COMPLIANCE WEEK

Internal Controls Get Poor Detection Marks, But Numbers Misleading

By Susan Schott Karr — July 20, 2004

In a recent study, The Association of Certified Fraud Examiners presented findings that bring to light a number of questions about the effectiveness—or seeming ineffectiveness—of internal controls as a detection measure for financial statement fraud and abuse.

RELATED LINKS

According to the ACFE's 2004 Report to the Nation on Occupational Fraud and Abuse, which looked at the initial detection of occupational frauds, the most effective detection method was through tips, accounting for 39.6 percent of the incidents. Internal audit was the second most common way in which fraud had been detected, accounting for 23.8 percent of the incidents. Fraud was detected "by accident" in 21.3 percent of cases, followed by detection via internal controls in 18.4 percent of cases.

Considering the prevalence of recent high-profile fraud cases, many of which involved falsification of a company's financial statements, and the current emphasis on the internal control provisions of Sarbanes-Oxley, it's surprising that "tips" far outranked internal controls as a detection mechanism.

Not only did internal controls rank fourth in the study, but the frauds that were detected by internal controls tended to be relatively small, with a median loss of $40,000—by far the lowest of any detection method.

Deterrence Through 404

If internal controls rarely detect fraud, and do so for typically small amounts of money, is all this emphasis on internal control assessments and attestations required by Section 404 of SOX a waste of time?

According to experts, the answer may not be a straightforward one.

Wells

"Although fraud is difficult to detect, oversight is a powerful deterrent, says Joseph T. Wells, founder and chairman of ACFE and a professor at the University of Texas at Austin. "Fraud is committed by people, not accounting systems or computers," he adds. "In order to discourage employees who are tempted, it is necessary that we increase the threat that they will be detected."

Mark Beasley, a professor of accounting and director of the enterprise risk management program at North Carolina State University, agrees with Wells. "Even if you rely on the ACFE survey and conclude that internal controls only detect smaller frauds, I think you might be overlooking the 'prevention' or 'deterrence' aspect of internal controls. The study only focuses on 'detection.'"

Beasley

According to Beasley, it's reasonable to assume that internal controls have prevented a lot of fraud because they're simply in place. "Imagine a company with weak internal controls—when that's more obvious, there is less prevention or deterrence relative to a company with strong controls."

In many ways, a company without controls is like a city without electricity. In a blackout, where lights and security are gone, looting and anarchy are more likely. That's no different than the looting perpetrated by executives at Tyco, experts say.

Carmichael

As a result, the internal control provisions of Sarbanes-Oxley actually become more critical to fraud prevention. According PCAOB chief auditor and director Doug Carmichael, those intent on committing fraud "are not going to be successful unless they can get around the internal controls that are in place."

Rick Sauer, a former assistant director with the SEC's enforcement division, agrees with Carmichael. "If internal controls detect a fraud," notes Sauer, "then in essence they're detecting a failure of internal controls." According to Sauer, now a partner at Vinson & Elkins who deals with corporate governance and securities law compliance issues, "This also can indicate that people who commit fraud know that they will have to circumvent internal controls."

Sauer

As a result, Carmichael believes that prevention is at the top of the list. On detection, he notes that "Perhaps more companies will find that internal controls help to detect fraud after they have come into compliance with the SEC's and PCAOB's standards."

A Broader Definition

DeLoach

James DeLoach, managing director of risk consulting and internal audit firm Protiviti Inc., actually thinks that the categorization of detection methods in the ACFE study is slightly misleading, and may underemphasize the importance of internal controls.

According to DeLoach, the categories of internal auditing and tips—which detected over 60 percent of the fraud cases—are actually *elements* of internal control over financial reporting. "Internal control appears to be much broader than what is included in this study," he notes.

According to DeLoach, the internal control framework developed by the The Committee of Sponsoring Organizations proves his point. "The reality is that if you're talking about the framework that companies are using, the only game in town is the COSO framework," he notes. "Any study that wants to draw conclusions has to use the definitions of internal control by using the framework."

According to DeLoach, "Internal control as defined by the COSO framework includes three of the top four of the elements included in this study."

COSO defines internal control as a process, with five interrelated components:

1. Control environment
2. Risk assessment software
3. Control activities
4. Information and communications
5. Ongoing monitoring

The PCAOB's Carmichael agrees. "An anti-fraud program has to be a coordinated effort of all components. The survey views this more narrowly." He notes, however, that AFCE understands this need for an integrated effort in combating fraud.

As a result, the experts agree that the impact of internal control over financial reporting has a much greater impact than the survey implies. In fact, they say, the study proves that internal control is by far the most dominant detection—and prevention—device available to a public company.

Back