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DELOITTE FIRESIDE CHAT IV: Responsibility for Preventing and Detecting Financial Reporting Fraud

IRA SOLOMON: Good afternoon and welcome to today's Deloitte Fireside Chat, focused on Responsibility for Preventing and Detecting Financial Reporting Fraud, and broadcast live on www.sechistorical.org. I am Ira Solomon, R.C. Evans Endowed Chair in Business and Head of the Department of Accountancy at the University of Illinois at Urbana-Champaign. I will be the moderator for today's program.

The Deloitte Fireside Chats are made possible through a partnership between Deloitte LLP and the SEC Historical Society. Deloitte is the brand under which tens of thousands of dedicated professionals in independent firms throughout the world collaborate to provide audit, consulting, financial advisory, risk management and tax services to selected clients.

The SEC Historical Society shares, preserves and advances knowledge of the history of financial regulation through its unique virtual museum and archive at www.sechistorical.org. The museum is free and accessible worldwide at all times and it currently welcomes more than 30,000 visitors a month. Both the museum and the Society are independent of the U. S. Securities and Exchange Commission and receive no funding from the public sector. The Society is grateful for the generous support of Deloitte LLP in making the Deloitte Fireside Chats possible.

I am delighted today to welcome Joseph Carcello, Ernst and Young and Business Alumni Professor of University of Tennessee at Knoxville; Cynthia Fornelli, Executive Director, Center for Audit Quality and a member of the Society's Board of Advisors; and Robert J. Kueppers, Deputy CEO, Deloitte LLP and a Trustee of the SEC Historical Society.

Before we begin our discussion, I would like to state that the views of the presenters are their own and do not reflect those of Deloitte LLP or of the SEC Historical Society. The Society is responsible for the selection of the moderator and presenters. We have determined the questions that will guide the content of our discussion. Now, off to the main event.

We are going to start with a definition as we are focusing today on a particular kind of fraud. My first question will be directed initially to Bob Kueppers. How would you define financial statement fraud?

ROBERT J. KUEPPERS: Thanks Ira. I think we could spend the hour on that but let's not. Let me just posit a sort of a working definition as I think about it. If you think of financial statement fraud as a material misrepresentation resulting from an intentional failure to report financial information in accordance with GAAP or Generally Accepted Accounting Principles, that tends to hit on what we classically think of as financial statement fraud. As we all know, the intent in addressing those kinds of frauds is because they are the ones that really impact the capital markets in the most severe way leading to an erosion of public trust. From a company standpoint, a major financial reporting fraud can be devastating to the company's reputation, even to the point of jeopardizing its very existence. So I take that as a most serious kind of fraud. It wouldn't include the minor misappropriation of assets every company experiences: expense report fraud or misuse of assets. Typically they are not material so I want to focus on what I call the big stuff when it comes to financial statements.

IRA SOLOMON: Who plays a role and has a responsibility when it comes to deterring and detecting financial statement fraud? And what are the responsibilities of those groups? Cindy?

CYNTHIA FORNELLI: Well, Ira, thank you and let me just for a moment add on Bob's answer to the definition of financial statement fraud. We, at the Center for Audit Quality on October 6th issued a report called "Deterring and Detecting Financial Reporting Fraud, A Platform for Action." And indeed we used that same definition that Bob articulated for our report. I think that if you focus on ways to deter and detect financial statement fraud, you will find that those tools will be applicable to other types of fraud. And so if a company for instance has a robust anti-fraud program then I think it will permeate throughout the organization. So with respect to who plays a role and who has responsibility and what those responsibilities are, we at the CAQ focused on four key players, what we call the supply chain for responsibility in deterring and detecting fraud in an organization.

First and foremost, of course, is management. They bear the primary responsibility for deterring and detecting fraud within an organization. So they are responsible for internal controls, for having a robust ethical program, for establishing and maintaining the whistleblower program. Then of course are the boards of directors and the audit committees. They have the responsibility for overseeing the business and control environment within an organization. Then in our minds came internal audit, if indeed the corporation has that function and of course a listed company is required to have an internal audit function. They don't necessarily have to have an internal audit department but the internal auditor function plays a really key role in helping the company create the internal control structure within an organization. And then last but not least are the external auditors who must be independent of the company and who provide a public report on the entity's annual financial statements, including for public companies over a certain market cap an assessment of the effectiveness of an entity's internal controls over financial reporting.

One way that we have talked about it within the Center for Audit Quality is that it's a model that starts with management and ends with the external audit and all four players bear some responsibility. What we found is that collaborating and working together is a much more effective way of dealing with fraud within an organization and deterring and detecting it than if each group tries to go it alone.

ROBERT J. KUEPPERS: Cindy, let me put a finer point on that because I think you have framed an extremely important model in this fine report. This is a very effective report. Too often when you analyze or do your post-mortem on a failure, the headlines or the reports on it are that the audit committee was asleep at the switch or the auditors weren't skeptical enough or management was misrepresenting themselves with a particular skill. But to place the responsibility on any one party exclusively ignores the reality that we are all in and that is the system is designed for all of these players to meet their responsibilities. And just to pick on two, the internal auditor is extremely important and I understand every single company doesn't have an internal audit function but those that do, the Institute of Internal Auditors' professional standards require that internal auditors evaluate the effectiveness of risk management and controls and specifically call out the potential for the occurrence of fraud and how the organization manages that fraud risk.

So if they are on their game that is a piece of the puzzle that the internal auditors are responsible for. And when it comes to my profession, the external auditors, a lot of people are surprised to hear, and it's really sort of unfortunate frankly, that by our standards in external audit is designed to access the fraud risk. But more importantly is executed in a way that is designed to detect a material fraud, if it were present, of course, not only material fraud but even material misstatements by error or otherwise. But the point is, that is a responsibility and what ties all these people together is their common duty, I will call it, or a parallel duty to the investing public. Every one of these people has a role.

JOSEPH CARCELLO: Let me jump in a little bit here on this one as well to just piggyback on what Cynthia and Bob said. One of the things Cindy said is that senior management plays a role along with the other three people that she talked about and I think used the words 'critical player' or 'most important player'. I would agree with that, I think she's right on with that. In some work that I have done with, that was sponsored by COSO with three other academics, we looked at fraud from late '90s to late 2000s and one of the things we found, which is really a follow-up to earlier work we had done, is when material financial statement fraud at least gets the attention of the SEC. Overwhelmingly, the CEO and the CFO are players in that fraud, at least alleged to have perpetrated the fraud to the tune of about 89% of the cases. So when we talk about and again I am completely on board with what Cindy said that the senior management is the most important player, but when we find fraud, they are often the ones who have perpetrated it.

Which makes it very hard for the other participants that Cindy talked about, the audit committee which maybe they meet for four or five or six times a year for a day or two, internal audit, granted that they are there more frequently every day and they are employees of the company. And even the external auditor, just a much more difficult fraud is a strategic act, as we know, Ira from the literature. And unless you have very incompetent fraudsters, right. A lot of times they are dishonest people but they are pretty bright. And they are going to take extensive steps to hide what they are doing. As a result of Sarbanes-Oxley, the consequences of being caught are draconian and in all likelihood Bernie Ebbers will die in prison, sentenced to 25 years at age 65. And so if you are going to commit fraud, you have a very very powerful incentive to hide it, which makes it quite difficult for these other parties to detect it. So I think one of the things that should come out of this is it's very challenging to detect fraud.

IRA SOLOMON: Joe, I am going to direct this next question right back to you as well. One of the parties that's been mentioned here of course is the independent auditor and there has long been a gap between what the public believes the independent auditor's role is with respect to detecting financial statement fraud and what it actually is. If you could talk a little bit about how that gap has evolved over time and where it stands today, I think that would be great.

JOSEPH CARCELLO: The gap certainly has been there for many years as we all know in this room. I think there's different levels of perception of the gap, Ira. I think to the general public, the man on the street, they often think auditors are checking every transaction and looking at every document. And that's obviously very unrealistic, unless you are looking at the very smallest company, even there it probably doesn't make a lot of sense. And when you are auditing very big companies, you are looking at samples. And so the belief that all fraud no matter how small, no matter how immaterial, is going to be detected is just wrong. Then there are more sophisticated users, who I think understand that the auditor's responsibility is to, as Bob, I thought very well explained, to detect any material misstatements in the financial statements, whether caused by error or fraud.

Now with that said as I said earlier, detecting misstatements caused by error, I am not going to use the word "easy" but you don't have the client fighting against you. When I was in public accounting, they usually would lead us to those errors. They didn't realize they were errors very often but they weren't hiding anything from us. With fraud it's a very different animal. Some users understand that and others don't. I think clearly there is a desire on the part of many users, whether they are individual or certainly the institutional investors that I have interacted with, for auditors to do more in this space. Bob and I served together I guess for about four years on the PCAOB Standing Advisory Group, and that is a group of auditors and preparers and users, investors, some academics. When we discussed the finer points of auditing often particularly the investors didn't seem too interested in the conversation. But whenever the conversation would turn to fraud, their level of interest really took a major jump up very quickly. And so I have heard investors say, "If you can't detect material fraud, what good is the audit?" Really it's, how valuable is that to us? We could have a whole separate discussion about that but clearly there's a desire on the part of many users, many investors to have the external auditors do better in this space.

CYNTHIA FORNELLI: I think to just point what he's talking about is exactly right. I was at an AAA conference a while back and one of the professors had an article from Victorian England in the 1800s that talked about the expectations gap. They didn't use those words but clearly they were talking about what is the proper role for this external audit function in finding fraud and preventing fraud within a corporation. So I think this misunderstanding has lasted for a long time.

But I think what's important is the need for all of the parties in that supply chain as well as others - regulators, academics, researchers, investors themselves - to have this ongoing dialogue and understand each party's roles and responsibilities and what they can do and what they should do. And making sure that all areas are covered so there aren't gaps, no pun intended, in the process and understanding whose going to do what so that we all work together to try and deter and detect fraud. One thing I am noting is that the title of our chat today is the responsibility for preventing financial statement fraud. And unfortunately, given human nature, I don't know if we will ever fully prevent financial statement fraud. I think that can be our aspiration but given people will have the pressure and opportunity and the rationalization, the classic fraud triangle, I think we are going to continue to wrestle with this problem. So we really have to try to find ways to try to prevent it and then deter and detect it along the way.

ROBERT J. KUEPPERS: Just a quick thought on the expectations gap. One of the things that I am very focused on is, it's been around forever, it's never going to be gone completely, but how do we narrow it, how do we close it? I think to be a little self critical, if I look at the profession of the 30 years I have been at this, too often in the early part of those 30 years, we spent our time saying, "Well, people just don't understand the limitations on an audit." The main program is to educate those on one end of the gap, so they would move closer to the middle. But I really think the only way to make true progress is to both increase the performance of the auditor to be more effective and detect fraud in a greater percentage of the cases, even when there is concealment which is hard, as well as educating those that might have unrealistic expectations. But Cindy's got the key to it all and that is, if you engage you can actually accomplish both.

IRA SOLOMON: We will have a chance in a few moments to learn a little bit more about some of the recent innovations in audit practice that may help narrow that gap. But now, what I would like to do is direct another question to Joe because the scholarly literature has some information in it for us about how and how well the independent auditor is performing with respect to detection of financial statement fraud. And so I would like to ask Joe if he would give us a quick tutorial on what that literature has to say.

JOSEPH CARCELLO: Thanks, Ira. There is a lot of literature on this topic as Ira certainly knows and Ira was kind enough to point me in the direction of two papers not written by accounting professors but economists and financial people. They really are consistent with what we know from other sources as well. But generally the external auditor is not among the primary sources of detecting fraud, at least over their entire sample.

What was interesting to find is that some groups that you wouldn't necessarily expect were quite important. Employees were important and I think we could have probably predicted that certainly with the advent of hot lines, employees were quite important. But so were short sellers, which makes some sense and they have an economic incentive, economic incentives usually work. And the media, they don't have an economic incentive but they have a huge human capital incentive. So some of those sources were really quite effective. The positive news for the auditors is that post-Sarbanes-Oxley their performance increased by a factor of four, it was pretty dramatic. So that's good. That speaks well to the profession, speaks well to the Act, at least in that domain, give the PCAOB some credit maybe. A lot of credit to go around, so that's a good thing.

In another paper that the authors had, Dyke, Morse and Zingales, they also have some baseline statistics on how prevalent fraud is. Now they use a novel methodology that I won't go into here and so you could certainly quibble with the methodology and it's not hard, it's an estimate. But they estimate that it could be as high as 7% of public companies have new frauds beginning in any particular year. Which I think, if you had to ask a typical person what the baseline rate of fraud was… and this is big public companies about $750 million in assets, I don't think they would have picked a number that high. So if that 7% is close to accurate. You hear a lot of complaining sometimes from various quarters about the expense of controls and the expense of auditors and the expense of various compliance related activities. Well, if 7% of large public companies have new frauds beginning every year and they documented the magnitude of the losses, it's 40% of firm value, of a 40% of the median firm's value if you have a fraud. So it's huge numbers involved here. That to me is indicating that the economic rationale for doing more in the fraud space I think is quite compelling. There is also other research, again I am not to run the whole litany but some work by Joe Brazel and others on the use of non-financial measures to assess fraud risk and I and Ira have done some stuff, some other work you have done over the years. Often what happens is the financial numbers are misstated but often the company doesn't go back or the perpetuators don't go back and back fill operating data. So then there's a disconnect between the operating metrics and the financial metrics.

So there's some good work being done in academia on some of these things, both descriptive and then trying to help us get better as well as I am sure things that are being done inside the firms that we may hear from Bob and Cindy about from later.

IRA SOLOMON: Joe mentioned the Sarbanes-Oxley Act. I would like to ask Bob and Cindy both to tell us from their perspectives what effect the Sarbanes-Oxley Act has had with respect to prevention and detection of financial statement fraud. Bob?

ROBERT J. KUEPPERS: Ira, I have a strong view on this. We know it is the Sarbanes-Oxley Act but I could have renamed it the Sarbanes-Oxley and Anti-Fraud Act of 2002. The reason I say that is, it actually touches on lot of the constituencies that we mentioned earlier. With respect to management, we have got the certification requirements which from the clients I visit, that's a pretty big deal. I mean this is pervasive in the organization to get sub-certifications usually and have that roll up because of the responsibility of the CEO and CFO, coupled with stronger penalties for crossing the line, criminal penalties and that's not a minor point. And then you take most importantly the management report and the effectiveness on internal controls over financial reporting and the companion piece, which is the auditor attestation of that, they are not for everyone but certainly for the large issuers.

And as we now know the Dodd-Frank Act that was just passed earlier this year has limited the 404(b) piece, I think regrettably because I find that there is direct correlation between the discipline that the internal control requirements have on the larger company and it's my perception of what the incidence of fraud is. I think it's much harder to commit a fraud if you have got an effective system of internals controls over financial reporting. It also touched on the audit committee with the financial expert requirement having that expertise and direct oversight over the external auditor plus the whistleblower programs. You take that as a package and even though, maybe that wasn't the driving force at the time in 2002, it certainly had the impact of, I think, effectively reducing the incidence of fraud.

CYNTHIA FORNELLI: Adding on to that - as we were preparing to put this report together, we at the CAQ went to five cities over the course of 18 months. We brought together not only representatives from those four key players and the supply chain but also regulators, fraudsters, investors, academics, researchers, financial press, just a whole host of different people in each of those five venues where we had this discussion. And in every venue the importance of Sarbanes-Oxley… even in London, they acknowledged the importance of some of the reforms in Sarbanes-Oxley, and Bob ticked through them all. Including, I might add, the independence rules separating the audit from the advisory side on the external auditors. All were pointed to as key drivers to help deter and detect financial statement fraud. And really from the investor perspective, as well as from those in the supply chain, were just critical components to increase everybody's awareness and performance. So I think that it was an important turning point for the detection and deterrence of financial statement fraud. Because it acknowledges that everybody has a role to play, that the four key players have some responsibility and they put it all in one place.

ROBERT J. KUEPPERS: I think the only thing that it didn't call out specifically and really wouldn't have been appropriate, was internal audit because that's not a universal requirement for a public company to have that function. But if it was, my guess is that it would have been something for them in there too.

CYNTHIA FORNELLI: And then the other thing that was in Sarbanes-Oxley was the creation of the PCAOB and the oversight role that they play.

ROBERT J. KUEPPERS: That's not insignificant.

CYNTHIA FORNELLI: No, it's not.

ROBERT J. KUEPPERS: Although the focus of the standard-setting agenda of the PCAOB at least so far has not been front and center on the fraud standard, which at the time the PCAOB was formed, was relatively new. That had just been done so but in the group that Joe and I served on together that was often a conversation, "What about the fraud standard and is it okay or not?" and I think it's still on the horizon, it's just not front and center on the agenda today.

JOSEPH CARCELLO: That's my sense.

IRA SOLOMON: Bob, earlier in the context of the discussion on the expectations gap, you talked about the need for the audit profession to make further progress with respect to approaches to detecting financial statement fraud. I wanted to give you a chance now to talk a little bit about some of the innovations that you have seen recently introduced or some that might be introduced in the near term in the future.

ROBERT J. KUEPPERS: I think, realizing that our profession, if you think about as you focus on the audits of public companies, there are a number of very large firms that have 100 or more public company clients. Those are the firms that get inspected by the regulator or the PCAOB each year, and then there are hundreds of other firms that are public companies, some maybe with only one or two clients that requires them to be registered. If you look at sort of the end of the market that I am on and that's the larger firms, there is significant amount of R&D, each and every year, that's designed to do just as you suggest, how do we improve our performance? And some of the things that we have seen and that is certainly universal across major firms, things like journal entry testing tools, always going to sound a little nerdy and technical, but those kinds of things deployed across a large practice can really make a difference in terms of effectiveness and consistency, along with things like file interrogation techniques which are more sophisticated than they were many years ago. And one of the things that I find to be particularly helpful and I know every firm probably has a different version of this, but the one I am used to is what I call it a risk profiling tool, where at least in our case we use 70 different data streams in a tool that essentially predicts risk of fraud and risk of business failure for our clients when we run it on a quarterly basis. We can calibrate that tool with certain parameters and if something falls outside the parameter that requires the engagement team to sort of follow-up and say, "Why is this relationship?" in the balance sheet or certain ratios in the income statement, sort of outside the norm that we would have predicted. My sense is, it heightens awareness of fraud risk and it actually impacts your planning and your execution of the audit. Because if you don't see it in the planning stage, you are probably not going to scope your audit properly or have the appropriate steps in execution. The next wave though, I think will really be transformational in many ways. I don't know how to explain it because it's a little bit beyond me, but the explosion of the use of data analytics, which can be very specific to a company or an aspect or an attribute that you are trying to test, has become front and center for certainly all the consulting firms. I was in a program yesterday and the IBM people were presenting it, our own people at Deloitte Consulting are talking about it in a huge way and it's being used for every sort of everyday applications, including neo-natal units trying to predict certain conditions before they are evident to a nurse or a doctor. I am told they are extremely effective. If we can take data and have predictability, that could be very powerful when I think about facing off against a potential fraud.

IRA SOLOMON: Next, we look ahead. What do you see as some of the most promising paths to enhancing the prevention and detection of financial statement fraud? I would like to turn back to the four parties that were in the supply chain that Cindy initially mentioned and see if we can talk about the answer to that question in the context of each party. So Cindy, why don't you kick this off?

CYNTHIA FORNELLI: I am happy to do that, Ira. In fact what I am going to say is that the work that we plan on doing, we want to do it collaboratively with the four participants in one supply chain. And so we have partnered with Financial Executives International, representing the preparers or management; the National Association of Corporate Directors, representing boards of directors and audit committees; and the Institute of Internal Auditors, who, of course, represent the internal audit function, to focus on where we might partner together to tackle some of these issues. We landed on four key areas that we are going to focus our collective work on and that is what are the pre-conditions that lead to fraud. That's the first one and by that I mean what causes one person to commit fraud, where another person who is faced with some of the same facts and circumstances doesn't. This gets to the behavioral and psychological aspects behind committing fraud. The second area we want to look at is skepticism. Certainly external auditors have a professional requirement to bring skepticism into the process, but shouldn't all of our parties be skeptical? And so how we talk a little bit about this internally is the "bias of trust." You do your due diligence to go on to an audit committee or to take on an audit client or to join a company, either in internal audit or as part of management. And so you don't, after you have made that decision, think that there is going to be fraud there. So how do you then, on your first day on the job, turn that around and how is that skeptical mind set? We want to explore ways around that. Also we want to explore the impact of short-term focus and so how do you mitigate the potential harms of short termism. That certainly goes to the fraud triangle, the pressure to commit fraud. If you are under immense pressure to make your numbers, how do you make sure the organization, be it from the audit committee, internal audit, external audit or the management side that you are not also creating an incentive to commit fraud?

And then finally, a little bit to Bob's earlier point, the role of information technology. IT can certainly be both a tool to commit fraud and also an effective deterrent to fraud. And so we would like to explore how IT can be used to help deter and detect financial statement fraud - particularly I think in this day and age where everything is done electronically. We don't sit across from each other and look each other in the eyes and have a lot of that human interaction that we used to have that can be, I think, an effective tool certainly in deterring and detecting fraud. And so there are other ways you can use information technology to overcome what has become a very electronic based society that we live in.

JOSEPH CARCELLO: I think that there's a lot of interest in the staff, like a lot of people looking at it, obviously CAQ, based on what Cindy just said is taking a lead in this. COSO has for many years and they have a number of things in the pipeline and there may be some things they will do together with CAQ. Bob talked about firm specific initiatives, I am sure that we had some other firms here we are talking about things as well. And then the Treasury Advisory Committee on the Auditing Profession recommended that the PCAOB establish a National Fraud Center. It appears that they are going to do that, I believe they are going to name the director and hopefully not in the too distant future. It will be interesting to see what that group does.

To me, Ira, the thing we need to do here and candidly the challenge always is data, right? The firms have the data and what they are doing with that maybe Bob can speak to it. But to me, they have an incredibly rich set of data, because they have thousands of audits every year for many years. And so to me one of the things you want to look at is, here's a set of proposed adjusting entries, in some cases maybe fraudulent, most cases not, most cases error driven. But I am sure there are situations where the firms do detect fraud and prevent it before a K or Q is filed. How do they do that? Are some audit procedures more effective? Are there differences in people? What makes one auditor more effective than another in detecting fraud? Are there institutional arrangements in terms of supervision, in terms of incentives? What works? They also have access to their work papers when a fraud occurs and they didn't catch it. Well, why didn't they catch it? What failed? What were the client characteristics that were present there? That we might also have risk factors but not all risk factors are necessarily equally diagnostic. And so which ones are really diagnostic and which ones aren't? Now, obviously Bob will respond to this. The firms are in business to make money and as you and I both know basic research is quite expensive. On the other hand, they have a powerful incentive to be better at this because at a minimum you would think that their litigation exposure would go down and their regulatory exposure would go down. So I don't know what they are doing in this domain. I would hope that they are doing a lot. If they are, they are not sharing it widely to the world and maybe they want to keep it inside for their own competitive purposes, which is fine, I understand that. I think some of the leaders in the firms and Bob and Cindy would certainly be consistent with this, have wanted to enable this kind of research by outsiders. Academics do bring a certain objectivity to the process if nothing else and we do this for a living. But there are a lot of obstacles, a lot of barriers to sharing the data outside but they can do a lot inside. And for that matter PCAOB can do a lot inside and I am not sure that some of these things that I am suggesting are being done as extensively as I would like. But I hope Bob will tell me I am wrong.

ROBERT J. KUEPPERS: Joe, to your point, the firms certainly from time to time get pretty rich information by analyzing audits that maybe fail to detect something. The question of much broader looks at adjusting journal entries, things like that and the ability to somehow harvest that data and do some independent research could be valuable. But I find that in looking at handful of situations that there are certain common attributes or elements that cause us to do a rethink on how we do things and reexamine our own quality controls from time to time. I mean the set up of the question about what is the most promising path. I got to tell you, look at the CAQ report that we mentioned a couple of times now, the platform for action on deterring and detecting financial reporting fraud. One of the things I think is the most promising is to take the equivalent of what we in my profession call professional skepticism and instill that same, maybe I have to call it something different, but I think in the report we just used that as a surrogate for the same kind of skeptical probing, questioning that audit committees would do, that members of management would do with the data that if I am running the accounting department or I am an assistant controller and my team is providing me data, I am not going to just accept that and send it to my boss. I am going to sit down and very critically review that and make sure it's right so I have said that same skepticism, in the same course of internal audit as well as the external auditor. My point is that, if everyone had that mindset and was being exercised at a concurrent time, I think we would greatly enhance the ability to detect fraud. I just think that's a direction we should head.

JOSEPH CARCELLO: I agree with Bob completely, Ira but I think the challenge at least from where I sit is again going back to what I said. If the fraud is a large scale fraud, they are not obviously going to be skeptical of something they know they are doing. So you can basically wipe top management off the list, so they are off the table. And then if a CEO or a CFO is going to be perpetrating a massive fraud, the last thing I want is a strong internal audit group and I control that. So I either understaff it or under-budget it, make sure that the people there are directed elsewhere. They weren't looking at the financial statements; they were looking to see whether restrooms and their facilities were clean, have them do operational audits. So there's lots of ways to defang them. Who's left at the end of the day, who's the free safety? It's the external auditor. One of the things that worries me a little bit and this is not the profession's fault, is that whenever we are going through an economic downturn, there's tremendous pressure on fees. You could argue that that's where the risk of fraud is greatest. And that's a problem. I don't think that's a problem that the profession can solve, obviously the profession doesn't think that's a good idea. I am not sure the PCAOB can directly solve that. I do think there is a role here for the SEC, and I hope they are looking at that.

ROBERT J. KUEPPERS: The one group that really plays a central role on the fee side is the audit committee of the Board and they are part of Cindy's four parties, supply chain as well.

CYNTHIA FORNELLI: Let me make just one quick point about the availability of research. I think that the collaboration that we are entering into with FEI, the IIA and the NACD might loosen some of that up as well. As you all know, the CAQ has tried to fund independent research and yes, it's five or six projects at a time so it doesn't totally solve the problem. Both the FEI and IIA have large research foundations and so if we all partner together, I am hopeful and optimistic that we can look at some of these issues, Joe that you talked about: what were the near misses, what worked, what didn't work and how can we talk about it? So I am optimistic that we can make real movement there.

JOSEPH CARCELLO: Cindy, I am very appreciative of everything you have done. But I think as Ira and I have both said, the biggest impediment isn't money. Academics are always happy to take money just as anybody else but the biggest impediment isn't money; the biggest impediment is data and subjects.

ROBERT J. KUEPPERS: I do believe that just to balance it out. Maybe there is no sort of ready repository of all this data but certainly on a project by project basis, we often cooperate on the proposals we get. I think it's helpful that the CAQ… when Cindy you said you tried, you have been successful?

CYNTHIA FORNELLI: Right.

ROBERT J. KUEPPERS: Funding some good research and the profession really has to support these efforts, one way or another and I think we will continue to do so the best we can.

IRA SOLOMON: So just a little inside humor here, the records should reflect that I did not put Joe up to answering my question that way and there's two humorous elements to that but I will leave that at that. I did want to come back to professional skepticism for a moment because that's come up in a couple of contexts here. This to me is an area where there is a huge need for some of the members of the academic community to work with the four groups that are part of this supply chain. This is a concept that's been around a long time, one only need review a few inspection reports from the PCAOB to see that it's often an issue. And yet I as an instructor in the auditing arena struggle when a student asks me, "So how do I become a professional skeptic superstar? What can I really do that is going to make me stand out?" This is an area that academics could play a role because not only is this concept present in the auditing arena but it's present in many other arenas. If you talk to police, if you talk to journalists, even medical doctors have a notion of skepticism. So there is an opportunity to draw from a wide variety of fields which could be part of the academics' comparative advantage.

So now with that commercial out of the way, I would like to ask about practical steps that audit committees and boards might take to promote deterrence and detection of financial reporting fraud. We will kick this off by asking Joe to weigh in.

JOSEPH CARCELLO: I think there are a number of practical steps that audit committees and boards can take, Ira. One thing that I think is important and that hasn't gotten enough attention is the board nomination and selection process. I have some work with a couple of academics that's forthcoming in an academic journal, and one of the things we look at is how do people get on boards? And basically the prior research finds that audit committee independence and expertise which are important components of the Sarbanes-Oxley Act are helpful in many areas in terms of improving financial reporting. But what we find is given greater CEO involvement and how individuals get on the board and the audit committee, those benefits not only are reduced, they are eliminated, there is no effect at all. So the nominating governance process, I think, is very important and sometimes I think doesn't get enough attention. I think that's one thing that can be done. I think we need to pay more attention to comp committees. I think we need to pay more attention to incentives; incentives matter an awful lot. If the incentives are so skewed towards making numbers, there is always that pressure to begin with. You are just creating a very high risk situation where some people are going to give in to those temptations. So I think we need to look at that.

I agree with what Bob and Cindy have said earlier in terms of the role of boards and audit committees, in particular, in being more involved in owning this process. Now in fairness to them, they are part time bodies and they are going to have to rely primarily on the external auditor and the internal auditor and at the end of the day, management. And if you have a CEO and a CFO who are bound and determined to commit fraud, it's going to be very difficult. If it's hard for the external auditor, it's going to be extremely difficult for an audit committee, who have four or five or six times to detect it. But there are things that they can do that don't guarantee detection but helps. One is supporting the external auditor in terms of scope of the audit, the fee. Savings the last dollar on the fee, I think that's very short sighted and foolhardy. Ensuring that the necessary investment and controls are put in place, that there is a competence among the finance and accounting and information technology people. I think there is a role for the board and the audit committee to not be primarily passive receivers of information, which often in the past has been the norm. I have heard audit committees describe this as "death by PowerPoint." They should have those agendas and those briefing books in advance and go through them in advance. The value of the meeting is to ask questions. That's what really where it's important and one audit committee member who I have talked to, I thought he had a great quote. He said to me one time, "I view dissent as an obligation." This is getting at what Bob and Cindy talked about earlier and that is essentially, I don't know if you want to call it professionally skeptical. Of course there is not a body of literature for audit committee members like there is for external auditors but it's the same thing, right? It's basically challenging the information you are given, challenging management, for that matter challenging the external auditor. I think when you have that, I think you end up with a more robust dialogue and I think you have a better chance. You are not going to be foolproof but I think you are moving in the right direction.

CYNTHIA FORNELLI: Joe, to your point, the National Association of Corporate Directors just issued a blue ribbon commission report on the role of the audit committee and they touched on many of these points. The importance of the audit committee being connected to the compensation committee, either through having overlapping members or attending each other's meetings, having the time to be able to really probe and to your point about "death by Power Point." The recommendation in there is that you expect that the people will have read the board books before you go in. And that you don't spend your meeting talking about what's in the board book but rather focusing on issues that were raised in the board book. Just having an expectation and an atmosphere that there is going to be this questioning mindset. And it's expected that people are going to probe and push and question. So that's the expectation and people come in there prepared. And then also to some of the points that we have made earlier about how the audit committee is not there all of the time. Well, maybe they should be there more both informally and formally. So maybe if it's a manufacturing company that has plants in different locations, the audit committee members should go visit the plants and talk to employees. Maybe they should have private meetings with the external auditor, of course, but also the internal auditor, so just really setting an atmosphere and that takes leadership. That takes the leadership of your audit committee chair. He or she has to run the agenda, run the meetings, and make sure that there's ample time to have these probing pressing questions.

ROBERT J. KUEPPERS: Cindy, to your point and Joe's points, it's totally hard to disagree. I think of it in sort of simple terms though that the very first step is to have board members and audit committee members acknowledge that fraud can happen at this company or at any company. I think we all acknowledge that board members certainly believe the organization that they have associated themselves with has integrity and that there is sort of this predisposition to trust one another. I think of all that you go through to get on a board and all the diligence you do to make sure that the reputation of the individuals in charge and the company as a public entity is of high quality. So I mean once you have done all that, you come in and sort of you are disposed to trust what you are seeing, at the same time having the knowledge that management override is one of those real worries at any company, given the statute you were citing earlier, Joe, about how often top people are involved. That's why I keep coming back to skepticism. The board, the audit committee have to understand the fraud triangle, the things that motivate -- pressure, opportunity and rationalization -- and really spend their time on some of the mitigating factors – culture, skepticism and communication -- those are the some of the best anti-fraud elements.

So even corroboration, people say, "How do you remain skeptical?" I corroborate a lot of things. I hear it from Sally but I am going to go find out separately from Joe whether what Sally's telling me is the right thing. It doesn't always have to be obvious to your client personnel that you are being skeptical but you find ways to corroborate, to verify, take a completely different angle of the same issue or problem. Sometimes you hear different things at which point you got to run that down. I do think that audit committees are in a tough spot on one hand but really have to develop a set of skills, that any of us would want in that situation.

IRA SOLOMON: The recently completed CAQ study on financial statement fraud has come up several times today already, but I did want to give you, Cindy, in particular, a chance to comment on anything that we might not have discussed yet.

CYNTHIA FORNELLI: The one area that emerged in our various discussions and that you will see as a key theme in the report that we have not yet touched upon today is the importance of tone at the top. And we use that as shorthand, but really what we are talking about there is a strong ethical tone and a strong corporate culture that permeates the entire organization. So, if we are going to keep with our alliterations: it's not just tone at the top, it's mood at the middle and it's buzz at the bottom. It starts at the top and it's key that the CEO and the CFO and the other C-level executives are committed to a strong culture of ethics within an organization. But they have to not just pay lip service to it, they have to live it and breathe it. And one way to do that is to have a strong whistle-blowing ethics program within an organization. I think that we have all seen statistics that the richest resource for detecting fraud is through whistle-blowers. But, at the same time, many employees within an organization do not feel confident, that if they do use the hot line or if they do raise the red flag, that it will be taken seriously and that they won't be retaliated against. It's really important that companies, supported by internal and external auditors, as well as the audit committee, really focus on, "Does the company have a strong ethical culture within the organization and do they really live it?" We talk a lot about that in the report. I will just put that as a marker down that that's really important.

IRA SOLOMON: I think in the interest of time, I am going to move on to a related but somewhat different focus. We have covered a lot of turf here. Much of what we have covered has, I believe had major educational implications. So I would like each of you, we will start with Joe, to share with us your views on what the most significant educational implications are with respect to a desire to increase auditor's capacity to detect financial statement fraud.

JOSEPH CARCELLO: I think there's a lot there, Ira and in the interest of time I will just hit on a couple of things. I think one thing is that there needs to be more of a focus on experiential-based learning. I think it's very hard to really teach someone how to detect fraud just based purely on reading text books and lectures and so forth. I think experiential-based learning is very important. I think graduate education is critical. In most of the states there is 150 hour law but can be 30 hours of essentially anything. And so I think good graduate programs are critical. I am not convinced necessarily that one year is sufficient. Law is a three year program, medicine is four plus many internships, residencies and so forth. When you think about a typical education program, they have an auditing class at the undergraduate level, maybe an auditing class at the graduate level, and I am just not sure that's sufficient. But probably the last thing I will hit on is composition of us, Ira, and that is, it's increasingly dominated by people who are really trained financial economists, financial accounting researchers, who have tremendous skills in finance and mathematics and statistics. Many of these people have no practical experience, no institutional knowledge whatsoever, no ties to the profession. I just think it's very hard to train the next generation of auditors, if that's who is going to be educating them. Now again that's a generalization, there's lots of exceptions to that. And the profession, I think is aware of this and they have taken some steps to try to deal with that in terms of the pipeline particularly in the area of auditing and tax. But that's going to be a long process and I think it's something we need to keep our eye on.

ROBERT J. KUEPPERS: Let me pile on a little bit. I think the quality of our sort of new hires and we recruit right out of college with a brand new degree, is very high. Obviously, to deploy them in an audit capacity, we have a training obligation of our own because we need to teach our own methodologies and some of the real fundamentals. But I would observe, the 150 hours, precious little of that is used in the auditing arena. There's a lot of accounting. Everybody takes a tax course and everybody takes an auditing course, but typically that's it. I am amazed because in my view, the skill sets you get from auditing education are utilized whether or not you spend your life being an auditor or not. In other words you could be an management accountant, you could be in a number of different capacities in the financial world and in the accounting world and I don't think any time spent on auditing education, auditing courses, is really wasted. So, if I had to pick one thing I would say a little more time in the auditing coursework.

CYNTHIA FORNELLI: I will clean up on that particular question with much more practical advice and that would be to the students out there in particular: don't lose your enthusiasm. I think it's hard for young people to keep their voice because they are afraid they are going to ask the dumb question or that there must be a reason this isn't being done because people are more experienced than I would have done it if it were important. And a lot of times that's true but a lot of times that's not true and so its sounds hokey but my dad always told me that the only stupid question was the question that you didn't ask. And so I would leave students with that: keep that questioning mindset, because even if it's not going to help you uncover a fraud, it's going to help you learn. That would be my advice.

IRA SOLOMON: Thank you. Well, unfortunately we have almost come to the end of our allotted time. So Cindy, Joe and Bob, thank you very much for this most thoughtful discussion. Both today's program and the October 14th Chat on Regulation in the Audit Profession will be important materials in the collection on accounting in the virtual museum and archive's collection. The audio of today's broadcast is now available on www.sechistorical.org and a transcript will be ready soon.

I invite you to visit the dedicated Deloitte Fireside Chats section under Programs at www.sechistorical.org at any time, where you will be able to access not only this month's programs but also the 2009 Fireside Chats on Professional Judgment and on Principles versus Rules-Based Accounting and Auditing Standards. These programs, along with the other 4000 plus materials in the museum, are free and accessible to you at all times. On behalf of the SEC Historical Society, I would like to thank Deloitte LLP for its sustained support and assistance in making today's program possible and the Deloitte Fireside Chat series as well. Thank you for being with us today and good afternoon.