

The New Fraud Standard – SAS No.

The Profession Takes a Bold Step Forward

Presentation by Jeff Close at AAA Ohio Region Annual Meeting

Dublin, OH

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Oh, What a Year....

- Enron - began to unravel October 2001
 - Early 2001 - 7th on the Fortune 100 list
 - December 2001 - Largest U.S. bankruptcy until
- WorldCom
 - Bumped Enron off top of largest bankruptcies
- Adelphia, Tyco, ImClone
- Crash of one of the Big 5 - Andersen
- Destroyed careers, investments, pensions...
- Sarbanes- Oxley
- Public Company Accounting Oversight Board

Doubts About U.S. Financial Reporting System

- Ironically, highlights importance of accounting
- Highlights complexities of GAAP
- Placed focus on what auditors do/don't do
- Turned eyes on others in corporate governance
 - Board of directors
 - Investment analysts and bankers
 - Attorneys
- Emphasized the lack of immunity

Jury Attitudes

Juries React to Corporate Misconduct

- 76% Are angry with corporate America
- 88% Think senior executives are overpaid
- 76% Think the way executives are paid promotes corruption
- 73% Believe auditors do what their clients tell them, even if it is dishonest
- 71% Believe upper level employees are more prone to lie on the witness stand
- 78% Believe many companies destroy documents to avoid getting in trouble
- 85% Think large corporations hide the truth about the dangers of their products

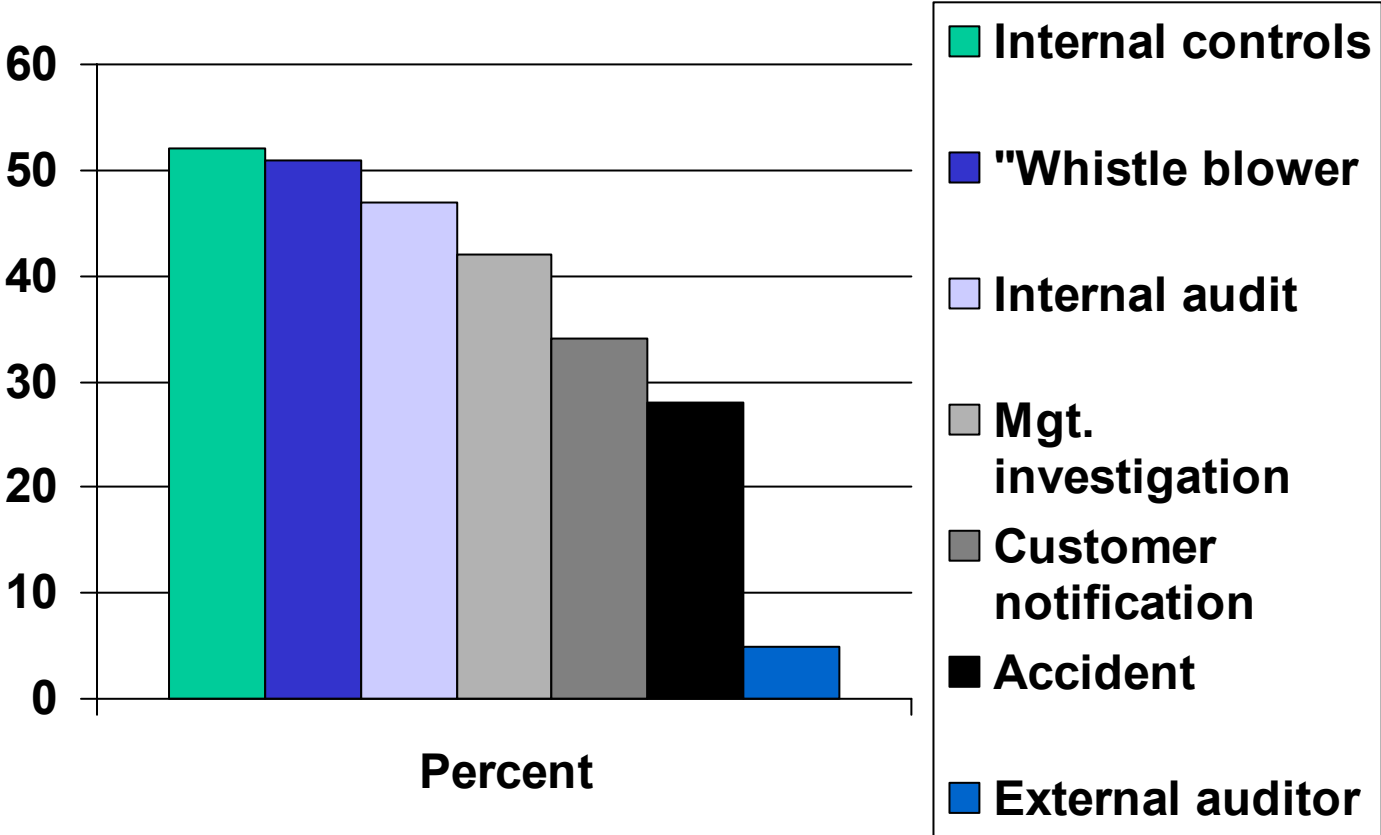
SOURCE: Minority Corporate Counsel Association and DecisionQuest (*New York Law Journal*, October 2002)

Let's Put Things Into Perspective

- A single case of fraud is one too many
- Over 16,000 U.S. public companies
 - file 3 quarterly and 1 annual set of financials
- Research over 11 years (1987-1997) found
 - 300 investigations of fraud by SEC
 - Same period - approximately 700,000 filings of financial statements
- Important to learn from our industry's "plane crash"

Combating Fraud

Know the Facts:



Why is Financial Statement Fraud So Hard to Detect?

- It's intentional
- Concealment is involved
- Directed from senior executive suite
 - huge opportunities for management override
- Often involves collusion
- Business transactions growing in volume, complexity, uniqueness
- Financial statements loaded with judgments

CFO Testifies His Intent Was To “Deceive Everyone”

Pat Finn, CFO, Phar-Mor, Inc.

- “Tried to show the auditors that I was acting in good faith”
- “Relationship based on lies and deceit”
- “Anticipated the auditors’ tests”
- “Instructed my staff to take whatever action was necessary to keep the auditors discovering the fraud”

Changes for Auditors – SAS No. 99

- SAS No. 99 recently issued
- Revised SAS No. 82
- Project long underway before Enron
- ASB committed in 1997 to revisit effectiveness of SAS No. 82
 - Commissioned research in 1999
- POB Panel on Audit Effectiveness Report called for changes - August 2000
- Revision task force 1st met in September 2000

Task Force Members

- Task Force members representing -
 - CPA firms - all sizes
 - forensic expertise
 - academia
 - internal audit
 - technology expert/GAO
 - international representation
 - legal expertise

Plan of Attack

- Review research
- Interviews with various stakeholders
 - Internal auditors
 - Forensic experts
 - Big 5
 - TIC
 - Technology experts
 - General counsels
 - QCIC
 - POB
- Consider current developments

Interviews – “Reasons For Undetected Fraud”

- Highly collusive fraud is outside what even the best auditor can detect
 - “Auditors need to understand that anyone is capable of fraud”
 - “A good fraud will always beat a good audit”
 - “Auditors are no match for a sophisticated CFO”
 - “Reality is you cannot protect against a sophisticated fraud”
- Bias that clients are honest
 - Stricter client acceptance policies may lead to false sense of security
- Failure to properly react to “red flags”
- Poor internal controls present in most frauds
- Didn’t understand the business
- Common characteristics
 - Aggressive, intimidating management style
 - High growth
 - Wall Street Expectations (“Isn’t this the real problem”)

Interviews – “SAS No. 82 Observations”

- No real experience with post-SAS No. 82 frauds
- Auditors do good job assessing risk
 - Need more effective linkage/response to audit testing
- Auditors are frustrated in trying to understand their responsibility
 - “What do I do with these risk factors?”
- Problems are in execution of audits, not a deficiency in the standards
- Biggest legal problem in defending an audit involving fraud is the “**Expectations Gap**”

“Expectations Gap”

From a real jury exercise:

Plaintiffs Leaders:

- *“I don’t know if I would award lots of money or maybe just a slap on the wrist, but there’s no excuse for not catching fraud.”* Female; Age: 35-44; Single
- *“Why hire auditors in the first place, if not to find fraud? What are they there for, if not that?”* Female; Age: 45-54; Married
- *“Auditors should be skeptical. They should assume (management) is lying. They didn’t investigate, scrutinize, take it apart to see what makes it tick as they said would do...they were paid to find fraud.”* Male; Age: 35-44; Married
- *“I think there’s enough negligence and recklessness for everyone to be taking in it.”* Female; Age: 45-54; Divorced

“Expectations Gap”

From a jury exercise:

Defense Leaders:

- *“I don't want to find the auditors negligent. I think they did a reasonable job. And that's all they were hired to do.”*
“It's not the accountants' job to be detectives. No one said come in and look for fraud. They were just there to audit the books.” Female; Age: 55-69; Married
- *“Everyone in business has two sets of books – one for your accountant, one for You show them the good one – you keep the bad one.”* Male; Age: 35-44;

Auditor's Responsibility for Fraud

SAS 82 says an auditor has a responsibility *“to plan and perform the audit to reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.”*

Basic responsibility - unchanged

SAS No. 99 - Overview

- Overview
 - Description of characteristics of fraud
 - 2 types of fraud - Fraudulent Financial Reporting; Misappropriations of
- Starting fraud risk assessment process
 - **Emphasis on importance of professional skepticism**
 - **Brainstorming among engagement team**
- Information gathering
 - Inquiries
 - Analytical Procedures
 - Consideration of Risk Factors
 - Consideration of Other Information
- Identifying risks of fraud
 - **Presumption revenue recognition - high**

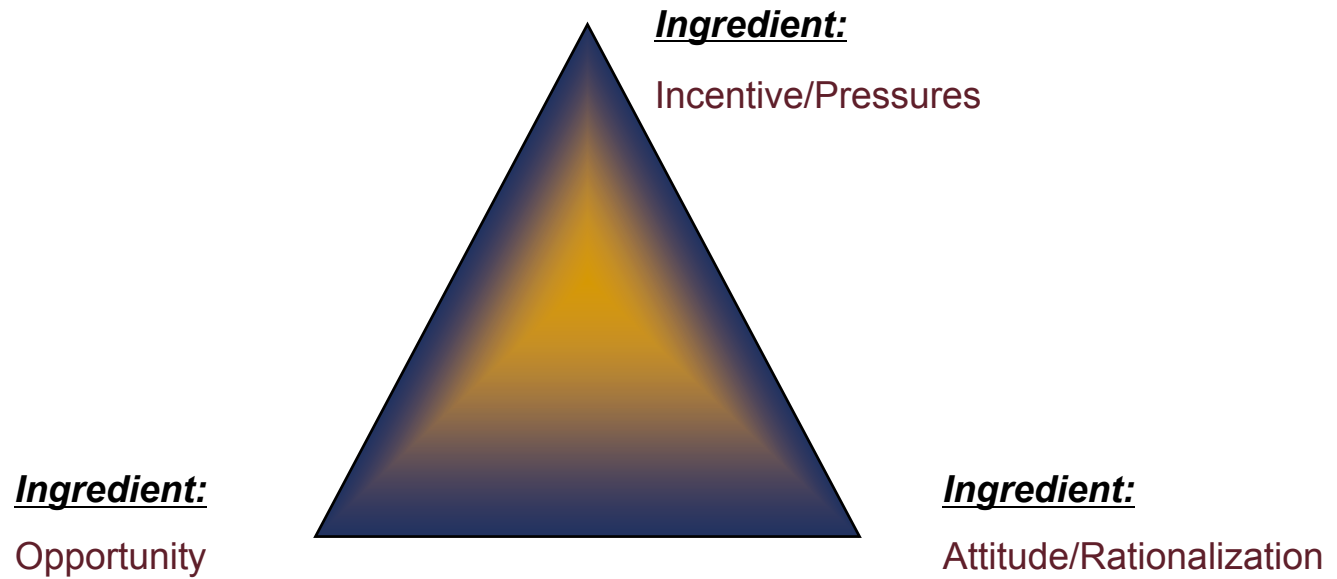
SAS No. 99 - Overview

- Evaluating management's responses
 - **Programs & controls**
- Developing auditor's response
 - Overall audit
 - Changes in nature, timing, and extent of specific tests
 - **Addressing risk of management override**
- Evaluating audit evidence
- Communication requirements
- Documentation requirements

Description of Fraud

- Characteristics of fraud - 2 types
 - Fraudulent financial reporting
 - Misappropriation of assets
- Three conditions present
 - “Fraud Triangle”
- Concealed - collusion or falsified documentation
- Management override of controls always present to some degree

The “Fraud Triangle”



Identifying Risks of Material Due to Fraud

Sources of Information

Communication
Among Audit Team

Inquiries

Risk
Factors

Analytical
Procedures

Other
Info.

Identification Process:

Type

Significance

Likelihood

Pervasiveness

Identified Risks of Material Misstatements Due to Fraud Requiring an Assessment



Auditor Responses to Fraud Risk

- Three types of responses
 - Overall response
 - Responses focused on specific accounts or classes of transactions with expanded examples
 - e.g., revenue recognition; restructurings
 - Responses to address management override

New Mandated Responses

- Address risk of management override
- Required in all audits
- Mandated procedures -
 - Test appropriateness of journal entries & adjustments
 - understanding of financial reporting process
 - Review accounting estimates for biases
 - retrospective review of significant estimates
 - Evaluate rationale for significant, unusual transactions
 - complexities, dependence on accounting
 - Consider predictability of auditing procedures
 - selected procedures in areas without identified fraud risks

Evaluating Audit Evidence

- Ongoing risk assessment throughout audit
 - Discrepancies in evidence
 - Conflicting or missing evidence
 - Problematic or unusual relationships
 - Consider possibility of fraud as reason for differences
- Evaluate results of substantive and final review of audit program
- Ensure appropriate communication from team throughout the audit - re: fraud risk

Communication and Documentation Responsibilities

Communications

- To appropriate level of management
- Involves senior management = report to audit committee
- Control implications = reportable conditions

Documentation

- Discussion among team members
- Procedures performed for information gathering
- Specific risks identified and auditor's response
- Other conditions or responses required
- Nature of communications

Key Points – SAS No. 99

- Inquire of lower level accounting personnel
- Get out of the accounting department
- Corroborate management representations
 - Internal consistency of responses
 - Third party evidence
- Take credit for analytical results
- Consider computer assisted audit techniques, especially for auditing journal entries
- Don't rely on past beliefs about management integrity
- Approach work with skepticism
- Introduce unpredictability into audit tests
- More focus on income statement accounts

Important Auditor Skills

- Communication
 - Interview techniques
 - Documentation of conclusions
- Technology
 - Computer audit assistance techniques
 - Electronic working papers
- Fraud expertise
 - Formally trained specialists
 - Design audit/forensic procedures

Final Observations

“We feel strongly that the standard will substantially change auditor performance thereby improving the likelihood that auditors will detect material misstatements due to fraud.”

“The standard reminds auditors that they must approach every audit with professional skepticism and not assume that management is honest. It puts fraud at the forefront of the auditor’s mind.”

Barry Melancon, AICPA President and CEO