Insider Trading from Internal Auditor's Perspective

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ABSTRACT

This paper explores the effectiveness of internal auditors as control mechanism over insider trading. We examine how contextual factors affect internal auditors' ethicality judgments of insider trading. We also investigate whether independent reporting structure and familiarity with insider trading laws including company policies influence internal auditors' willingness to pursue illegal trading activities. One Hundred internal auditors participated in our electronic survey. Our results reveal that internal auditors are less likely than others to be swayed by contextual factors in their perceptions of trading activity. However, our results also suggest that the internal audit profession is under-educated regarding insider trading laws.

INTRODUCTION

The stock options frenzy in the 90s resulted in top executives receiving massive grants of stock options, motivating them to boost their companies' stock by beating Wall Street's expectations. Corporate insiders, faced with astronomical incentives, were led to "pick their moment to buy low, sell high and cash in big on company stock" (Sullivan 2002). Unfortunately, this incentive led some to use their insider (non-public) knowledge to their personal advantage in illegally setting and trading stock options and securities. Our goal in this study is to explore the effectiveness of one possible control mechanism over insider trading – internal auditors. Our study addresses three issues related to insider trading and internal auditors: contextual factors that could impact auditors' ethicality judgments of insider trading, independence of internal auditor reporting structure and severity of insider trading penalties that could impair auditors' willingness to pursue such matters, and internal auditors lack of familiarity with insider trading laws and company policies which could impair the auditor's ability to carry out their responsibilities for enforcement.

Insider Trading

Although there are legal forms of trading by insiders, the term "insider trading" generally refers to illegally buying or selling a security while in possession of material, non-public (inside) information about the security (Oliver et al., 2000; SEC, 2006; SEC, 2007). From the charges of Mark Cuban’s alleged insider trading of Mamma.com to the conviction of Martha Stewart’s sales of her ImClone stock, insider trading makes for captivating news headline. Insider trading has also resulted in significant problems for many companies in the last few years. As of October 2006, at least 135 companies were under government investigation or internal review for stock option practices. Misleading statements due to options stocks grants made up approximately 33% of the enforcement case brought by the SEC in 2007 (Scheer, 2007). Insider trading laws reflect a belief that insider trading creates an unfair advantage on the part of a select few and thus violates the ethical norms of the American investing public. More importantly, insider trading is unethical because it severely threatens the fiduciary relationship that underlies the heart of our business organizations (Moore, 1990).

Prior research shows that there is a positive association between insider trading and fraud. For instance, Summers and Sweeney (1998) find that in the presence of fraud, insiders are more likely to engage in insider trading. They also contend that insider trading should be considered as a red flag for fraud. According to the Statement on Auditing Standards No. 99, internal auditors can served as an extremely important oversight function with their knowledge about their corporations (AICPA, 2002). Internal auditors are in a unique position regarding the illegal and unethical acts of those within their organizations. Internal auditors can act as both detection and a deterrence measure against corporate wrongdoing such as insider trading. While they are charged with protecting the organization from possible actions that may harm the organization, given the nature of insider trading, internal auditors may find themselves reporting to the very individuals who are committing these acts. The extent to which internal auditors can be expected to serve as control mechanisms over illegal trading activities in organizations is also impacted by their knowledge of trading laws and policies. Awareness that an act is illegal or unethical is a necessary precursor to the decision to investigate the alleged act. Therefore, if we are to understand the extent to which internal auditors can be expected to serve as control mechanisms over illegal trading activities, we must first understand what internal auditors know about and how they perceive this issue. Because there is significant disagreement regarding the actual harm of trading activities informed by an in-equilibrium of information and there is little evidence regarding the attitudes of internal auditors, the purpose of this project is to explore those factors which will form the foundation of an internal auditor's decision regarding the investigation of trading activities in his or her organization.

BACKGOUND

Thorne et al. (2007) suggests that investors judge insider trading more unethical and illegal, and impose consequences more harshly when based on “favorable” (resulting a gain) rather than “unfavorable” (preventing a loss) earnings news. Investors are also thought to judge insider trading as more unethical and make more harsh consequence-related judgments when the trade involves the purchase or sale of options rather than the purchase or sale of equities because options may be perceived as an attempt to hide the activity or as "tricky." If internal auditors are subject to the same contextual factors to which investors fall prey (Thorne et al., 2007), this could impact their ability and willingness to identify and investigate possible violations of insider trading laws. We employ Thorne et al.'s (2007) research scenario which varies the nature of the trading transaction and of the potential reward resulting from the transaction. We also explore possible punishments, assuming that auditors would be less willing to report acts when they perceive the potential punishments to be too harsh.

Internal auditors’ decisions to investigate may also be influenced by whether their reporting structure includes the individuals involved in the trading activity. Individuals may be less inclined to critically evaluate the decisions made by those in their reporting structure (the chain of command through which an individual reports). They may also be less willing t report questionable activities by those in their reporting structure, or even not understand how to go outside of that structure to report.

Another impediment to the investigation of insider trading is a possible lack of knowledge of the laws and company policies regarding trading activities. Executive stock option accounting is governed by a complex set of rules. Many individuals naturally assume that an activity is legal and ethical unless they specifically know that it is not. Thus, lack of knowledge regarding insider trading laws and corporate policies leads to lack of understanding of an action’s illegality or unethical nature. This could result in a failure to investigate and therefore a failure to identify an illegal activity.

RESEARCH METHODOLOGY

We constructed an electronic research instrument and invited all members of an Institute of Internal Auditors (IIA) chapter, in a large southwestern metroplex, to complete the survey. One hundred internal auditors complied. Most of the participants worked for public companies, subject to SEC regulation. All responses were anonymous and participants worked independently on the instrument. We classified reporting independence by Chief Auditing Executive (CAE) reporting responsibility - those whose CAE reported to a more independent party (such as Board of Directors or Compliance/Legal) were classified as Independent Reports (IR) while those whose CAE reported to less independent party (CFO, VP-Finance, or CEO) were classified as Non-independent Reports (NR). In an effort to identify characteristics that impact ethicality judgments of trading activities, we employed a 2x2 between-subjects case that described a stock trading scenario (Thorne et al. 2007).

After reading the case, participants provided an assessment of the legality of the CFO’s trading action. Overall, those transactions stemming from favorable news (gain) were considered more illegal than those stemming from unfavorable news (prevent a loss). There was no difference in legality judgments based on trading method (stock/options). Participants were also asked to make an ethical assessment of the CFO's trading. The average of the ethicality perceptions was 1.96 on a scale of 1(unethical) to 7(ethical). Those perceptions did not differ

	Average	N	%
Gender			
Male		56	56%
Female		44	44%
Age (min 22, max 65)	40		
Education			
Hours in accounting course work	29		
Hours in finance course work	12		
Associate's degree		1	1
Undergraduate degrees		60	60
Graduate degrees		39	39
Majors in accounting and finance		93	93
Year of Experience			
Professional positions	16.7		
Audit	11.6		
Internal audit	10		
Knowledge			
Number of times reviewed financial statements in the past year	8		
Investment in the stock market			88
Ability to read and to understand financial statements (on a 7-point scale)	5.4		

significantly across the different versions of the case. Descriptive statistics of our participants are presented in Table 1.

Table 1: Descriptive Statistics

Participants provided a series of "agreement" judgments about potential penalties / consequences the CFO could confront for engaging in the trading activity. All means were over the median of 3.5 on a scale of 1(disagree) to 7(agree) - thus participants indicated agreement with possible actions by the Board of Directors, including firing the CFO (6.02) or informing the SEC of the CFO's activities (5.93), and possible actions by the SEC, such as monetary fines (5.82) and jail (4.95).

The only consequence in which internal auditors differed significantly according to the trading method (stock/option) was their perception of whether the CFO should go to jail, with options trading generating greater agreement with a jail sentence. Agreement with two consequences differed according to type of news: auditors were less inclined to inform the SEC or impose a severe fine when the trading involved unfavorable news (preventing a loss) than when the action involved favorable news (gain). Similarly, the average agreement score across all penalties differed according to type of news. There was also an interaction of the two variables for informing the SEC: auditors were significantly less willing to inform the SEC when the trade was of stock in unfavorable situations (avoid a loss). The above analyses indicate that internal auditors felt that trading in the face of unfavorable news (preventing a loss) was not as deserving of severe consequences as trading in the face of favorable news (achieving a gain). When asked if existing investors should have the right to sue the insider trader directly, responses were divided as 49% agreed with this right, 26% disagreed and 25% were unsure. These responses did not differ depending upon the version of the case they were assigned.

Independence of Reporting Structure

We next compared attitudes regarding ethicality and legality of the action, and potential penalties, across independence of reporting structure levels. Those with non-independent reporting structures perceived stock trades to be *slightly more* illegal than option trades and those with independent reporting structures considered stock trades to be *significantly less* illegal than option trades (see Figure 1).

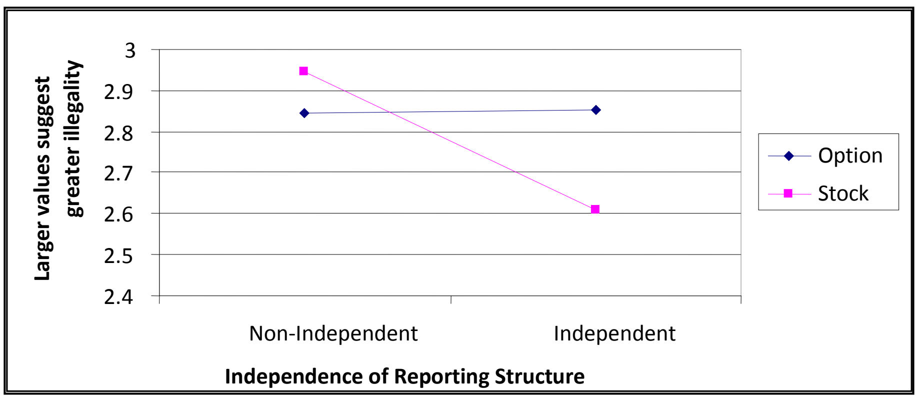

Figure 1: Legality Opinion

In line with the above findings, those with more independent reporting structure were *less* supportive of firing of the CFO than those with non-independent reporting structures. Additionally, those whose CAE reported to a more independent party agreed more strongly with the investors' right of action than did those whose CAE reported to less independent party.

Finally, we analyzed responses to potential penalties for interactions between reporting structure and case characteristics. As Figures 2 depicts, attitudes regarding possible CFO firing did not differ across reporting levels for unfavorable news, but those with non-independent reporting structure agreed much more strongly with the firing when the news was favorable (gain) than did those with independent reporting structures.

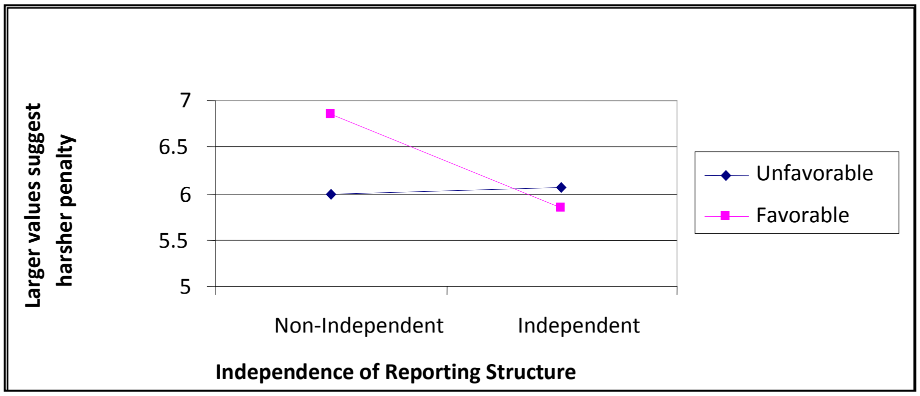

Figure 2: Penalty: Should CFO Be Fired?

As Figure 3 depicts, those with independent reporting structures did not differ on whether to inform the SEC depending on the direction of the news, while those with non-independent reporting structures were more supportive of the penalty when the news was favorable (gain) compared to unfavorable (loss).

These analyses support our contention that reporting structure may impact auditor perceptions. However, contrary to expectations, the attitudes of those with non-independent report structures were more negative toward the behavior and supported stronger penalties.

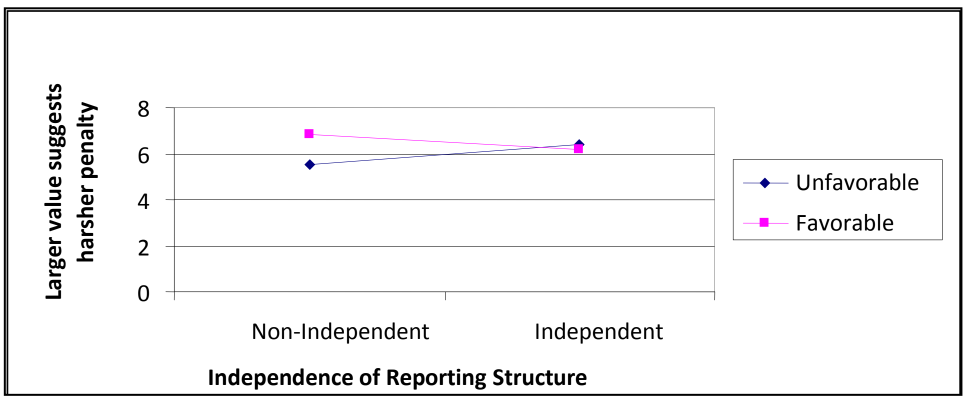

Figure 3: Penalty: Should SEC Be Informed?

Individual Differences Analyses

These legality, ethicality and consequence judgments were analyzed according to demographic characteristics. Ethicality attitudes differed between genders, such that males felt the action was more unethical than females, but legality did not differ by gender. While attitudes toward the four company and SEC originating consequences did not differ by gender, males did agreed with the right of action by third parties more so than females. There was also an interaction of gender with type of news (see Figure 4), with males perceiving trading based on favorable news to be more illegal than trading on unfavorable news, while female judgments did not differ. These results are interesting due to recent research that suggests females tend to view questionable actions as more unethical than males (Stedman et al. 2007).

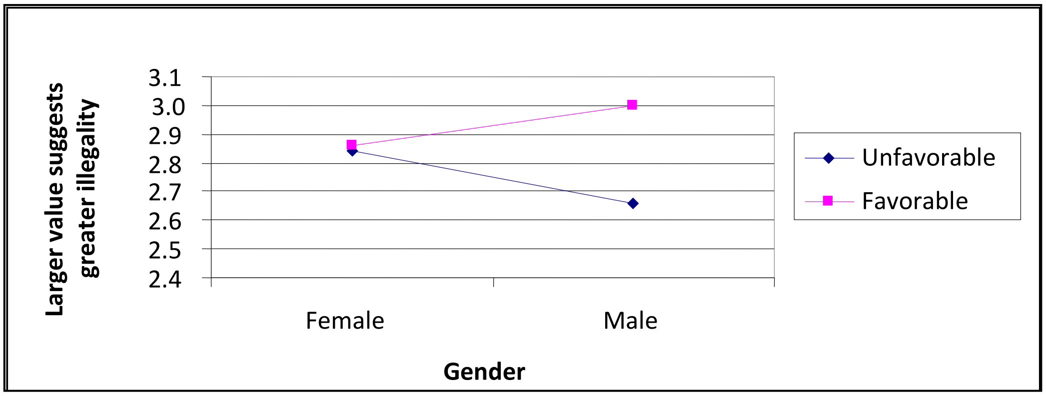

Figure 4: Legality Opinion

These attitudes did not differ based on years of experience, age, or education but specific types of experience did result in some differences of opinion. For example, attitudes regarding company-imposed consequences differed by ability, such that those who classified themselves with greater ability to read and understand financial statements also felt more strongly that the CFO should be fired and that the SEC should be informed. Additionally, those who have personally invested in the stock market in the past felt the actions were more unethical than did those who had not. Finally, the attitudes regarding fining the CFO differed across college majors.

Company Policies

To inquire as to company policies related to employee trading and gauge internal auditor familiarity with their companies' policies, we asked a set of questions related to the internal auditor's organization's employee investment policies. In general, internal auditors have limited knowledge of their company's policies regarding equity trading and confidential financial information disclosures. While it is interesting to see the variety of policies related to this sensitive subject, the most notable factors we can derive from the above discussion is the alarming lack of knowledge regarding company policies by internal auditors. If, as we have asserted, lack of knowledge regarding policies and laws prevents investigation and enforcement of such policies and laws, these results certainly identify a severe void in the ability of internal auditors to serve as effective components of organizational internal control mechanisms for insider trading.

SUMMARY AND CONCLUSIONS

The primary objective of this research was to identify whether and when internal auditors perceive insider trading activities as illegal and unethical, and to gauge their perceptions regarding the appropriate penalties regarding those activities. Thorne et al. (2007) suggest that opinions of the general investing public, related to insider trading, vary according to the type of news that precipitated the trade and the type of trade. Results suggest that internal auditor perceptions of ethicality, legality and harshness of penalties do vary, to some extent, by the nature of the trading activity (stock/options) and the nature of the potential reward to the trader (gain/preventing loss), although their reactions to these factors were less extreme or consistently reactive to the variations in context than those found in the investment community.

There is also some evidence that perceptions vary by the reporting structure in which auditors find themselves. For example, the interaction between independence and type of trade suggests that trading in stock may be perceived differently depending on whether the auditor's reporting structure is independent of the person making the trade. Those with non-independent reporting structures also agreed more strongly that the CFO should be fired, but less strongly with the right to sue by third parties. We also identified two interactions between reporting structure and perceptions of penalties. Those with non-independent reporting structures supported firing the CFO when the trading was based on favorable news (gain) than those with independent structures and then when the trading was based on unfavorable news (loss), while those with independent reporting structures did not differentiate based on news. Similar although less extreme results, were found for the potential penalty of informing the SEC. These results should be interpreted cautiously, however, as they are purely based on correlation, with no evidence of cause and effect. Finally, some limited differences were identified based on individual differences. For example, males differentiated in their legal opinions depending on the type of news motivating the trade.

Questions related to existing company policies shed light on corporate governance activities. Disregarding the “do not know” responses, every potential governance policy overwhelmingly received more “yes” than “no” responses. Thus, it appears that companies are, in general, instituting the types of policies and mechanisms necessary to address insider trading issues. However, the significant number of “do not know” responses suggests a need for education of the internal audit community in order to ensure that internal auditors can serve as effective components of the company-level control framework in regard to insider trading.

In conclusions, while internal auditors did react to some contextual factors of the trade and did demonstrate some variation due to gender or their current reporting structure, their reactions were generally less than those found in the general investing public. This is encouraging, because it suggests that internal auditors may not be as easily swayed in their attitudes by seemingly irrelevant information as others observing the same activity. However, it appears that the internal audit profession is under-educated regarding insider trading laws and organizations' policies. If internal auditors are to serve as effective controls against activities having the potential to significantly damage their organizations, they must accept the challenge of educating themselves and addressing both existing policies and those who violate them.

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