain its objectivity? For example, if the career path of most internal audit staff (including in some cases the chief audit executive) is to rotate back into the mainstream organization, is there a conflict of interest that potentially compromises objectivity?

Culture and External Audit

Professional standards require the external auditor to obtain an understanding of the company's system of internal control as part of the audit planning process. To this end, an auditor considers several factors such as management's philosophy and operating style (including the integrity and ethical values practiced by management), the company's commitment to competence, the effectiveness of the board and audit committee's oversight, and the company's human resource policies and practices (including compensation arrangements). These factors encompass the auditor's evaluation of an organization's tone at the top and overall corporate culture, including incentives or pressures that may exist for management to engage in fraudulent financial reporting. This evaluation is an important consideration in the auditor's overall design of the audit and the assessment of the risks of material misstatement of the financial statements due to error or fraud.

Because external auditors work with a wide variety of people across many parts of a company's operations, they often have the opportunity to gain insights at various levels about the company's culture, as well as on the effectiveness of internal controls. CAQ discussion participants suggested that external auditors can leverage their experience from working with multiple clients—assessing a broad range of control systems, practices, and organizational structures—to identify possible warning signs and concerns that should be discussed with the company's board and audit committee. By analyzing past frauds and understanding the conditions in which they came about, auditors serve as a useful resource for boards, audit committees, and members of management who may not have a similar breadth of experience or training.

POINT TO PONDER

As part of their regular communications with audit committees, should external auditors discuss the observations related to a company's tone at the top and its culture (including management integrity) obtained as part of the annual audit and quarterly reviews?

SUMMARY OF CONSIDERATIONS RELATED TO TONE AT THE TOP

For Management

1. Clearly articulate the organization's ethical standards in a set of core values and a formal code of conduct, and hold all personnel strictly accountable for compliance with the code. Enforce discipline for violations consistently across all levels of the organization.

2. Set the right tone at the top. Embed the code of conduct into the fabric of the company's culture by "walking the talk," leveraging communications and training, and reinforcing the standards at all levels of the company through appropriate management systems and processes.

3. Build a mood in the middle that mirrors the tone at the top. Emphasize the critical role of supervisors in setting the tone for their direct reports and their teams by both word and deed.

4. Establish a comprehensive fraud risk management program, including a whistleblower program and fraud awareness training for all employees. Consider cultural differences in other jurisdictions. Assign responsibility for the fraud risk management program to an appropriate member of senior management, and assess the effectiveness of the program at least annually.

5. Internally communicate the actions taken related to tips received from the whistleblower program.

6. Design incentive compensation programs so that their structure does not unintentionally provide a potential incentive for misconduct or fraud.

7. Set and enforce high standards for compliance with internal controls over financial reporting, including diligent monitoring and the provision of adequate resources to comply with established procedures.

For Boards and Audit Committees

1. Personally "walk the talk" of the company's core values and code of conduct. Be visible outside the boardroom, and interact personally with employees at various levels to obtain their perceptions of the corporate culture and reinforce high ethical standards.

2. Adopt a strong tone of compliance, communicate it to the entire organization, and hold management accountable. Take decisive action against any member of senior management who does not adhere to the company's ethical standards and code of conduct.

3. Regularly review key strategies and business plans and assess the achievability of goals in light of current circumstances. Goals should be structured to avoid a rigid short-term focus that might push management or employees to commit fraud.

4. Establish a regular process for assessing management integrity, and do not let this activity become perfunctory.

5. Approve the internal audit charter and the annual work plan to ascertain that it is aligned with and addresses the audit committee's needs and its expectations for internal audit.

6. Review and understand the results of reports to the whistleblower program, focusing on complaints that involve senior management or reflect on the ethical culture of the company. Leverage the internal audit function.

7. Evaluate ways to strengthen relationships between the audit committee and the compensation committee—either through overlapping membership, joint meetings, or audit committee chair attendance at relevant meetings of the compensation committee—with the objective of designing compensation packages that promote ethical behavior, as well as providing incentives to meet financial goals and build long-term shareholder value.

8. Consider the role of the audit committee in evaluating the performance and compensation of the chief audit executive, as well as the benefits of adopting a policy that the audit committee concurs in employment or termination decisions for both the chief financial officer and the chief audit executive.

For Internal Audit

1. Work proactively with the audit committee to develop a clear, shared vision of the internal audit function in order to reinforce the integrity and importance of the function throughout the company.

2. Require basic fraud detection training, including the detection of financial reporting fraud, for all internal auditors.
3. If warranted, consider allocating one internal audit position for a fraud specialist, ideally someone with appropriate experience and certifications.
4. Take an active and visible role in supporting the ethical culture, including evaluating hotline results, conducting ethics surveys of employees, and collaborating with other departments to address results and remediate applicable findings. Analyze year-over-year changes in key metrics.
5. Evaluate soft controls and the corporate culture, including assessment of the company's fraud risk management program, and involve appropriate departments in addressing the results.
6. Establish or otherwise ensure there is a formal process to educate the board and audit committee on the risks and red flags of financial reporting fraud, with a particular focus on the risks of management override of controls.

For External Auditors

1. Inquire of management and the audit committee how they push the tone at the top down through the entire organization and integrate it into the culture at all levels. Focus the discussion on the details of the company's communications and training programs, including the tools that help each level of management reinforce the desired messages with its direct reports.
2. Discuss with management and the audit committee how they monitor the company's culture to confirm that it does in fact reflect the tone at the top. Ask what tools and methodologies are used, such as employee surveys and reports summarizing hotline results, and what is done with the results.
3. Proactively engage the audit committee in discussing observations related to the tone at the top obtained as part of the audit, as well as insights into ways to identify possible red flags and warning signs.
4. Provide management, the board, and the audit committee with examples of leading practices related to ethics communications, hotlines, and programs to mitigate the risk of financial reporting fraud.

CHAPTER 3

Skepticism
An Enemy of Fraud

Skepticism—a questioning mindset and an attitude that withholds judgment until evidence is adequate—promotes risk awareness and is inherently an enemy of fraud. Participants in the financial reporting supply chain naturally believe that the organizations with which they are associated have integrity, and are therefore predisposed to trust each other. But this bias to trust can also inhibit raising questions, and it is all the more reason why stakeholders should consciously adopt an attitude of skepticism.

Skepticism involves the validation of information through probing questions, critical assessment of evidence, and attention to red flags or inconsistencies. Skepticism does not mean a lack of trust. Rather, it means, "I trust you, but my responsibilities require me to confirm what you and others tell me." Some refer to this as the "trust but verify" approach.

The starting point for effective skepticism is the recognition that even the best system of internal control has weaknesses, and fraud can occur. Effective skepticism involves knowledge of the company's business, including the risks associated with the industry and company, the manner in which the company manages those risks, and the company's overall internal control structure.

While skepticism is a concept that is primarily used in the context of the professional skepticism of an external auditor, CAQ discussion participants stressed that the ability to question and critically assess information is a skill that also is essential for boards, audit committees, management, and internal auditors in the conduct of their responsibilities. Academic research has confirmed a positive relationship between skepticism characteristics and fraud detection skills.[19]

By exercising skepticism and promoting the cultural expectation that questions are healthy and appropriate, management, the board, the audit committee, internal audit, and external audit can work to counteract the three forces of the fraud triangle and mitigate the risk of financial reporting fraud. As one of the CAQ discussion participants stated, "That is one of the biggest deterrents to fraud—knowing that people are interested, are listening, and will react."

Skepticism and Management

CAQ discussion participants agreed that effective managers rely on the use of skepticism in virtually all activities. Whether in designing strategy, assessing risks, setting goals, reviewing progress, or evaluating results, managers need a questioning attitude.

For instance, management's assessment, design, and implementation of internal controls over financial reporting should acknowledge that the organization can be susceptible to fraud, despite past experiences or beliefs about employee integrity. As a result, an appropriate system of internal controls should create checks and balances and should include processes to continually monitor and reevaluate the effectiveness of controls.

In reviewing operating and financial reports, discussion participants suggested that management follow up when results seem inconsistent with expectations or with economic trends in the company's industry sector. In effect, skepticism involves management stress-testing its own decisions and assumptions about financial reporting processes and controls, as well as the decisions and work of subordinates, to gain confidence that nothing significant has been missed and that things are what they seem. Through this process, management can offset many fraud risk factors. Skepticism also tends to diminish the perception of opportunity for fraud and the ability to rationalize fraudulent behavior.

Skepticism and Boards and Audit Committees

CAQ discussion participants suggested that the audit committee needs to be keenly aware that business pressures can find their way to personnel from many different directions. Once these pressures and influences come into play, management can lose objectivity and start down the road of reporting improper results. Over time, the accounting determinations can become even more aggressive and ultimately can lead to large-scale financial fraud.

As CAQ discussion participants continually emphasized, the foundation for effective governance and oversight by the board and its committees is skepticism, in the form of vigorous and probing questions of management, the internal auditors, and the external auditors to find sources of bias. To do so, the audit committee first needs to acknowledge the possibility that bias may exist and that something may go awry, potentially resulting in fraud. Good board and audit committee members know what techniques to use to evaluate management, how to ask the right questions, when to drill down with follow-up questions, and how to identify and assess possible "uncomfortable" behavior. Probing questions are essential both to test the integrity of management and to communicate a clear expectation of ethical behavior. At times, that approach may be uncomfortable. However, as one CAQ discussion participant stated, "Comfort is not a requisite for directors. . . . I don't need to be comfortable. I just need to be able to ask the hard questions." Asking the same questions of various people is another tool that audit committees can employ to assess the consistency of answers and obtain multiple perspectives.

> **Board members should be a little more skeptical and less trusting. Not that they don't trust the company's management. But they should do their own due diligence and recognize they have to keep their eye on these things by spending more time making judgments, connecting the dots and following through by asking more questions.**
>
> **Peggy Foran,** Vice President, Chief Governance Officer, and Corporate Secretary, Prudential

To exercise skepticism effectively, as CAQ discussion participants underscored, members of the board and the audit committee need to have a thorough knowledge of the company's business, including its industry, its competitive environment, and the key risks that may affect management's ability to accomplish objectives. The board and audit committee can benefit from focused conversations with management and the internal and external auditors on the risks of financial reporting fraud. In particular, boards and audit committee members need to understand how their organization makes money. Because revenue manipulation and the acceleration of future results into the current period are the most common forms of financial reporting fraud, under-

Six Characteristics of Skepticism

- Questioning Mind—A disposition to inquiry, with some sense of doubt
- Suspension of Judgment—Withholding judgment until appropriate evidence is obtained
- Search for Knowledge—A desire to investigate beyond the obvious, with a desire to corroborate
- Interpersonal Understanding—Recognition that people's motivations and perceptions can lead them to provide biased or misleading information
- Autonomy—The self-direction, moral independence and conviction to decide for oneself, rather than accepting the claims of others
- Self-Esteem—The self confidence to resist persuasion and to challenge assumptions or conclusions

Summarized from R. Kathy Hurtt, "Development of a Scale to Measure Professional Skepticism," *Auditing: A Journal of Practice and Theory,* May 2010.

standing what drives the company's revenue is critical to deterring and detecting financial reporting fraud.

KPMG's 2007–2008 *The Audit Committee Journey* survey of public company audit committee members found that only 28 percent were "very satisfied" that they understood management's processes to identify and assess significant risks facing the company, and only 21 percent were satisfied with the information they received on the organization's risk management efforts. Because it is necessary to understand business risks in order to manage them, these findings raise concerns.

Although the complexity of the information that boards and audit committees must absorb can be daunting, particularly given the relatively short amount of time available, there are resources and tools that can be of assistance. For instance, the internal audit function, the external auditors, ethics and compliance personnel, and reports and statistics from the company's internal whistleblower program can provide in-depth information that is both nuanced and candid. Where appropriate, boards and audit committees should also have ready access to outside experts and legal counsel.

> **Board members need to be trained to ask the kinds of questions that are very probing without sending a signal that there is no trust in anything being done.**
>
> **William J. White,** former Chairman of the Board, Bell & Howell Company

The role of an audit committee member is to oversee the financial reporting activities of the company, not to directly manage the company. In particular, audit committee members should understand the exposure to management override of controls and take action to monitor those risks and mitigate the possibility that an override could occur, or, if it did occur, that it could go undetected. Skepticism openly displayed, in combination with a solid understanding of the business and current environmental opportunities and challenges, forms the foundation for effectively monitoring the risk of management override.[20] Audit committee members should be comfortable in asking probing questions and should use internal auditors, external auditors, ethics and compliance personnel, or others as sources of information to supplement what they learn directly.

POINT TO PONDER

If skepticism can be defined as "trust but verify," would audit committee members benefit from training to enhance their ability to evaluate non-verbal cues during discussions with management?

Monitoring the Risk of Management Override—Key Steps for Boards and Audit Committees

- Understand the business and industry, including:
  - Key drivers of revenue and earnings and related key performance indicators
  - Factors that may threaten management's ability to achieve its goals and strategies
  - Pressures created by the company's incentive compensation programs
- Brainstorm with management, external auditors, and counsel in an executive session to identify fraud risks
- Assess the tone at the top and the corporate culture through an evaluation of corporate communications on ethics and the results of employee surveys
- Establish an effective whistleblower hotline
- Develop a broad information network that extends beyond senior management to include internal auditors, external auditors, the compensation committee, and key employees such as business unit leaders, marketing and sales personnel, and corporate managers just below the senior management level. Interaction with key employees during company meetings or other functions can provide the opportunity to build relationships and establish confidential dialogues.

Summarized from *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention,* American Institute of Certified Public Accountants, 2005.

Inquiring about Financial Reporting Fraud—A Guide for Audit Committees

The mere mention of the word fraud can be enough to stall a conversation or at best elicit a canned response. Also, compliance-oriented questions do not tend to yield a productive discussion. Shifting the focus away from compliance and toward the sources of influence on the financial reporting system that can cause fraud has proven to be an effective method of starting a productive fraud discussion.

During a conversation between the audit committee and management, the internal auditors, or the external auditors, the audit committee should be alert for indications of where follow-up is needed to validate processes and controls that deter or detect fraud. The list of questions below is not intended to be all-inclusive; rather, it represents sample inquiries designed to elicit information from management or the auditors about fraud risks without asking about fraud directly.

These examples are not a checklist of questions to be posed word for word. Rather, they were developed by the Center for Audit Quality to advance the thinking of audit committees around the most likely sources of weakness, with a particular eye for business pressures that may influence accounting judgments or decisions. It is important that audit committees fine tune these questions to fit the organization and recognize that these suggestions are only the starting point for a conversation.

1. What are the potential sources of business influence on the accounting staff's judgments or determinations?
2. What pressures for performance may potentially affect financial reporting?
3. What about the way the company operates causes concern or stress?
4. What areas of the company's accounting tend to take up the most time?
5. What kind of input into accounting determinations does non-financial management have?
6. What are the areas of accounting about which you are most worried?
7. What are the areas of recurring disagreement or problems?
8. How does the company use technology to search for an unnatural accounting activity?
9. If a *Wall Street Journal* article were to appear about the company's accounting, what would it most likely talk about?
10. If someone wanted to adjust the financial results at headquarters, how would they go about it and would anything stop them?

These questions are intended to assist in obtaining a better understanding of the sources of influence on the financial reporting system that may affect the objectivity of accounting judgments or determinations.

The reason for this focus is that fraudulent financial reporting rarely starts with dishonesty. Rather, it typically starts with pressures for performance that influence accounting judgments and thereby introduce bias into the system.

A key objective of the audit committee, therefore, is to uncover potential sources of bias or influence on accounting judgments.

Skepticism and Internal Audit

Internal auditors can be a valuable resource to provide boards and audit committees with insight into the company's ethical culture, the effectiveness of its internal controls, and its exposure to management override. IIA standards call for the internal auditor to have an impartial and unbiased attitude, and internal audit's professional responsibilities include evaluating both the potential for fraud in an organization and how the organization manages the risk of fraud.

Appropriate skepticism is critical to this role—it assists an internal auditor in reviewing audit evidence, verifying management's assertions, assessing the sufficiency of management's fraud risk assessment, and evaluating the design and operating effectiveness of internal controls intended to detect or deter fraud. Additionally, skepticism reinforces alertness to information or conditions indicating that a material financial misstatement, intentional or otherwise, may have occurred. Because of their constant presence in the company and their intimate knowledge of the company's culture, personnel, and operations, internal auditors are particularly well situated to identify early indicators of potential fraud, including indicators that the external auditor normally might not be in a position to identify.

Specific factors that internal auditors should consider in the conduct of their work include:

- The risk that senior management may override internal controls
- Known external and internal matters affecting the entity that may create incentives to commit fraud or enable rationalizations for committing fraud
- The need for persuasive evidence that thoroughly probes into complex issues

The 2010 IIA survey on *Emerging Trends in Fraud Risk* found that internal audit performs a variety of consulting and assurance activities that add value to the organization's fraud risk management efforts, including the following top four: conducting tests to determine if fraud is present in areas identified with potential risk (73 percent); evaluating the design and operation of internal controls (71 percent); taking an active role in support of the organiza-

Professional Responsibilities of Internal Auditors Related to Fraud

The International Professional Practices Framework (IPPF) of The IIA specifically requires that internal auditors address the risk of fraud:

- "The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk." (IPPF 2120.A2)
- "The internal audit activity must evaluate the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives." (IPPF 2210.A2)

In addition, The IIA recently issued a practice guide that identifies the following specific internal audit responsibilities related to fraud:

- Consider fraud risks in assessing internal control design and determining audit steps to perform
- Have sufficient knowledge of fraud to identify red flags that fraud may have been committed
- Be alert for opportunities for fraud, such as control deficiencies
- Evaluate whether management is actively retaining responsibility for oversight of the fraud risk management program
- Evaluate any indicators of fraud and recommend investigation when appropriate
- Communicate with the board regarding fraud risks and prevention and detection programs, as well as any incidents of actual fraud

Internal Audit and Fraud Practice Guide, The Institute of Internal Auditors, 2009 tion's ethical culture (66 percent); and performing its own fraud risk assessment (61 percent).

In addition to exercising skepticism in the conduct of their activities, internal audit should be alert for any attempts on the part of management to limit or influence the scope or nature of its activities. For instance, as one CAQ discussion participant pointed out, WorldCom management appeared to purposely divert their internal audit function away from its audit responsibilities and into a cost-cutting program, thus effectively eliminating a key internal control over financial reporting fraud.

Skepticism and External Audit

Professional auditing standards call for external auditors to exercise professional skepticism, which is defined as "an attitude that includes a questioning mind and a critical assessment of audit evidence."[21] For an external auditor, the exercise of professional skepticism means evaluating and challenging audit evidence and remaining alert for information that suggests that a material misstatement of the financial statements may have occurred. Additionally, external auditors should apply professional skepticism when they consider the risk that management may override internal controls,[22] and take that risk into account when formulating judgments about the nature and extent of audit testing. Through this level of scrutiny, auditors increase not only the *likelihood* that fraud will be detected but also the *perception* that fraud will be detected, which together reduce the risk of fraud.

In order to emphasize the importance of skepticism in the conduct of an audit, professional standards require members of the audit engagement team to discuss the potential for material misstatement due to fraud.[23] At a minimum, these discussions should involve the key members of the engagement team (including the auditor with final responsibility for the audit, i.e., the lead engagement partner) and should generate an exchange of ideas, or "brainstorming," about the following:

- How and where the engagement team believes a company's financial statements could be susceptible to material misstatement due to fraud
- How management could perpetrate and conceal fraudulent financial reporting
- How assets of the company could be misappropriated
- The importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud

Of course, the importance of skepticism does not stop with the completion of the brainstorming session. Rather, it is integral to the development of the audit plan. For instance, professional standards require auditors to perform analytical procedures on a company's financial results to identify any unusual transactions or trends that may indicate matters that have financial statement and audit planning implications.[24] These procedures require the auditor to have a level of knowledge about the company and the industry sufficient to evaluate whether the results suggest that a fraud risk exists. Skepticism also is integral to the execution of the audit plan, as auditors must be alert to indications of fraud risks as audit evidence is evaluated and modify the audit plan accordingly.

Because professional skepticism is a critical skill for external auditors, academic preparation and continuing professional training programs are important tools for instilling and reinforcing the exercise of skepticism, particularly in the assessment of fraud risk, including the risk of management override of controls, and in the design of audit testing to respond to identified risks. Face-to-face meetings to obtain information are often helpful—in part because they provide an opportunity to assess body language and other non-verbal communications.

In addition to the role of skepticism in the conduct of the external audit, discussion participants suggested that external auditors can be a valuable resource for boards and audit committees by providing insights on the company's ethical culture, the effectiveness of its internal controls, and its exposure to management override, including information on leading practices in similar companies. The external auditors can also advise the board and audit committee on questions to ask management.

POINT TO PONDER

Whistleblower tips can serve as an important source of information about fraud and other misconduct. How can external auditors leverage data regarding the nature and frequency of whistleblower tips to enhance their fraud risk assessment?

SUMMARY OF CONSIDERATIONS RELATED TO SKEPTICISM

For Management

1. Acknowledge that fraud can occur and consider such risks as part of the company's risk assessment process.

2. Build skepticism into the culture. Establish a clear expectation that all levels of management will question and challenge all results for which they are responsible, with the specific intent of confirming that corporate standards of accuracy, excellence, and ethics were met.

3. Aggressively pursue the root cause of any deficiencies in controls, and take remedial steps promptly.

4. Monitor your company and benchmark it with others in the industry for the purpose of identifying indicators of fraud.

For Boards and Audit Committees

1. Confirm that all board and audit committee members have a strong understanding of the company's business and its industry. Leverage outside training and consultants as necessary, with the objective of enabling all members of the board and audit committee to ask probing questions about strategy and operations. Audit committee members should also have a working understanding of financial reporting, even if they are not financial experts.

2. Ask questions of management, internal auditors, and external auditors to elicit potential concerns related to opportunities or incentives for financial reporting fraud.

3. Use face-to-face meetings whenever possible to obtain information, encourage open discussion, and assess nonverbal communications such as body language.

4. Actively oversee those aspects of the company's strategy and risk management program that affect financial reporting, with a specific focus on risks that could potentially create incentives for financial reporting fraud.

5. Question management in depth about its program for managing fraud risk, focusing on areas where management has identified the greatest vulnerabilities, including the risk of management override of controls. Ask management to explain how those vulnerabilities are being addressed and consider utilizing internal audit to evaluate the effectiveness of management's activities.

6. Leverage the internal and external auditors as key resources. Have regular, confidential meetings between the audit committee and the chief audit executive, and perhaps separately with other senior members of the internal audit department, as well as executive sessions with the external auditor.

For Internal Auditors

1. Suggest to the board and audit committee specific ways in which internal audit can provide support, with a particular focus on the risk of financial reporting fraud.

2. Take the lead role in assessing the company's program to mitigate the risk of financial reporting fraud, and report annually to the audit committee on that assessment.

For External Auditors

1. Based on the fraud risk assessment developed in planning the audit, proactively suggest questions that the board and audit committee may want to ask management.

2. Regularly evaluate the audit firm's internal communications and training programs to confirm that they adequately address the exercise of professional skepticism and the assessment of fraud risk.

3. Reinforce the importance of interviewing and inquiry skills in the audit process, including consideration of nonverbal communications.

4. Emphasize the value of corroboration as a means of obtaining sufficient audit evidence, and provide guidance on mechanisms and methodologies such as company communications for obtaining corroborative information.

5. Consider including in the brainstorming sessions individuals outside of the engagement team with industry expertise and those who have experience with situations involving financial reporting fraud.

6. Consider face-to-face meetings to obtain information, in order to encourage open discussion and assess nonverbal communications.

7. Encourage the academic community to strengthen the auditing curriculum's focus on professional skepticism and techniques for fraud detection.

4 CHAPTER

Communications

Knowledge Sharing to Deter and Detect Fraud

Each of the participants in the financial reporting supply chain has a separate but interconnected role in the shared responsibility to deter and detect fraud. Fulfilling this responsibility successfully requires leveraging each party's complementary activities by sharing information and concerns and identifying any gaps in the collective efforts to mitigate the risk of financial reporting fraud. To this end, CAQ discussion participants emphasized the importance of regular, open, and robust communications across the financial reporting supply chain. They also encouraged collaboration to stimulate continuous improvement in efforts to deter and detect financial reporting fraud. Effective communications are a self-reinforcing cycle. Frequent, high quality communications enhance the knowledge and understanding of all parties, resulting in better questions and a constantly improving communications process.

The audit committee is a hub for coordinating many financial reporting communications because it has primary reporting lines from management, the internal auditor, and the external auditor. It is the responsibility of the audit committee to see that these communications work well.

Effective communications require both time and commitment. Adequate time on the board and audit committee agendas for all priority matters promotes open, two-way discussion and critical challenge rather than a superficial or minimalist approach. CAQ discussion participants noted that it is important to foster a culture of inquiry so that board and audit committee members are not intimidated or discouraged from asking questions or challenging management or other board or committee members. In particular, executive sessions of the board and audit committee with the chief financial officer and key employees, the internal auditors, and the external auditors are invaluable in providing all parties with a broad perspective on the company's financial reporting environment and the reporting culture, including whether controls are respected and complied with faithfully.

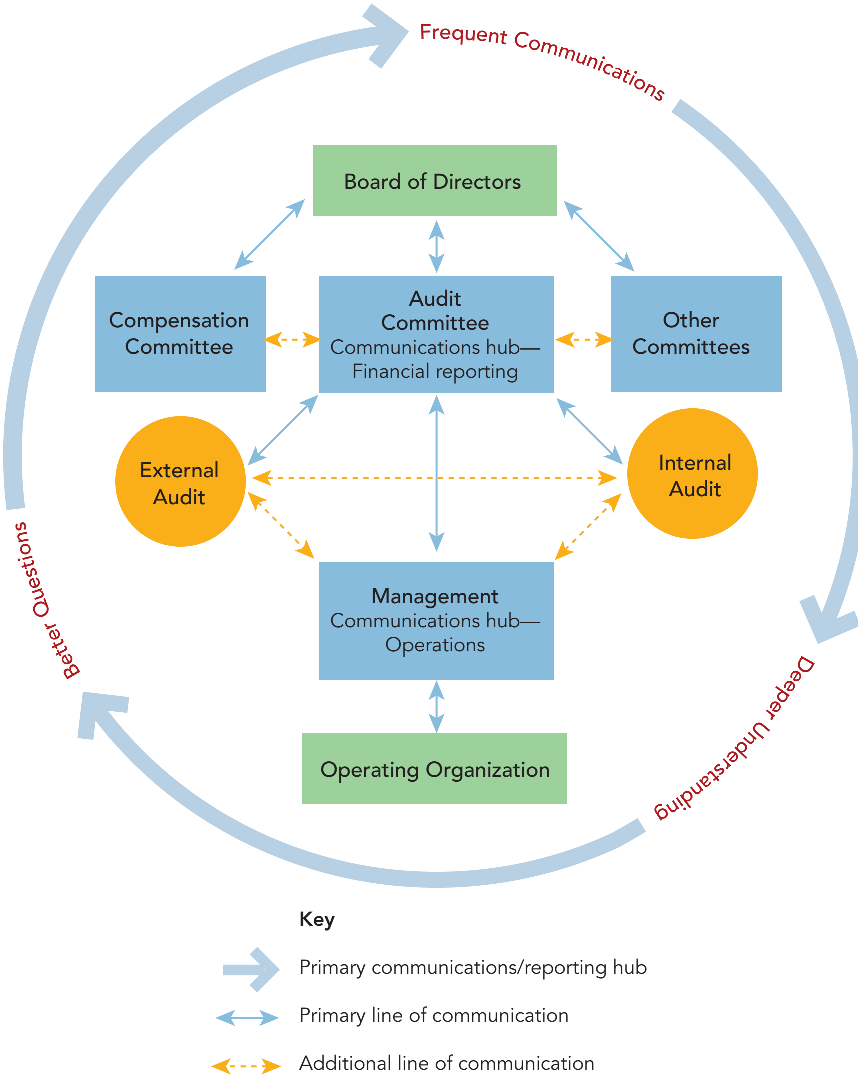
> **It's a risky business when you don't have all these parties that are committed to and responsible for the audit working in tandem and securing results that are greater than the sum of the parts.**
>
> **Richard Thornburgh,** Former U.S. Attorney General, currently Of Counsel, K&L Gates, LLP

The KPMG Audit Committee Institute's *The Audit Committee Journey* reports that "the audit committee's executive sessions with the external audit partner are viewed [by 75 percent of respondents] as most productive, followed closely by internal audit and the CFO." The report goes on to state "The external auditor continues to be the best source of suggestions for improving the audit committee's organization and activities."

Executive sessions provide the opportunity for the audit committee to go beyond the review of financial reports and have frank dialogue on "soft" topics such as corporate values, management style, and the potential for financial reporting fraud. For example, when the audit committee is discussing the financial statements with management, or the results of internal audit engagements with the chief audit executive, committee members may want to consider specifically asking about and probing the controls over financial reporting, including controls over management override.

Audit committees should also consider expanding their communications beyond senior management. Conversations with operating personnel and with financial management below the

Financial Reporting—Lines of Communication



top level can provide valuable insights into the company's culture and the risks it is facing. Audit committees should consider asking questions such as "Were you pressured to do anything?" and "What are you uncomfortable with?" If the person knows that his or her response will be held in confidence, they will be more inclined to share concerns.

POINT TO PONDER

There is almost never enough time on board and audit committee agendas, and yet time constraints should not curtail critical discussions. What are the best techniques to ensure that all issues of concern to the board and audit committee are adequately discussed? One approach is to minimize opening remarks and formal presentations. What else works well?

Most participants in the CAQ discussions and interviews agreed that the Sarbanes-Oxley Act requirement that the audit committee engage the external auditor has facilitated the discussion of difficult issues and allowed for more effective oversight of the financial reporting process. External auditors are required to report annually to the audit committee on a variety of matters, and audit committees are one source of input into an auditor's assessment of the risk of material misstatement in a company's financial statements and the related audit response. Discussion participants emphasized that these communications should not be viewed as a routine compliance exercise, but rather as the starting point for an in-depth discussion of any matters that concern either the audit committee or the external auditors.

Of course, not all communications run through the audit committee; communications also regularly occur between management and the internal auditor, management and the external auditor, and the internal auditor and the external auditor. In most organizations, the internal audit function reports administratively to a member of senior management, and internal audit's activities serve a key role in helping management assess the effectiveness of the control environment and the risk of financial reporting fraud. Internal audit should consider management's risk assessment and other input in developing its audit plan, although management should not limit the scope of internal audit's work. Internal audit's findings and recommendations can provide management with important insights in assessing whether the intended tone at the top and ethical messages have permeated throughout the organization's culture.

CAQ discussion participants noted that the objectives and professional standards of internal and external auditors with respect to the risk of financial reporting fraud are similar and complementary. Internal audit's evaluation of management's fraud risk assessment, as well as the results of internal audit's testing of internal controls, are important to the external auditor's assessment of fraud risk and its planning of the external audit. Similarly, the results of the external audit may also inform the ongoing internal audit plan. Continuous communication about these matters is mutually beneficial to both parties and is essential to avoiding gaps in the effort to mitigate the risks of financial reporting fraud.

Participants in the financial reporting supply chain should work diligently to establish and maintain an environment of open and ongoing communication. As the discussion participants underscored, the goal is to share knowledge, insights, and concerns to enhance the collective efforts of all supply chain participants and make the whole greater than the sum of its parts. Communications also foster collaboration among all stakeholders and stimulate continuous improvement in efforts to deter and detect financial reporting fraud.

Required External Auditor Communications to Audit Committees

PCAOB auditing standards require the external auditor to communicate various matters to the audit committee, including, but not limited to, the following:[25]

- Significant accounting policies, management judgments, and accounting estimates
- The auditor's judgments about the quality, not just the acceptability, of the company's accounting principles
- Significant difficulties, if any, encountered during the audit
- Uncorrected misstatements that were determined by management to be immaterial, individually and in the aggregate
- Audit adjustments arising from the audit, either individually or in the aggregate, that in the auditor's judgment could have a significant effect on the entity's financial reporting process
- Significant internal control deficiencies or material weaknesses and disagreements with management

SUMMARY OF CONSIDERATIONS RELATED TO COMMUNICATIONS

For Management

1. Encourage two-way communication between managers and employees at all levels in the organization.
2. Work proactively to make sure that boards, audit committees, internal auditors, and external auditors are well informed on a timely basis about the company's operations, strategies, and risks, including the latest developments.

For Boards and Audit Committees

1. Routinely ask questions of management, internal auditors, and external auditors to elicit indications of potential concerns related to incentives or opportunities for financial reporting fraud.
2. Work to connect with the organization outside the boardroom. Seek opportunities to interact with managers, employees, vendors and customers to enhance knowledge of the company and possible risks of financial reporting fraud.

For Internal Auditors

1. Establish a regular schedule of face-to-face meetings with senior management, the audit committee, and the external auditor to exchange insights and perspectives. Explore opportunities for the external auditor to leverage the work of internal audit.

For External Auditors

1. Proactively promote opportunities for robust conversations between the external auditors and the audit committee on relevant matters, including the factors considered in the auditor's assessment of fraud risk and the company's approach to developing significant accounting estimates. Seek an executive session with the audit committee at all meetings to encourage candid conversation, even when there are no special concerns or significant issues to discuss.
2. Work with boards and audit committees to vary the nature and focus of their questions to management, internal auditors, and others such as key employees in order to extend the breadth and depth of the discussion and obtain an enhanced understanding of the business and the potential risks of financial reporting fraud.

5 CHAPTER

The Case for Collaboration

Increasing Effectiveness Across the Financial Reporting Supply Chain

Effective communication among the key stakeholders in the financial reporting supply chain is critical to successfully deterring and detecting fraudulent financial reporting. While supply chain participants in individual organizations work to deter and detect financial reporting fraud one company at a time, the professional organizations that represent each major stakeholder group, including FEI for management, NACD for boards and audit committees, The IIA for internal auditors, and the CAQ for public company auditors, are actively engaged in the effort to mitigate the risk of financial reporting fraud broadly for all companies. Each of these groups historically has developed methods, practices and tools to assist in mitigating the risk of financial reporting fraud, and they are continually developing new ideas for study and conducting research to further advance the skills of their constituents.

As illustrated throughout this report, not unlike the members of a sports team, each of the players in the financial reporting supply chain has a distinct role in the deterrence and detection of financial reporting fraud. But it is not enough for each group to excel on its own. In order to become a winning team, each player must share his or her knowledge of the opponent and work together.

As part of its vision to enhance investor confidence in the capital markets, the CAQ acts to convene and foster collaboration with other stakeholders to advance the discussion of critical issues. In that capacity, the CAQ has identified areas of focus for future collaboration among participants in the financial reporting supply chain. The goal is to establish consensus on what needs to be done and to develop resources to assist stakeholder efforts, as well as to identify areas where further focus and study are warranted. The overall objective is to advance the abilities of all stakeholders to deter and detect financial reporting fraud through a spectrum of specific activities, such as those described below, to share ideas, sponsor research, and perhaps develop new tools and methodologies.

Joint Commitment to Collaborate in Anti-fraud Efforts

The CAQ's efforts to convene representatives of stakeholders on the issue of fraud deterrence and detection led to the development of this report and provide a mechanism for ongoing communication, coordination, and collaboration among all participants in the financial reporting supply chain. The continuation of this interaction should facilitate the exchange of experiences and perspectives, and could also go further to help identify ways to leverage existing resources and develop and prioritize future joint activities to advance the deterrence and detection of financial reporting fraud. The goal of such efforts would be to enhance thinking around areas critical to fraud deterrence and detection, as well as potential tools targeted to the roles and responsibilities of each stakeholder group.

FEI, NACD, and The IIA, organizations that already are actively engaged in efforts to mitigate the risk of financial reporting fraud, plan to collaborate with the CAQ. Our efforts also will provide the opportunity for collaboration with additional organizations whose constituents have specialized knowledge in particular areas, which should contribute to fraud deterrence and detection. We anticipate that the results of these efforts will be transparent and inclusive, and will be communicated broadly to key stakeholder groups. Such communication could be through white papers or other written materials, as well as the delivery of webcasts and conferences. In addition, we intend these efforts to complement the activities of the PCAOB's Financial Reporting Fraud Resource Center and look forward to opportunities for collaboration with the new Center.

Based on the observations highlighted throughout the report, our initial collaborative efforts will focus on four broad areas.

1. Advance the Understanding of Conditions That Contribute to Fraud

A wealth of research has been conducted on the motivations for fraudulent behavior and the related rationalization process. As detailed more fully in Chapter 1, the fraud triangle provides a simple model of three factors that contribute to fraud: pressure, opportunity, and rationalization. However, the fraud triangle does not explain one critical phenomenon: why one person takes actions to distort financial results, while another in a similar situation does not.

Management, boards and audit committees, and internal and external auditors could benefit from tools and resources that help operationalize the vast amount of behavioral research on the factors that move an individual past the temptation or opportunity to commit fraud. Working together, the major stakeholder groups can leverage their current guidance, analyze past frauds, pursue further areas of research, and develop new materials to enhance understanding about the pre-conditions and indicators of financial reporting fraud. Building awareness in these areas could assist all the financial reporting supply chain participants in identifying fraud risks and potential red flags, while at the same time further strengthening internal control systems.

An important and related area for consideration is the human conditioning that can prevent people from finding a fraud even when they sense that something may not be right. It will be important to discuss and understand what environmental and behavioral factors may discourage an individual from asking the next question that might unveil the fraud.

2. Promote Additional Efforts to Increase Skepticism

As discussed more fully in Chapter 3, the ability to critically assess, question, and corroborate information is an essential skill for management, boards, and audit committees, and is expected of internal audit and the external auditor. All stakeholders could benefit from efforts to enhance the ability to think critically and skeptically about the information presented to them. Stakeholder collaboration in this area would facilitate improvements in the deterrence and detection of fraud.

For example, a key method used by stakeholders to identify potential indicators of concern is the review and analysis of a company's financial results and related complex information. Developing tools or techniques to enhance the ability of management, internal auditors, external auditors and audit committee members to evaluate a company's financial results (by comparison, for instance, with management budgets, analyst expectations, and the results of industry peers) could facilitate more robust discussions and help identify potential indicators of concern. Frameworks to assist in assessing other potential fraud risk factors, such as compensation arrangements, could further improve the review process.

In addition, enhancing stakeholders' communication abilities, including their interview and inquiry skills, would complement the other efforts described above. Such efforts to strengthen skepticism could also include examining behavioral traits or other environmental factors that may impede the application of effective skepticism.

3. Moderate the Risks of Focusing Only on Short-Term Results

Long-term value creation for investors is the responsibility of management, boards, and audit committees. However, this goal may conflict with the incentives that are introduced by short-term pressures, such as internal profit targets, short-term performance goals in compensation plans, or analysts' expectations and the demands of stock traders and intermediaries who focus on short-term stock price performance. An emphasis on short-term results can create pressures on multiple levels of an organization, which can increase the risk of financial reporting fraud. It is important that management, boards and audit committees, and internal and external auditors remain sensitive to the presence of and potential risks associated with short-term goals and take steps to mitigate such risks.

Through collaborative activities, stakeholders can share perspectives on short-termism, its role in the accomplishment of an organization's objectives (including those of investors), and its impact on a company's operating environment and system of internal controls. This awareness and sharing of experiences could allow all stakeholders to better understand and evaluate potential risks and mitigating factors.

4. Explore the Role of Information Technology in Facilitating the Deterrence and Detection of Fraudulent Financial Reporting

Given its central role in systems of internal control, information technology is another area where all participants in the financial reporting supply chain may be able to benefit from sharing experiences and ideas. Information technology can be instrumental in deterring and detecting fraud. On the other hand, technology can also be exploited to facilitate fraud if not adequately controlled.

Ongoing discussion of the benefits and challenges related to information technology and its impact on deterring and detecting financial reporting fraud could help all stakeholder groups identify and address technology-related risks for fraud. In addition, it would be beneficial to consider whether additional or improved use of technology would enhance internal control structures and assist in identifying potential fraudulent activity. For example, increased use of technology could facilitate the operation and monitoring of controls, mitigate the risk of human intervention, and provide information about the effectiveness of controls, all of which would assist stakeholders in the effective conduct of their oversight responsibilities.

Among the areas where stakeholders could share information and consider future action are the management and auditing challenges created by electronic business communications and recordkeeping, where the majority of information used for business decisions is stored electronically (e.g., via e-mail or electronic documents stored centrally or on individual hard drives). Exploring ways to tap into and leverage electronic information to identify possible indicators of fraud could enhance the ability to detect fraudulent behavior. Focused collaboration could produce new ideas and tools, such as data queries and analyses that could be applied to general ledgers, sub-ledgers, e-mails, vendor master files, and other electronic repositories to assist in identifying potential fraud.

A potential barrier to realization of the full benefits of the use of technology to enhance a company's ability to leverage electronic information is the disparate nature of the information systems companies use to maintain their books and records. No standard format exists for maintaining general ledger information, and that lack of standardization may inhibit the development of common tools that could be used across platforms to access, monitor, and analyze ledger data for various attributes that could contribute to fraud detection. Stakeholders in the financial reporting supply chain may want to consider exploring whether a standardized data format for key elements of a company's general ledger would significantly facilitate the development of tools to assist in monitoring, analyzing, and evaluating financial information.

CONCLUSION

The CAQ's roundtable discussions and interviews underscored that there is no silver bullet solution to deterring and detecting fraud. Every group in the financial reporting supply chain plays a key role—from senior management to boards, audit committees, internal auditors, and external auditors. While the Sarbanes-Oxley Act has led to significant improvements in financial reporting processes, controls and overall corporate governance, all supply chain participants must maintain a vigilant watch for the presence of the elements of the fraud triangle.

The observations in this report represent the beginning of a focused and coordinated long-term effort to advance the deterrence and detection of financial reporting fraud, with the ultimate goal of benefiting investors, other users of financial reports, and participants in the capital markets. The CAQ is especially pleased that FEI, NACD, and The IIA have agreed to join with us to collaborate and advance this complex and vital issue. The CAQ looks forward to working with all stakeholders in these endeavors.

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22. See note 12 above.

23. See note 12 above.

24. See note 12 above.

25. See note 13 above.

Appendix 1
Participants in CAQ Discussions and In-Depth Interviews

NOTE: An asterisk (*) indicates discussion participants who also provided in-depth interviews.

SAN FRANCISCO

Discussion Moderator: Terence Smith

Tim Arnold, Chief Auditor, Visa, Inc.

David Bernstein, Former Chief Accounting Officer, CBS Interactive

John A. Bohn, Commissioner, California Public Utilities Commission

David F. Bond, Senior Vice President, Finance and Control, Safeway Inc.

Gregory Burke, Chair, California Society of Certified Accountants

John Diaz, Editorial Page Editor, San Francisco Chronicle

John Doyle, Director, Board of Directors, Xilinx, Inc.

Roger F. Dunbar, Chair of the Audit and Risk Management Committee, and Chair of the Finance Committee, Silicon Valley Bank; Global Vice Chair-Retired, Ernst & Young Global

Marc J. Fagel, San Francisco Regional Director, Securities and Exchange Commission

Cindy Fornelli, Executive Director, Center for Audit Quality

Scott Grossfeld, Chief Executive Officer, Association of Certified Fraud Examiners *

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Charles T. Horngren, Ph.D., Edmund W. Littlefield Professor of Accounting, Emeritus, Stanford University Graduate School of Business

David F. Larcker, Ph.D., James Irvin Miller Professor of Accounting, Stanford University Graduate School of Business*

Norman Marks, Vice President, Governance, Risk and Compliance, SAP BusinessObjects *

Kay Matthews, Vice Chair, Pacific Northwest Managing Partner, Ernst & Young

Mary Hartman Morris, Investment Officer, Corporate Governance—Global Equities, California Public Employees' Retirement System

Mark Niswonger, Partner, KPMG LLP

Kenneth E. Scott, Ralph M. Parsons Professor of Law and Business, Emeritus, Stanford Law School

Cynthia L. Zollinger, President and Chief Executive Officer, Cornerstone Research, Inc.

NEW YORK

Discussion Moderator: Terence Smith

Rick Antle, Ph.D., William S. Beinecke Professor of Accounting, Yale School of Management

Ian Ball, Ph.D., Chief Executive Officer, International Federation of Accountants *

Thomas F. Bongiorno, Vice President and Corporate Controller, Quest Diagnostics Incorporated

Neri Bukspan, Executive Managing Director and Chief Quality Officer, Standard & Poor's

Douglas R. Carmichael, Ph.D., Claire and Eli Mason Professor of Accountancy, Baruch College

Thomas J. Colligan, Former Director and Chair of the Audit Committee, Schering-Plough Corporation; currently Member of the Audit Committee, Office Depot and Targus

J. Michael Cook, Chair of the Audit Committee, Comcast Corporation *

Cynthia Cooper, Chief Executive Officer, CooperGroup LLC

Cindy Fornelli, Executive Director, Center for Audit Quality

Jay Goldberg, Vice President, Internal Audit, Take Two Interactive Software, Inc.

Trevor S. Harris, Ph.D., The Arthur J. Samberg Professor of Professional Practice and Co-Director, Center of Excellence in Accounting and Security Analysis, Columbia Business School

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Susan Lister, Partner, National Director of Auditing, BDO USA, LLP *

Mary Louise Mallick, First Deputy Comptroller, State of New York

Michael A. Moran, Vice President, Global Markets Institute, The Goldman Sachs Group, Inc. *

Robert E. Moritz, Chairman and Senior Partner, PricewaterhouseCoopers LLC

Howard J. Mosbacher, Senior Vice President, General Auditor and Chief Information Security Officer, The Hartford Financial Services Group, Inc.

Floyd Norris, Chief Financial Correspondent, The New York Times

Walt Pavlo, President, Etika, LLC

Janet Pegg, Senior Accounting Analyst, Encima Global LLC

Richard Thornburgh, Of Counsel, K&L Gates, LLP *

Tom Warga, North American Director, Board of Directors, The Institute of Internal Auditors

David B. Wyshner, Executive Vice President and Chief Financial Officer, Avis Budget Group, Inc. *

CHICAGO

Discussion Moderator: Terence Smith

Peggy Foran, Former Executive Vice President, General Counsel and Secretary, Sara Lee Corporation; currently Vice President, Chief Governance Officer and Corporate Secretary, Prudential *

Cindy Fornelli, Executive Director, Center for Audit Quality

Brenda Gaines, Chair of the Audit Committee, Office Depot

Varda Goldman, Corporate Vice President and General Counsel, PCTEL, Inc.

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Bob Kueppers, Deputy Chief Executive Officer, Deloitte LLP *

Michael Lev, Associate Managing Editor for Business, Chicago Tribune

John Markese, Ph.D., President and Chief Executive Officer, American Association of Individual Investors

Steve Priest , President, Ethical Leadership Group

Mark Sullivan, Former Managing Director and Head of Loss Prevention, Kroll; currently Principal, Forensic Accounting & Investigative Services, Grant Thornton LLP

Kathy Swain, Vice President, Internal Audit, The Allstate Corporation *

Scott Taub, Managing Director, Financial Reporting Advisors, LLC *

John Trakselis, Past President, Financial Executives International — Chicago Chapter; Chair, Vistage International Inc. *

Curtis Verschoor, Emeritus Research Professor, School of Accountancy and MIS, DePaul University

Linda Vincent, Ph.D., Associate Professor in Accounting Information and Management, Kellogg School of Management, Northwestern University

Joe Weber, Formerly Chief of Correspondents, Chicago Bureau, BusinessWeek; currently Associate Professor, College of Journalism and Mass Communications, University of Nebraska-Lincoln

William J. White, Former Chairman of the Board, Bell & Howell Company; currently Professor, Robert R. McCormick School of Engineering and Applied Science, Northwestern University *

Russ Wieman, Formerly National Managing Partner of Audit and Advisory Services, Grant Thornton LLP; currently Chief Financial Officer, Grant Thornton LLP

WASHINGTON DC

Discussion Moderator: Terence Smith

Peter Barnes, Senior Washington Correspondent, Fox Business News

Mark S. Beasley, Ph.D., Deloitte Professor of Enterprise Risk Management and ERM Initiative Director, North Carolina State University *

Nancy Zucker Boswell, President and Chief Executive Officer, Transparency International USA

Keith T. Darcy, Executive Director, Ethics and Compliance Officer Association

Joseph T. Doyle, Member of the Audit Committee, USEC, Inc.

Charles M. Elson, Edgar S. Woolard, Jr. Chair in Corporate Governance, and Director of the John L. Weinberg Center for Corporate Governance, University of Delaware *

Cindy Fornelli, Executive Director, Center for Audit Quality

Craig Greene, Partner, McGovern & Greene, LLP

Stephen D. Harlan, Chair of the Audit Committee, Sunrise Senior Living, Inc.; ING Direct Bank; and MedStar Health Inc.

Roderick M. Hills, Chairman, Program on Governance, Center for Strategic and International Studies; Partner, Hills Stern & Morley LLP

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Suzanne M. Hopgood, Chair of Nominating/Governance Committee, Acadia Realty Trust

David M. Johnson, Executive Vice President and Chief Financial Officer, Fannie Mae

Henry Keizer, Deputy Chairman and Chief Operating Officer, KPMG LLP

Dan Lasik, Hospitality Industry Partner, Ernst & Young LLP

Nell Minow, Editor and Co-Founder, The Corporate Library *

John F. Olson, Partner, Gibson, Dunn & Crutcher LLP

Michael G. Oxley, Of Counsel, Baker & Hostetler LLP *

Zoe-Vonna Palmrose, Ph.D., PricewaterhouseCoopers Auditing Professor, University of Southern California Marshall School of Business

Robert M. Tarola, President, Right Advisory LLC; formerly Chief Financial Officer, W.R. Grace & Co.

Glenn W. Tyranski, Senior Vice President, Financial Compliance, NYSE Euronext

Ann Yerger, Executive Director, Council of Institutional Investors

LONDON

Discussion Moderator: Clive Crook

David Alexander, Director of Forensic Services, Smith and Williamson *

Felicity Banks, Head of Business Law, ICAEW

Ruth Bender, Ph.D., Reader in Corporate Financial Strategy, Cranfield University School of Management

Paul Boyle, Former Chief Executive, Financial Reporting Council

Peter Butler, Founder, Partner & Chief Executive Officer, Governance for Owners LLP

David Clarke, Detective Superintendent, Head of National Fraud Intelligence Bureau, City of London Police

Valerie Dias, Executive Vice President & Chief Risk and Compliance Officer, Visa Europe

Helenne Doody, Formerly Fraud Risk Management Specialist, Chartered Institute of Management Accountants; currently Senior Manager — Business Banking Fraud, Barclays

Jonathan Fisher QC, Barrister, 23 Essex Street Chambers and Fraud Advisory Panel *

Richard Fleck, CBE, Chairman, Auditing Practices Board, Financial Reporting Council

Cindy Fornelli, Executive Director, Center for Audit Quality

Robert Hodgkinson, Executive Director, Technical, ICAEW

Michele Hooper, Co-Vice Chair, Governing Board, Center for Audit Quality; President & Chief Executive Officer, The Directors' Council

Jennifer Hughes, Senior Markets Correspondent, Financial Times

Christopher Humphery, Professor of Accounting, Manchester Business School

Martyn Jones, National Audit Technical Partner, Deloitte LLP

Craig Josephson, Regional Anti-Money Laundering Officer, EMEA Northern Trust

Ronald Kent, Executive Vice President, NYSE Euronext

Steve Maslin, Head of External Professional Affairs, Grant Thornton UK LLP

Allan McDonagh, Director, Hibis Europe Limited

Liz Murrall, Director, Corporate Governance, Investment Management Assoc.

Michael O'Higgins, Chairman, Audit Commission

Jeff Pott, General Counsel, AstraZeneca

Peter Smith, Chairman of the Audit Committee, Associated British Foods

Myles Thompson, Technical Audit Partner, KPMG LLP, UK

Nicolas Veron, Research Fellow, Bruegel

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Appendix 3
Methodological Statement

This report was created using a combination of primary research techniques and secondary studies on a variety of topics dating back approximately 10 years.

The primary research techniques employed for this study were as follows:

- The Center for Audit Quality convened moderated roundtable discussions in four U.S. cities and London with more than 100 invited representatives of key stakeholders, including corporate executives, members of boards and audit committees, internal auditors, external auditors, fraud specialists, investors, regulators, and academics.
- In-depth interviews with a subset of representatives from the stakeholders who participated in the moderated discussions were conducted by an outside independent research firm.

The information gleaned from the moderated roundtable discussions and interviews has been supplemented by secondary research conducted by a number of organizations (see Bibliography).

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