



**U. S. Securities and Exchange Commission**  
Washington, D. C. 20549 (202) 272-2650

**News  
Release**

Remarks of

David S. Ruder  
Chairman

United States Securities and Exchange Commission

Before the Institute of Internal Auditors'  
Business Issues and Audit Conference

Washington, D.C.  
April 25, 1988

**THE INTERNAL AUDITOR'S ROLE IN DETERRING,  
DETECTING, AND REPORTING OF FINANCIAL FRAUDS**

---

The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners, or the staff.

THE INTERNAL AUDITOR'S ROLE IN DETERRING,  
DETECTING, AND REPORTING OF FINANCIAL FRAUDS

I. Introduction

It is a pleasure to address a group of internal auditors. You have special responsibilities to guard against fraudulent financial reporting and you therefore play a key role in our disclosure system. One of the important areas within your sphere of responsibility is the design and maintenance of systems of internal control that will eliminate fraudulent financial reporting. My remarks today will focus on those systems and other means of helping to reduce fraudulent financial reporting.

II. Recent Spotlight on External Auditors

Much of the spotlight regarding fraudulent financial reporting has recently been focused on the role of the external auditor. Highly publicized frauds such as ESM Government Securities and ZZZZ Best have left many observers, including several on Capitol Hill, asking -- "where was the auditor?" These cases, as well as other concerns, have ignited a great deal of debate and activity about the roles of both internal and external auditors.

This debate is reflected in the current investigation being conducted by the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, often referred to as the Dingell Subcommittee, after its Chairman, the Honorable John Dingell. A number of groups, including your Institute, have testified before this Subcommittee to share views on what might be done to help deter fraud. I am expected to testify a week from today.

Congressman Dingell's subcommittee is not alone in its concern about fraudulent financial reporting. Let me give you three examples. First, the Commission has expanded its enforcement program and is exploring ways to enhance the credibility of financial reporting. Second, the National Commission on Fraudulent Financial Reporting has completed its report. As you know, the Treadway Commission, named after its Chairman, was a private-sector initiative sponsored by five groups representing constituencies concerned with fraudulent financial reporting. The Institute of Internal Auditors was one of the five Treadway Commission sponsoring groups. Third, the Auditing Standards Board of the AICPA has developed new and revised auditing standards to address questions about the role external auditors should play in detecting financial fraud. The ASB work has become known as the "expectation gap" project because one of its objectives is to close the gap between what the auditor does and what the public believes he does.

Although much emphasis has been placed upon external auditors it is noteworthy that the final Treadway Report, while commenting on the crucial role of the external auditor, also stated that responsibility for reliable financial reporting resides "first and foremost" at the corporate level. The report indicates that "top management - starting with the chief executive officer - sets the tone and establishes the financial reporting

environment." 1/ It goes on to state that "reducing the risk of fraudulent reporting must start within the reporting company." 2/

Thus the initial responsibility falls on the corporation and inevitably upon the internal auditor's crucial role in the corporation's control structure. The importance of the internal auditor is certainly not a new notion, and it is significant that the Treadway Report identifies the internal auditor as extremely important in reducing the risks of fraudulent financial reporting.

### III. Responsibilities of the Internal Auditor

Although the Treadway Commission goal of improving internal controls is laudatory, your organization, the Institute of Internal Auditors, should be recognized as playing a primary role in assisting the internal auditor in the financial control and reporting process.

Your organization's standards dealing with the concepts of control, fraudulent financial reporting, and quality assurance programs 3/ provide strong guidance for internal

---

1/ Report of the National Commission on Fraudulent Financial Reporting ("NCFFR Report") at 6 (October 1987).

2/ Ibid.

3/ The Institute of Internal Auditors has issued the following Statements on Internal Auditing Standards (SIAS):

- SIAS No. 1, "Control Concepts and Responsibilities;"
- SIAS No. 2, "Communicating Results;"
- SIAS No. 3, "Deterrence, Detection, Investigation, and Reporting of Fraud;" and
- SIAS No. 4, "Quality Assurance."

auditor activities aimed at achieving effective systems of corporate internal control.

As you know, the IIA Statement of Responsibilities of Internal Auditing indicates that the scope of internal auditing encompasses the examination and evaluation of the adequacy and effectiveness of the organization's system of internal control and the quality of performance in carrying out assigned responsibilities. The scope statement, drafted in 1947 and revised most recently in 1981, states that good internal auditing includes:

- ° reviewing the reliability and integrity of financial and operating information and the means to identify, measure, classify and report such information;
- ° reviewing the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant impact on operations and reports, and determining whether the organization is in compliance; and
- ° reviewing the means of safeguarding assets and, as appropriate, verifying the existence of such assets.

To help the internal auditor carry out internal control responsibilities, the IIA has also published other Statements on Internal Auditing Standards 4/ including one providing guidance to the internal auditor for the "Deterrence, Detection, Investigation and Reporting of Fraud." The latter statement emphasizes the need for inside auditors to communicate the results of fraud investigations, and offers a good starting

---

4/ Ibid.

point for examination of federal legislation, the Treadway Report, and Securities and Exchange Commission activities in the financial fraud area.

IV. The Foreign Corrupt Practices Act

An important legislative link between your profession and the Commission was enacted in 1977 with the passage of the Foreign Corrupt Practices Act ("FCPA") 5/. As you know, the FCPA mandates that companies devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that accurate books and records are maintained and that assets are safeguarded. These concepts were not new when they were adopted. For some time, generally accepted auditing standards have required a study and evaluation of internal controls during an audit. And the IIA's Statement of Responsibilities indicates that the study and evaluation of internal controls is encompassed in the scope of the work done by the internal auditor.

Despite the prior existence of similar standards in the accounting profession, the FCPA has been an effective statute because it has given the internal auditor a strong lever in efforts to obtain cooperation from other corporate officers in establishing internal controls. As a result, following enactment of the FCPA, many companies examined their internal control systems and took steps to remedy areas of deficiencies.

---

5/ 15 U.S.C. §78m(b)(2).

V. Current Environment

Despite the existence of the FCPA, there still appear to be deficiencies in the financial reporting process. Although serious frauds have been discovered in only a small percentage of reporting companies, the frauds that have been discovered have resulted in significant losses to some investors. These cases provide significant incentives toward improving our reporting systems.

I am pleased to see that substantial initiatives are underway to better understand the causes of such financial reporting problems and to recommend solutions. These initiatives have been undertaken in several sectors, most prominently by the Treadway Commission.

VI. Treadway Commission

The Treadway recommendations provide a number of constructive comments that may contribute to an improved financial reporting environment. The Treadway recommendations focus on four groups -- the public company, the independent public accountant, the Securities and Exchange Commission, and the academic community. Since the Commission is currently evaluating those recommendations, I will deal with them only in general terms. Nevertheless, even a general recitation reveals the wide scope and importance of the recommendations.

The Public Company

The recommendations for the public company are aimed at promotion of a corporate environment that emphasizes good financial reporting. Recommendations for key participants in the financial reporting process are directed at the audit committee, management, internal accounting personnel, and internal auditors. The aim of the Report is to bring to top management a sense that internal controls are very important to the disclosure process.

External Auditor

A number of the Treadway recommendations are directed at the role of the external auditor. Suggestions are made for changes in auditing standards to provide greater responsibility for detection of fraudulent financial reporting and to ensure better communications to those parties that rely on the work of the outside auditor. I may note that the Auditing Standards Board, under Commission oversight, has recently adopted auditing standards that are intended to address several of these recommendations. 6/ The Commission has also recommended changes

---

6/ The Auditing Standards Board has recently adopted nine new auditing standards: (1) The Auditor's Responsibility to Detect and Report Errors and Irregularities; (2) Illegal Acts by Clients; (3) The Auditor's Consideration of an Entity's Ability to Continue as Going Concern; (4) Consideration of the Internal Control Structure in a Financial Statement Audit; (5) Analytical Procedures; (6) Communication of Internal Control Structure Related Matters Noted in an Audit; (7) Communication with Audit Committees (8) Reports on Audited Financial Statements; and (9) Auditing Accounting Estimates.

geared to improving audit quality, including steps to improve and expand the peer review process and to expand guidance for the concurring, or second partner review. 7/

The Securities and Exchange Commission

Among the Treadway recommendations for the Commission are those relating to two matters on which the Commission has taken action, peer review and opinion shopping. 8/ Others relate to audit committees, management reports, auditor involvement with quarterly reports, and additional enforcement remedies. We are reviewing all of these suggestions.

Education

The Treadway Commission also recognizes the importance of education in influencing participants in the financial reporting process, and recommends a number of changes directed at business and accounting curricula as well as changes in professional certification examinations and continuing professional education.

The Internal Auditor

Of course, the portions of the Treadway report which should be of most interest to members of the IIA are those recommendations directly affecting the internal auditor. The internal audit function is an important part of the Treadway package of

---

7/ See, e.g., U.S. Securities and Exchange Commission Fiftieth Annual Report at 18(1984); also see Securities Act Release No. 6695 (April 1, 1987) [52 FR 11665] at note 20, in which the Commission emphasizes the importance of concurring partner reviews.

8/ Financial Reporting Release No. 31 (April 12, 1988) [53 FR 12924]; Securities Act Release No. 6695 (April 1, 1987) [52 FR 11665].

recommendations directed towards the public company. These recommendations emphasize that all public companies should maintain an effective and objective internal audit function. Management and the audit committee are both urged to involve the internal audit staff in the audit of the entire financial reporting process, including coordination with the external auditor.

As a package, the Treadway recommendations represent good business practices. Importantly, the internal auditor will play a major role in the implementation of the Treadway recommendations. The IIA has given a positive endorsement in public testimony of the Treadway exposure draft 9/ and is participating in the group formed to monitor and encourage the implementation of the recommendations contained in this report. I urge your continued efforts towards implementation of the recommendations.

#### VII. Commission Activities

The Treadway Report, of course, was prepared against a background of strong Commission policy directed toward the prevention and detection of fraudulent financial reporting. A substantial portion of the Commission's resources are devoted to monitoring the fair presentation of financial results, and the Commission has recently taken steps to increase its efforts in this area.

---

9/ Statement of the Institute of Internal Auditors before the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce (July 27, 1987).

In recognition of the importance of fair presentation, the Division of Corporation Finance is increasing the number of accountants on its staff. Our goal is to have accountants comprise half of the professional staff of the operating branches of that Division. The increase in the accounting staff, which will better enable the Division to address increasingly frequent sophisticated, complex, and novel accounting issues, will also enable it to review more financial statements.

In addition to strengthening the review process, the Commission has also enhanced its enforcement program. Substantial resources in its Division of Enforcement are devoted to uncovering and pursuing accounting and financial reporting abuses. Examination of the role of the external auditors currently is an important aspect of the enforcement program. The Commission's examination of financial fraud or other abuses by registrants always includes an examination of the role of the auditor in order to determine whether the auditor has violated the federal securities laws, aided and abetted issuer violations of the federal securities laws, or engaged in improper professional conduct. 10/

---

10/ The Commission protects the integrity of its processes by disciplining professionals, including accountants, who practice before it in proceedings pursuant to Rule 2(e) of the Commission's Rules of Practice. A pending rulemaking initiative would change the presumption from private to public hearings in these proceedings. See Securities Act Release No. 6662 (September 29, 1986) [51 FR 35653].

Over the past few years, the Commission has brought an increasing number of cases against both issuers and their accountants for failures in the financial reporting process. Perhaps of particular interest to this group, several Commission enforcement actions have included settlements requiring the registrant to improve the internal auditing function. 11/

The Commission also has recently taken several initiatives that are responsive to and indeed anticipated the Treadway Commission report. These include a proposal recommending mandatory peer review and recently adopted rules concerning enhanced disclosures about changes in auditors in potential opinion shopping situations.

#### Peer Review

The Commission's mandatory peer review proposal would, if adopted, require an independent assessment of an accounting firm's quality control systems for its auditing and accounting practice, including a judgment by the peer reviewer regarding the system's protections against inferior audits. 12/ Peer review is an extremely important concept and, although I believe the present program conducted

---

11/ See, e.g. SEC v. Allegheny International, Inc., Accounting and Auditing Enforcement Release ("AAER") No. 151 (September 9, 1987); In the Matter of Marsh & McLennan Cos. Inc., AAER 124 (January 22, 1987); SEC v. Oak Industries, Inc., AAER 63 (June 25, 1985).

12/ Securities Act Release No. 6695 (April 1, 1987) [52 FR 11665].

by the AICPA's SEC Practice Section has helped to improve the quality controls of its member firms, much remains to be accomplished regarding peer review. The Commission expects to take additional action in this area in the near future.

Although not labeled as "peer review", the IIA has an internal audit standard 13/ which provides guidance for implementing a quality assurance program in internal auditing departments. Such programs should help promote more effective internal audit functions just as peer review should make public accountants' performance more effective.

#### Opinion Shopping

In the "opinion shopping" area, the Commission recently adopted amendments to its disclosure requirements 14/ for increased disclosures concerning changes in accountants. The term "opinion shopping" is not defined in either the accounting or auditing literature. Nevertheless, it is generally understood to involve the search for an auditor willing to support a proposed accounting treatment designed to help a company achieve its reporting objectives even though that treatment might frustrate reliable reporting.

If the perception exists that an auditor's opinion can be influenced by competitive "business-getting" pressures, great doubt will be cast over these opinions,

---

13/ SIAS No. 4, "Quality Assurance" (November 1986).

14/ Securities Act Release No. 6766 (April 12, 1988).

regardless of the individual circumstances surrounding them. The final Commission rule requires new disclosures in Form 8-K (and Form N-SAR for investment companies) when a registrant changes its outside auditor. It also more clearly identifies circumstances constituting a reportable disagreement between the registrant and the auditor. Under the rule, the term "disagreement" would be interpreted broadly to include any difference of opinion which, if not resolved to the auditor's satisfaction, would have been referred to in the auditor's report.

Along with its final rule, the Commission also published for comment proposed rules 15/ that would shorten the period of time from fifteen to five calendar days for reporting on Form 8-K an auditor change or the resignation of a director. The Commission also is proposing to reduce the time required for the filing of a letter by the former auditor indicating whether the former auditor agrees with the disclosures made by the registrant about the circumstances surrounding the auditor change. The Commission believes these changes may help to ensure more timely reporting of matters that might signal financial reporting problems.

The Commission believes these recent initiatives will help promote full and fair disclosure of financial results and are responsive to several of the recommendations of

---

15/ Securities Act Release No. 6767 (April 12, 1988).

the Treadway Commission. The Commission will continue to examine other initiatives to ensure the credibility of financial reporting.

VIII. Summary

I have noted a number of activities focused on one common objective -- to continue to develop ways to improve the deterrence, detection, and reporting of financial fraud. As I have noted, internal auditors can and should be an important part of the corporate environment needed to help reach these goals. I encourage the IIA to continue its active posture in increasing the effectiveness and objectivity of the internal audit function.