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WHY AUDITORS DON'T FIND FRAUD:
AN EXPERIENCE-BASED ASSESSMENT OF THE
IMPEDIMENTS THAT MILITATE AGAINST
AUDITORS FINDING FRAUD.

NICHOLAS M HODSON

INTRODUCTION

In 20 years of auditing I detected one fraud. I had many colleagues who never encountered a fraud during an entire career in auditing; in fact they would be in the significant majority. In 20 years of investigative and forensic accounting I investigated hundreds of frauds and was aware of thousands more. Was it that all but one of my audit clients was immune to fraud? Were the clients of my colleagues also immune? Or were my colleagues and I just lucky? Evidence on the incidence of fraud in corporate North America makes the likelihood of my clients' immunity remote.¹ This paper examines the impediments that militate against auditors finding fraud, and financial reporting fraud in particular. It considers the changes to auditing standards that place more emphasis on auditors' responsibility to find fraud and the potential impact of those and other recent changes. It looks at the real-world circumstances auditors face and the way the odds are stacked against them in one example, and one hypothetical composite illustration taken from my audit and forensic experience.

¹ In 2002 Ernst & Young LLP in Canada commissioned a telephone survey of employees in North America. Employees were asked: 'Thinking specifically about your place of work and the types of fraud listed above as well as other forms of fraud, I would like you to tell me whether you are *personally* aware of any situations *involving yourself or people you know* where fraud occurred approximately in the last year? Please remember your answer is entirely confidential, and we are only asking about situations you have witnessed personally' (emphasis added). Employees had been pre-sensitised to this question. They had been previously asked about their opinions about the seriousness of different types of fraud in order to raise their focus beyond trivial thefts of stationery. One in five employees responded positively to this question. There are probably no public issuers with fewer than five employees.

Finally it considers some changes to the governance model that would, in the author's view, lead to more effective stewardship regarding the management of the risk of fraud by senior management. As my career for the last 30 years has been in Canada, it is the North American environment from which my experience has largely been drawn.

I AUTHOR'S EXPERIENCE

As this is an experienced-based analysis, some information about my background may be relevant. My career has been in public accounting. Initially, in England, I learned the ropes of auditing. In 1975, after two years in Belgium, I moved to Canada. I continued auditing for a further decade with Ernst & Young in both audit client service and through a five year term in the firm's National Auditing Department, an applied research, development and technical resource group. In 1985 I joined the firm's then incipient investigative and forensic accounting practice. I retired as the head of that practice in 2005. My auditing experience ranged from the granular details of junior level auditing to directing auditing services for Canadian public companies and Securities and Exchange Commission ("SEC") registrants. The search for audit evidence to verify assertions embodied in financial statements including compliance with generally accepted accounting principles was, for me, a technical, analytical pursuit. I found it a disciplined, detailed process, with its share of complexities and stress.

My term in our firm's National Auditing Department caused me to think about what auditors did. I was able to engage in research and technical debate with my colleagues and others, and to hear and respond to a continual flow of technical queries from my client service colleagues. During this time I also remodelled and directed the

firm's audit quality review program. The last 20 years of investigative and forensic accounting presented a different perspective on the obstacles auditors faced.

II THE ESSENTIALS

In my view, auditors have difficulty finding fraud for the following reasons:

Training and experience issues:

- They have inadequate training in the nature of fraud;
- They have inadequate training in investigative methodologies;
- They have insufficient understanding of how hard it is to find fraud;
- They have no experience of searching for and investigating evidence of fraud.

Inertia of history:

- They have the inertia of generations of acknowledgement that their job is to search out and examine evidence to confirm the correctness of the financial statements before them;
- They have the inertia of audit documentation of prior years that may contain no evidence or suspicion of fraud;
- Until recently, auditors have been entitled to presume management's good faith absent evidence to the contrary.

Audit design limitations:

- They have auditing procedures whose focus is designed around the attestation to positive assertions embodied in financial statement components — such procedures are not well-aligned with the search for fraud;

- They plan audits whose scope incorporates a quantitative concept of materiality in the measurement of an entity's operating results, but are required to consider an ill-defined subjectively evaluated notion of materiality in regard to evidence of potential misstatements caused by fraud, that may be less than a quantitatively determined materiality determined for planning purposes.

Service model limitations:

- They have a service model that requires inexperienced junior staff to seek evidence and explanations of complex and possibly fraudulent schemes from senior executives with experience and in positions of authority;
- The service model that places the least experienced audit team members in the front line of contact with the most direct exposure to the client personnel and the evidence also places the most experienced audit team members in the rear, often with the least exposure to the client personnel and evidence;
- They have a service delivery model that invariably provides to clients a roadmap, and frequently a detailed roadmap, of the timing, nature and scope of the audit, and engages client personnel, several of whom may have formerly been auditors, in the identification and presentation for audit of relevant document evidence, the location and provision of audit document evidence and the preparation of summaries and analyses to form part of the auditors working papers;
- They have a service model that requires inexperienced junior audit staff to bring forward, to other less inexperienced audit staff, who in turn are

required to bring forward for review by the partner, matters of consequence that may have arisen through the execution of their work. There may be other routes available for junior staff to reach the partner if they believe their concerns are not receiving attention. While there is nothing that prevents junior staff speaking directly with the partner, except fear of embarrassment for themselves if they are wrong or for their colleagues if they are right, if these matters are not brought forward through the normal review channels they may not be identified in the audit by other means, as they would largely be dependent on the persistence and fortitude of junior staff to take the initiative.

Time and budget constraints:

- They have the imposition of inelastic time constraints that do not contemplate the time requirements for inquiries that may be required to pursue and resolve indicia of fraud;
- They have client filing deadlines that present obstacles to the delay in completion of the audit that the discovery of fraud will probably require;
- They have budgets and procedures planned generally in contemplation of the absence of fraud unless particular fraud risks are identified, in which case auditors are required to expand their procedures; however, given auditors' inexperience in dealing with fraud there is a risk that such planning will be ineffective if in fact fraud risks are identified;
- The pursuit of evidence of fraud can be time-consuming and expensive. Audit fees are not developed in contemplation of the possibility that extensive and expensive procedures to address fraud may be required,

and may therefore need to be charged to the client beyond the budgeted audit fees and there may well be resistance to such additional charges.

Counter incentives:

- They have a performance review and related compensation and career advancement criteria that reward completion of procedures on time and on budget.

Access to senior corporate stewards:

- They have, until recently, had limited practical access to the board and its audit committee.

Most of these characteristics are developed through example, illustration and other analysis in this paper. Regulators and others have perceived a potential conflict of interest in auditors generating revenues from the provision of non-attest services to corporations that they also audit. This has given rise to the proscription of certain services to audit clients, and the requirement that other non-attest services be subject to scrutiny and approval of the audit committee. This issue is absent from the above list as it has not been relevant in my personal experience or in my knowledge of the conduct of colleagues. The personal avoidance by auditors of any relationship such as investing in a client of the auditing firm or holding directorship positions or having business relationships with clients of the auditing firm, that could bring into question the independence of the auditing firm has been at the core of auditing ethics throughout my career. This also is absent from the above list as it has also not been relevant in my personal experience or in my knowledge of the conduct of colleagues.

III DECEPTION

The whole point of fraud is that you are not supposed to find it. This may seem so obvious that is hardly worth stating, but I find it central to this analysis. Fraud is a secret scheme, with purpose and goal. It is not just lying there for someone to stumble over. The plan is to deceive those who may expose the scheme, including the auditors, and to maintain the deception for as long as the fraud continues and for as long thereafter as it may be discoverable. Fraud is not easy to discover or to prove because it is not intended to be easy to discover or to prove. The perpetrators make their fraud as difficult as possible to discover and prove, and actively manage the environment and the personalities who might represent threats. The more experienced and intelligent the perpetrators are the more ingenious and Machiavellian their risk management strategies may be. The deception is achieved by presenting evidence that simulates relevant aspects of legitimate business and conceals evidence that would be indicative of fraud rather than legitimate business. One of my mantras throughout my investigative accounting career has been that there is always evidence of fraud. Fraud can look like reality at higher levels but real business activity is a series of complex multilateral interactions of more or less independent parties, each with their own agendas. It is impossible to simulate this reality at its most granular level. But most audits do not look for this type of evidence. It can be time-consuming and expensive to obtain and corroborate and intrusive as the mere search for it may imply accusation.

There is nothing neutral or random about fraud. It does not occur by accident. It is parasitic. It is a scheme deliberately engineered by one or more parasites for their personal benefit at the expense of the host on whose behalf they are generally engaged. Like all parasites, if they manage their scheme well enough the host will survive. If not the host may die and so may they.

Fraud is not just about numbers and money. It is an egregious crime that injures, through deceit, those who granted their trust and paid for services or invested their funds along with other innocent third parties who just happened to be in the wrong place at the wrong time. It is an aspect of fraud that is painfully apparent to those whose work brings them into close proximity with the victims. Victims swept up in the scheme are often seriously harmed both financially and emotionally. They lose their life savings or their pensions, some with no prospect of recovery. Some live in fear for their personal safety. Sherron Watkins, cast as the Enron whistleblower, expressed concern for her personal safety in her testimony before Congress in February 2002. And auditors, while hardly innocent bystanders, do not escape and are close enough to the financial carnage to be casualties. Arthur Andersen is the ultimate example, but any partner in charge of the audit of a public company in which fraud is disclosed other than by the audit is at risk of living in hell for years and sometimes for the rest of his or her life.

IV THE DECEIVERS

If we begin at what I think is the beginning, *people* commit fraud: it is not the system, the controls, the processes, it is the people. While people at one end of the scale may be lazy, not very bright or prepossessing, at the other end they are extraordinary, do astounding things, put forth incredible effort, show unbelievable fortitude and will. I know people at bottom and the top of the range. Senior corporate managers come, in my experience, exclusively from the top end of the range. Financial reporting fraud is perpetrated generally by smart, driven, experienced, senior members of corporate management. They did not achieve their senior positions of authority and trust by accident. They rose to those positions because of their

recognised abilities to achieve better results than their peers. Access to capital and enhancement of its value is gained by achievement of returns, or milestones on the road to returns, acceptable to the capital markets. Demonstration of attainment of objectives pleasing to the capital markets is a valued measure in promoting and hiring senior executives. A career in the front line of management in the corporate world is a continual competition. Apart from a necessary degree of skill and knowledge, those who push hardest rise above those who take a more passive or balanced attitude towards their career. This tends, in my view, to concentrate similar personalities at the senior levels of public corporations: people who understand that getting results sometimes involves distasteful but necessary decisions; people who accept that successful risk-taking is, in significant measure, what brings them rewards; people who are prepared to override the decisions of others and perhaps, in some cases, to override controls that present obstacles to the realisation of objectives; and people who prevail not only through intellect and industry but through charisma and will. The people who engage in fraudulent financial reporting are drawn from this community.

A *Thoughts on Collusion*

In many types of fraud, the requirement for collusion is typically considered to mitigate the risk of fraud for a number of reasons. The involvement of other people increases the risk of detection. The other people who have to be involved may be rivals and less likely to engage in cooperative activity. Other people who need to be involved may have the moral development to resist.

In financial reporting fraud collusion is virtually a prerequisite. Manipulation of the data underlying the financial statements of almost any but the very smallest

public company is hard, if not impossible, to do single-handedly. The frauds that have been the subject of media headlines in the last few years were all collusive endeavours. If the people surrounding the CEO neutralise the same threats and enjoy premium rewards from attaining a collective corporate target, and if they are bound together through their collective exposure to past adversity, whether legitimate or otherwise, collusion may not be a totally foreign condition. It may be simply be considered a pejorative word for teamwork with an objective that requires some sharp business practice and risk-taking by the team members.

B *Detailed Knowledge of Audit Process*

Many senior corporate finance positions are populated by accountants, many of whom are former auditors, and some who may have previously worked for their company's auditors. They know the audit process, its limitations and its weaknesses. They also know the human frailties of their former colleagues. They routinely work with the auditors in scheduling and planning the audit, in providing assistance in the form of locating and providing documents for auditors to review, and in preparing schedules specifically for audit purposes that in due course form part of the auditors' working papers. This practice does not absolve the auditor from examination of appropriate audit evidence, but it lays out a roadmap for corporate management of the direction the audit will take, its timing, its breadth and depth. This enhances the ability to exploit the limitations of the audit and the frailties of the people who conduct the audits. War strategists would tolerate great sacrifices to acquire this level of knowledge about their enemies.

V THE DECEIVED

Around 90 per cent or more of people who join the Big Four accounting firms in North America do not make their careers there. They are and have been for generations a training ground for accountants who migrate to industry positions. It means that there is a constant and significant turnover of staff. It also means that the average age of an average audit team is probably under 30. In larger public companies the average age of the audit team may tend to be even lower as the ratio of junior to senior staff expands with larger volumes of detailed work. Junior audit staff in Canada are typically in their early to mid 20s with undergraduate commerce degrees. Senior audit staff are typically in their late 20s with a chartered accountant designation. Managers and senior managers would also be chartered accountants in their 30s. Audit partners, of whom there are perhaps one for every 15 or more staff, range from their 30s to their late 50s or perhaps early 60s.

Most senior corporate finance managers from controller through to CFO will have business administration and/or accounting degrees and be the age of the parents of the audit staff or at least the age of their older siblings. They are people in authority and used to wielding it with effect. I have interviewed executives faced with irrefutable evidence of wrongdoing, steadfastly ignoring the evidence and redirecting the interview to areas where they can control the dialogue as they try to win me over to their own version of events and their own rationalisations of their conduct. These are people who have talked their way out of threatening circumstances time and again and are astoundingly talented manipulators of people.

This is not a battle of equals.

VI AUDITOR–CLIENT RELATIONSHIPS

Perhaps surprisingly, my experience is that auditors seldom have a close, or, as some suggest, cosy, relationship with senior management. In my work in the investigation of fraud I routinely dealt with CEOs, CFOs and CLOs (chief legal officers) and the board and committees thereof. As an auditor, in my larger clients I seldom encountered the CEO, hardly ever met corporate general counsel and, perhaps even more surprisingly, in many client relationships, seldom dealt directly with the CFO. Auditors typically have their key relationship with whoever is the primary producer of the financial statements, frequently the controller, perhaps even an assistant controller, or sometimes a more senior finance officer who reports to the CFO. It would be true to say that of the senior management group, the CFO would be the person with whom the auditor would typically have most interaction, but in my experience it was hardly a close relationship. I sometimes felt, even as a partner, that there was a barrier keeping me away from the most senior ranks of corporate management. I believe that experience is not uncommon among auditors.

With the *Sarbanes-Oxley Act of 2002*,² a greater tension has come to exist in the relationship between management and auditors. More interaction occurs between auditors and audit committee, although the relationships among auditors and audit committee and management may still be in gestation as the ripples from *Sarbanes-Oxley* continue to oscillate.

VII SENTENCING

In the 17th century Jonathon Swift offered a fairly sanguine view about fraud.

In *Gulliver's Travels* he noted, in speaking of the Lilliputians:

They look upon fraud as a greater crime than theft, and therefore seldom fail to punish it with death; for they allege, that care and vigilance, with a very common

² Pub L No 107–204, 116 Stat 745 (2002) ('*Sarbanes-Oxley*').

understanding, may preserve a man's goods from thieves, but honesty has no defence against superior cunning.

In the 21st century we have almost caught up with Lilliput. As capital punishment has been abolished in many jurisdictions, the sentence for the most extreme crimes in those jurisdictions is life imprisonment. Bernie Ebbers, former CEO of WorldCom, was effectively sentenced to life imprisonment — at 64 years old a 25 year sentence is effectively a life sentence. Jeffrey Skilling, former CEO of Enron, is serving a 24 year sentence. As I write this, Conrad Black, former Chairman of Hollinger, is facing the greatest challenge of his life in a Chicago courtroom; a trial whose outcome, if unfavourable to him, could result in his incarceration for the rest of his life. As I see it, the spectre of spending close to the rest of your life in jail is the primary guardian of corporate ethics, not auditing, not controls, not oversight by board or regulators. If, as has been argued, it is the intensity of enforcement in the United States that confers the premium on a corporation's stock, perhaps there is economic merit in the severity and intensity of the enforcement actions and their consequent sanctions.³

VIII A REAL EXAMPLE

In my early career I was the recently qualified senior staff accountant with a mid-sized firm in London, in charge of the audit fieldwork of a public company whose business was of no consequence to what will follow. In the client's head office where I was stationed, in Mayfair just around the corner from the Dorchester in London, a clerk, as I would have called him in those days, looked after the payroll and performed a selection of other clerical tasks. My junior colleague and I were conducting the interim audit. One of the things we did back then as part of our interim audit program was to check a couple of periods of the payroll. The payroll for the

³ John Coffee, 'Law and the Market: The Impact of Enforcement' (Paper delivered at the Dynamics of Capital Market Governance Forum, Australian National University, 14 March 2007).

head office was maintained in a handwritten ledger. One section of the payroll was devoted to a small group of people who cleaned the head office premises. At the time we asked for the ledger the clerk said he was in the middle of doing the payroll but said we could have it for an hour or two if he could have it back so he could finish the payroll.

My junior colleague picked up the ledger and went through the routine check of names to the UK government National Insurance cards that everyone held, to see there were no fictitious people on the payroll (an interesting acknowledgement of responsibility for fraud). He checked the clock cards to see that the hours worked corresponded to the hours for which pay was calculated. Among these and several other procedures, he checked the additions and verified the accuracy of the payroll totals which we would check in due course to the posting summary, which was the medium through which the payroll costs were allocated to various functional operations of the head office that were controlled by budgets. As my colleague advised me that he was finished he pointed out to me that the total payable amount for the current week of the cleaning staff payroll was recorded in pencil. This did not seem odd at the time as the clerk had said he was working on the payroll. He had probably added a column of figures and noted the total in pencil until he checked that the cross addition confirmed the accuracy of the ledger page. My colleague asked if he should write over the total in ink, as we were warned in those days against accepting figures in pencil (another interesting acknowledgement of responsibility for fraud). I suggested he make a note of the number, rather than write on the client's records, and he did. He took the ledger back to the clerk and asked if he could have it back on the following day.

Later the next day the clerk brought the ledger to our room together with the posting summary allocating the payroll costs to the various departments and left it with us. He also brought the cheque, which he said he his co-worker would be taking to the bank to have cashed so that he could make up the pay envelopes for the cleaning staff who received their wages in cash each week. My colleague thanked him and said we would like to attend the payout to check that the appropriate people received the appropriate pay envelopes (yet another interesting acknowledgement of responsibility for fraud). My colleague checked the allocation of the payroll and advised me he was finished. I asked him if the posting summary agreed with the payroll and if the additions of the posting summary were also correct. He confirmed that everything seemed to be in order, including the comparison of the cheque amount to the total net pay for the current week.

As I glanced at the ledger and the posting summary to see that we had recorded the appropriate marks on the items we had checked, it was clear that the total previously in pencil was now recorded in ink. I asked my colleague if he had checked to see that the number he had recorded in pencil the previous day was the same as the total now recorded in ink. He had not, but did so right away, and to our surprise the number was different. It was £100 more than the number my colleague had recorded. I suggested he check the addition again. He did and confirmed that the total was overstated by £100. That meant that the clerk would get cash from the bank, pay out the cleaners' wages and have £100 left over. It may seem a small amount today and, while still small then, to give some value context my charge-out rate at the time was £4 an hour. It was also large in comparison to the total of the cleaners' weekly payroll, which was around £400. Notwithstanding these value perspectives it was still immaterial in the context of the company's financial statements. We presumed he had

made a mistake. We nonetheless decided to extend our work and my colleague checked the addition of the net pay for the previous three weeks and each time found the total was overstated by £100. We extended our work to the entire ledger for the cleaner's payroll and found the same pattern throughout the year. There were no problems with the main part of the head office payroll. The head office staff, other than the cleaners, were paid by individual cheques. We spent the remainder of the day and much of the next day considering possible explanations for the anomaly and being unable to support them. In due course I spoke with the Chief Accountant who appeared unconcerned and said I should ask the clerk to explain. He presumed the clerk must have been getting additional cash for a petty cash fund or some other department cash requirement. We had in fact already considered and ruled out these possibilities. The likely explanation was right before me but somehow I did not want to face the obvious conclusion. Today I would probably have taken all of five minutes to reach presumptive conclusions that I would quickly corroborate. It amazes me, in retrospect, how much time we spent looking for reasons for it not to be what it was, and how ready we would have been to rationalise some other explanation if we could have found any evidence that supported such an explanation.

Ultimately, I asked the clerk to our room, making surrealistic small talk as we walked from his desk to the office we were using. I then explained to him exactly what we had found. He seemed puzzled. He did not disagree with or challenge our findings but could offer no explanation. He offered to check all the additions himself saying that there had to be an explanation. I was afraid he was going to get up and take the records and disappear. This was my first interview of a suspect and it was not going well. I had expected he would offer some explanation we had not considered. We would pound our foreheads and say, 'Of course. Why did we not think of that?'

There was a long pause while I was thinking what to do. I swallowed hard and asked him a question that has stood me in good stead in subsequent years. ‘How long has this been going on?’ I did not say what ‘this’ was, and avoided terms that would have meant the clerk having to acknowledge expressly that he did what he did. It generated the dialogue that led to a confession. It transpired that ‘it’ had been going on for around five years. He had indeed been overstating the total payroll by adding £100 to the total. He made up the pay envelopes and put the surplus £100 in his pocket. He duly allocated the total payroll costs, including the extra £100, among several cost centres where the effect of the fraud would be reduced to an amount so far below the radar that no one noticed.

The clerk was found to have a criminal record, having been previously convicted of a similar offence. He had been taken on six years previously from a temporary help agency when the company was short staffed, and when the person who did the payroll became seriously ill, he volunteered to help out as he had done that sort of work before. The lesson I took from the experience was: never be parted from the truth by what you would like to believe. I did not want to believe that the clerk had committed a fraud, I think mostly because I was afraid of accusing someone and did not know how to deal with the stress of interviewing someone who was about to be exposed as a thief. I wanted there to be a legitimate explanation. I wanted it to go away.

After the clerk’s confession, I left him with my colleague and related our findings to the Chief Accountant who took off hurriedly to see the clerk. I asked if he would like to use our room to conduct his interview and I took my colleague for an early lunchtime beer to celebrate, basking in the contemplated gratitude of my client. Perhaps a bonus from my firm would have been in order or at least a commendation

from my partner. I received no accolades. The Chief Accountant, our principal point of contact, was embarrassed that we had found out that he had been asleep at the switch, the partner in charge of the audit was embarrassed that the fraud had been occurring under the noses of him and his staff for the prior five years and apparently received some caustic communication from the Managing Director of the client.

Today no auditor would do what we did. Obviously technology has changed the circumstances, but apart from circumstantial changes, the entire head office payroll would be immaterial and of little relevance in the context of the financial statements. It is ironic to reflect that the fundamental purpose of the work we did, that was unconnected in any direct way to financial statement assertions, was to identify fraud.

IX A HYPOTHETICAL ILLUSTRATION

For people other than those directly involved, auditing is an obscure and even secret process. The vast majority of the population never has any relevant experience of what is involved in planning and executing an audit. In addition to the above actual example (the only fraud I ever discovered as an auditor), perhaps the best way to illustrate the current challenges is to simulate the environment and ask you, the reader, to put yourself in the shoes of a junior auditor. There is risk in doing this as the facts and circumstances are hypothetical, and while I may find them consistent with my experience as an auditor, they are not independently verifiable and consequently should be taken as they are presented, as an illustration intended to open a small window on to the nature of the auditors' world.

You are a second year auditor assigned for the first time to the year-end audit of a small-to-mid-sized public company in the telecommunications equipment and

systems businesses. You are assigned a subsection of Accounts Receivable called Other Receivables and Prepaid Accounts. Other Receivables includes refundable deposits, an insurance claim that had been approved but not received by the year-end, amounts due from two former executives whose recoverability was questioned at the audit planning meeting and several other minor non-trade receivables. Other Receivables were collectively greater than the \$4m materiality judgment set in the audit planning. At the audit planning meeting there had been a discussion about fraud risks. The company was stable, with long-term occupants of the CEO and CFO positions, and while its stock price was up and down, it followed industry movements. It was in the middle of the pack in size in its industry. No one perceived that there were any obvious fraud risk factors that elevated the company's profile. It was in fact a somewhat boring client. There was no comment about Prepaid Accounts or Other Receivables.

During your assigned work you find included in Other Receivables a small investment and a larger related receivable. Other Receivables is not normally the financial statement locations for investments but the carrying value of this particular investment was trivial so it was of no consequence. These connected items were not specifically noted in the planning meeting or documentation. You look at last year's file, and the third quarter review file. There is a note on the schedule relating to the receivable in last year's file that all amounts are guaranteed and a copy of what is noted to be a form of guarantee in Spanish is annexed. There is also a copy of a page of what is noted to be to be from an agreement involving a trust and a foreign electronics business. Again the documents are in Spanish. A note, appended presumably by your predecessor to the working papers, indicates that the investment is trivial so no audit work was done and the loan is fully guaranteed. Last year the

value of the receivable at \$0.2m was immaterial and noted as such on the working paper. This year it has grown to \$3.8m, an amount just under your team's assessment of what would be material to the financial statements. You note from the third quarter file that the growth in the receivable occurred in the last quarter. The person who did this work last year was reassigned to another job and has not returned your calls and is not responding to your instant messenger inquiries. A colleague tells you he had heard the person was leaving the firm. You ask one of the more senior staff for help. She is busy on another section of the audit. She does not understand what you are saying and does not have time to think about it as she has to get her inventory section finished by the end of the week. You call the audit manager back at the office who vaguely recalls the matter from last year and the quarterly reviews and suggests you ask the relevant client finance or accounting person. He reminds you that your personal self-review form is due next week. Apprehensively, fearful of appearing inexperienced and uncertain, which, of course, you are, you ask the Assistant Controller to explain the arrangement. She fires an explanation at you that you still do not really grasp either and says she answered the same question for your predecessor last year and is getting tired of training auditors every year. She suggests you should check your last year's file, as the explanations will be there.

Do you walk away and go back to the audit manager to confess that you do not understand, acknowledging your failure? Do you walk away and try again to figure it out with the clock ticking against you and no more information than you had before? Do you walk away with the growing belief that whoever did the work last year did not understand either and begin engaging in the rationalisation that it must be ok if it passed muster last year? But it was very small last year. Do you stand your ground and ask the Assistant Controller to explain again until you understand? The

last option may require a level of maturity and fortitude that some junior auditing staff may not possess.

You have sufficient maturity and fortitude and decide to persevere with the Assistant Controller. You explain that the guarantees you were given last year only covered the value outstanding at the time and the amounts are larger now. She acknowledges this and undertakes to get you the guarantees for the additional funds advanced. The next morning on your desk in the audit room is a copy of a form of guarantee similar to the one on your file last year, but with a different amount that now corresponds to the current amount outstanding and with a current date. You go to thank the Assistant Controller for the guarantee document and ask if she has a copy of the trust indenture the full agreement for with the foreign electronics company. With some irritation, she finds a copy of a 35 page multi-year research agreement with an overseas business partner through a trust. She is not happy. She gave the same document or part of it to your colleague last year. She says she needs it back. You make a photocopy to incorporate in your working paper files and return it to her. You apologise if it seems tedious, but it would be helpful if she could go through the explanation in simple terms one more time. She sighs ponderously. In essence, your client owns a very small interest in an overseas business venture, the majority of whose shares are held in a trust, because the jurisdiction in which the business is located does not permit foreign control in particular industries such as the one in which your client is engaged. The trustee is a local person and the foreign electronics company to which the agreement refers is the beneficiary of the trust. The company has made an interest-free loan to the trust to fund research into an electronic process that has potential military and commercial applications. The account receivable is the money your client has lent to the trust. The foreign electronics company will repay the

money to the trust under a scheduled repayment program commencing next year, and in return for the interest-free loan the foreign company will grant an exclusive license for your client to use the technology throughout North America. The foreign electronics company has signed guarantees to support the settlement of the loans made to the trust. You ask for the address or email address of the trustee so you can confirm the amount receivable. The Assistant Controller stares hard at you. She says she does not have either. She asks why you would possibly need to confirm anything. You have the guarantees and they were satisfactory last year. She says as far as she knows the trust was set up to get around the local foreign ownership regulations, and the COO has said that any questions should be directed through him. He said the whole thing was very sensitive because of the local foreign ownership situation. That was why the company had arranged the guarantees.

While wondering how to respond to this you ask if you can review the original signed agreement and an official English translation? You also ask if there is a trust indenture. The Assistant Controller tells you she does not have anything more than she has given you. She suggests that either or both documents may be with the Legal Department. You ask the Legal Department. They do not have the documents. The clerk to whom you spoke has never heard of them. You go back to the Assistant Controller who suggests they may be with the COO. He had been involved in setting up the arrangement last year, and it was his assistant who had provided the guarantee documents. The COO is away, and his assistant says she does not have the original or translations of either the research business venture agreement or the trust indenture. She says she speaks Spanish and could help if there was something particular you needed help understanding about the document. At your request she flips through the agreement and describes for you what each section addresses, and you annotate the

agreement with her comments at each section. There seems to be nothing surprising. You ask when the COO will be back, and find he is actually out of the country meeting with the senior executives of the foreign electronics company and will back next week.

You go back a further time to ask the Assistant Controller if you could talk to the R & D people about the arrangement as this seems to be a research project. She becomes quite annoyed and unpleasant. She asks you what you know about electronics research. She asks if you think for a minute that the research eggheads will know the first thing about where the money comes from. She tells you your job is to audit the receivables, not their research projects. You have the guarantees and she has nothing else she can give you. Why, she asks, are you questioning the judgment of your own firm? If the guarantee was acceptable last year it is acceptable this year and as far as she is concerned that is the end of the discussion. You point out that the amount is larger but she has risen and is holding the door for you to leave. Smarting and wondering if you are making a mountain out of a molehill, you return to the audit room where you and your colleagues are housed. When you check the name of the foreign electronics company on your web browser you find that it does exist and appears to be substantial, with operations in several countries in South America. It develops and markets electronic communications devices predominantly for commercial and military applications. You include the link to the company's web site in your file. You have signed guarantees for the outstanding amounts (actually photocopies of the guarantees) and a full copy of the agreement (actually a photocopy of the agreement), with a rough indication of the meaning of each section, which is more than was on the file last year.

You are supposed to have already started on the other section of the work you had been assigned on Prepaid Accounts. After your last performance review you worried about a comment by your manager, who said you have to learn to focus as you were spending too much time on things that did not matter and needed to be more aware of getting your work done within the time budget. It was just hard when you were naturally curious to stay focused sometimes but you really need to get this work done within the allocated time budget. The likelihood is that if you follow the path of last year and rely on the guarantee, the senior staff accountant who will review your work will accept it. He will not understand it any better than you and will be impressed by the guarantee and the full 35 page agreement. If you take this path, the partner and manager will still review the work, and with appropriately diligent review decisions may have to be made about the need to do more work when there may be little or no time left to do it and while the amount in questions is almost material it is just under your threshold.

Do you begin to have misgivings when, on your way home, it occurs to you that if your client had spent money directly on research instead of loaning it to the trust, the expenditures would have been charged against operations rather than appearing as a receivable? What if the entire scheme was fictitious? What if all the documents were forged? How do you know there really is a trust? How do you know there is a legally enforceable agreement with the foreign company? How do you know who actually is the real beneficiary of the trust? How do you know, even if there were a real trust and a real research agreement, that there is not an overriding side agreement that protects the foreign company and provides financial incentives for its participation in parking some research expenditure? What if there was no actual cash transfer made to the trust and instead there was a fourth quarter journal entry

transferring research expenditures to the trust loan account? How do you know that the foreign company has available exportable funds to meet its potential guarantee obligations? If there is substance to the arrangement, how do you know that it is not under the effective control of your client and your client's share of the results of the trust and the foreign business venture should not be consolidated in your client's operations? How do you know that the increase in the loan value was not deliberately set to just below your materiality threshold to give you an escape route? Let us assume these misgivings did not occur to you on the way home because you are young and you have a life and you were not going home but were on your way to a party for one of your friends who was about to be married. And in the morning you are not feeling too well. So you put your problem to one side even though you are not comfortable about the whole thing and start on Prepaid Accounts. You plan to get back to the trust loan account but you run out of time. Maybe the manager is right. Perhaps you are just not cut out to be an accountant. How do your colleagues seem to get their sections done within the budget? It leaves so little time for thinking.

Two weeks later, with the closing meeting with your client management and meetings with the audit committee looming, you are called in to see the partner and the senior manager and asked about the trust and the loan account. They tell you they are not comfortable with your reliance on the guarantee. Your client advanced funds to the trust, and the trust in turn advanced the money to the foreign company to fund the research that would be done in the business venture. The foreign company was borrowing the money from the trust so it had a legal obligation to repay the trust. The guarantee would only be of value if the trust failed to pay over the amount to your client, and as the trust is simply a conduit, why would this be problem? They are all the more suspicious because of the perception that the client had perhaps arranged the

guarantees as a smokescreen to forestall further inquiry. They are clearly worried about the collectibility of the receivable. The partner finally calls the Controller and explains the concern about the value of the loan to the trust. Yes, it is less than materiality but there are other issues on the list of issues for discussion, and while he did not want to hold things up, he would have to get original supporting documents and confirmations. We need to get it resolved before the audit committee meeting. The Controller is really angry. You can hear him yelling down the phone at the partner. He just cannot believe that issues that we have had weeks to address are being raised now at the 11th hour when he has no time to deal with them. He says it is not even material, but the partner says there are other adjustments that he believes the audit manager has discussed with him and this was one that should be easy to fix. The Controller says he needs to speak with the CFO and will call back.

Later in the day, the CFO calls, and acknowledges that the deal was not as well documented as it might be. He attributes that to the COO who had arranged the deal and was a 'big picture person'. It had somehow slipped by him that the receivable had increased so much and, while not agreeing, acknowledges our concern about the recoverability. He had spoken to the COO who had recently returned from a visit to see the foreign electronics business partner. The COO was bullish about the project and was troubled that the auditors were suggesting there was a problem with the receivable. But he wanted the matter resolved. The COO was concerned that they should not risk jeopardising the relationship that had been hard enough to negotiate, by having auditors making his business associates nervous. The CFO announced that fortuitously the company had just concluded the sale, to a used equipment broker, of a job lot of obsolete inventory, which had been completely written off in the fourth quarter. The Controller had been going to propose that the year-end inventory

obsolescence provision be reduced by the value of the proceeds, as it was clearly overstated by at least that amount, but rather than take that whole adjustment into income he is proposing half of it be used as a provision against the trust loan account. The inventory sale proceeds were slightly less than half the trust loan account, thus a provision equivalent to half of the inventory sale proceeds would reduce the exposure well below materiality. He undertook to have a more comprehensive set of documentation put together in the first quarter to support the arrangement, as it was probably going to grow in significance.

The partner proposed that, given the lack of knowledge and uncertainty even within the company, it would be more prudent to apply the whole amount to the provision for the trust account receivable, subject, of course, to satisfying himself about the inventory sale. The CFO said that as far as he knew there was no uncertainty and the COO had a complete understanding of the arrangements, but if it would get the issue off the table for the year-end he would agree to allocate the whole amount to the trust receivable provision on the understanding that it would not be on any list of issues for discussion with the audit committee. He did not want to embarrass the COO. He reconfirmed that he would get chapter-and-verse on all the documents in the first quarter. He said he had all the inventory sale documents for our examination and if we wanted to send someone to his office he would give them the package. The partner sends you off to get the documents. The CFO, who you had not previously met, is engaging. You introduce yourself and shake hands and he asks how long you had been with the firm and hopes his people had been helping you find everything you needed. He gives you a large binder of documents relating to the inventory sale. He is tall with grey hair and a kind face, an impressive executive presence — a cut above the Assistant Controller. He said while you were there that

you should really get the story on the trust loan from the horse's mouth, and leads you to the adjacent office and introduces you to Jose Gonzales, the COO. Jose shakes your hand and waxes long and loud about his belief that the technology developed for military purposes by the foreign electronics firm will revolutionise handheld communication devices. And the exclusive license for North America could be worth billions. It had taken over a year to set up all of the details surrounding the trust and hammer out the research agreement. Placing his hand on your shoulder he smiles and says: 'It's a good job we have smart young auditors like you to keep us out of trouble.'

As this is a hypothetical account I can invent a hypothetical epilogue. In the first quarter of the next year, the COO left to take up another position with another company. There was little fanfare. The money advanced to the trust was never repaid, and the research never produced. The loan was written off over the next three quarters by increases to the provision as the uncertainty grew. The trust and business venture were quietly dissolved. The provision at the year-end eased the impact on the following year's results and as the amounts charged in each year were immaterial, no reference was made to the matter in the annual or quarterly reports.

In fact, the arrangement was a fraud perpetrated by the CEO, the COO and the CFO. There was a foreign electronics company and there was a joint business venture, but it was an empty shell. The beneficiary of the trust was not the foreign electronics company but a lawyer who held the shares in trust for an unnamed party, in fact a holding company owned by the CEO of the foreign electronics company who was the COO's brother-in-law. The business venture, not the foreign electronics company, drew down the funds from the trust, and under a sub-contract agreement paid the entire amount to a research consulting business in a different jurisdiction. The sub-

contractor went into bankruptcy and the research results were never received. The story circulated that the research failed to fulfil expectations and was scrapped. In fact the sub-contractor invested in four other research management businesses, which in turn paid management fees for the full amount received to tax haven-based management companies of independent ‘researchers’, who were in fact the CEO, COO, CFO and the CEO of the foreign electronics company. The researchers’ management companies invested the management fees in rare postage stamps.

The CFO would not want this matter raised at the audit committee. He would have probably expected that the guarantees set up last year and accepted for immaterial amounts would not hold this year. The increase in the provision was a deliberate fourth quarter event so it would not have hit the auditors’ or the board’s radar screens, although there had been careful mention of the venture in passing at the second quarter board meeting so no one could say anything was being concealed from the board. It had been mentioned that there was some expectation of the possibility of it gaining traction by the third or fourth quarter or possibly the first quarter of next year. Timelines were less predictable when dealing with South America. The receivable was purposely limited to a value below the auditors’ materiality threshold so that if the issue did reach the surface it could still be argued on grounds of materiality.

The next position was the one the CFO wanted to achieve — to take a provision of sufficient size that the problem would be mitigated by accounting for it and that would reduce the amount to be written off in the following year. Had the auditors not raised the issue, he would have announced his own concern that the meeting with the foreign electronics company management had not gone as well as

hoped and he believed it would be prudent for them to make a provision against the receivable.

The Assistant Controller knew nothing more than she told you. She had been given instructions by the COO to keep the auditors away from the foreign business associates. The last thing he wanted was to have auditors crawling all over his associates. They were nervous enough about the deal because of the foreign ownership regulations. If the auditors asked questions she was to stall until they ran out of time. And if necessary, he or the CFO would handle the auditors. If you had asked the Controller, as the partner ultimately did, he had instructions to warn the CFO and refer the auditors to him. If the partner were to insist that the original supporting documents be provided, they would be. It would be foolish of the CFO and the rest of the team not to have hand signed authentic documents drawn up by local counsel in Spanish. It would have been possible to produce the local trustee on the phone. It would have been a local relative of the foreign company's CEO. Had the matter had been tabled with the audit committee, the CFO would have explained that this had taken him a little unawares. He would apologise for the state of the initial documentation but would explain that the relevant documents had now been provided to the auditors. He would have recorded his agreement with the auditors on a matter of judgment about the prudence of a provision given the inherent uncertainty of research and the inherent possibility that the expectations for the research might not pan out. He would tell the audit committee that he had proposed a provision that would reduce the exposure to an immaterial amount and the auditors were satisfied. In the final analysis the money was actually still in the trust at the year-end so if a confirmation had been required it could have been produced.

While this is a hypothetical account, it is drawn from practical experience. If the partner were to accept the CFO's proposal, not only will a fraud have escaped detection but the matter would not even be brought to the attention of the audit committee. As tracks had been laid to deal with the problem by providing for the receivable, the audit focus would have been on the prospective recoverability, so when additional provisions were made in succeeding quarters the auditors would have been increasingly content.

The points this hypothetical model is intended to illustrate are:

- how much rests on the work of relatively inexperienced audit staff;
- how much depends on the linkage between the work done in the field and the review conducted by partners and managers;
- how hard it can be to conceive that a fraud might have occurred;
- how easy it can be to rationalise reliance on conclusions drawn in prior periods;
- how difficult it can be when prior years' decisions are held out as precedents to avoid reaching different conclusions or conducting different procedures ;
- how everyday time pressures and performance measures affect execution of audit procedures;
- how even more experienced auditors may tend to think in terms of value solutions rather than a possible fraud;
- how actively senior management can manage auditors to keep frauds from being disclosed;
- how middle management can be used as a foil to delay and deflect the auditor's inquiries;

- how the insertion of layers of management can protect the most senior managers by facilitating plausible deniability;
- how easily an auditor can be misled by senior managers intent on deceit;
- how a fraud can occur without there necessarily being advance warning signs;
- how easily plausible practical difficulties can be presented as reasons to prevent the pursuit of more effective audit procedures;
- how a fraud can be presented as a difference in judgment or an error rather than an intentional deception;
- how hard it can be to prove that a member of senior management committed a fraud;
- how difficult it can be to prove fraud and to prosecute it;
- how the auditor becomes the scapegoat;
- how auditing, like other personal services, is subject to the imperfections of the real world.

Once again, this is a hypothetical model that does not represent any actual case with which I have had involvement.

X THE EVIDENCE OF FRAUD

In this hypothetical case, what evidence would be available to prove that a fraud had occurred? Any business venture such as that contemplated in the illustration would normally involve an appropriate level of due diligence on the part of management. In the case of a business venture to conduct research, there would normally be a research plan, specifications of what research would be done, and who would undertake the research. There would be a business case developed and an

assessment of the feasibility of the technology and the possible markets. There would be review and reporting provisions for the research that would require the presence of an administrative structure. To the extent that the research was relevant to an existing product line there would normally be evidence of that relevance. There would normally be meetings and communications between the parties in arriving at the concept and drafting the agreements. There would normally be evidence that the party undertaking to do the research had the capability to do so and was in fact doing so. As the project was a sham there would be no actual need for any of these things and, while they could conceivably have been fabricated, at some point the simulation of reality becomes unsustainable. The evidence of fraud would be the absence of evidence normally associated with a legitimate research project. While the absence of anything might not in itself be sufficient to prove that a fraud had occurred, it would be sufficient to bring to the audit committee to support the initiation of an inquiry. An investigation, if required, would follow the money and search for evidence of communications in the emails and hard drives of the COO and his assistant in the first instance. In following the money, the layering of funds through shell vehicles in different jurisdictions would not be consistent with this being a legitimate project. It can be particularly difficult to trace funds through overseas jurisdictions, and generally funds can be moved more quickly than they can be traced.

Evidence of the nature described would not be focused on supporting assertions that a receivable:

- exists;
- is owed to the company;
- is complete;
- is appropriately valued; and

- is presented in accordance with generally accepted accounting principles.

Rather it would be focused on supporting the assertion that the receivable is the product of a fraud. It would therefore be predicated on that proposition that a fraud may have taken place. If the risk of fraud is not contemplated it is unlikely that anyone will seek out or recognise relevant evidence. Would it be necessary for an auditor to search for such evidence? If the auditor is to gain reasonable assurance that the financial statements are free from material misstatement because of fraud, the answer must be: well, perhaps. It would be argued that if sufficient provision is made, the financial statements are no longer materially misstated; in fact even if a provision is not made it might still be argued to be immaterial. If senior management stole or schemed to steal from the company an amount just less than the quantitative materiality threshold used for audit testing and planning purposes, and ultimately wrote off that amount over two years, the company's earnings would be understated by the amounts written off and the financial statements would omit disclosure of a claim against the perpetrators or, more likely, the company's insurers, of the fraud for the amount they stole. The fact that the amount at issue may be below the calculated value the auditors may use in their assessments of materiality in either year in which the funds were written off ignores any subjective assessment of materiality in the case of fraud. The Public Company Accounting Oversight Board ('PCAOB') has said: 'Qualitative considerations related to indications of fraud may mean that misstatements of relatively small amounts are material.'⁴ It would be hard to say, after the event, as a subjective value judgment, that a loss of millions of dollars arising

⁴ PCAOB, *Observations on Board's Implementation of PCAOB Standards Relating to Auditors' Responsibilities with Respect to Fraud* (Release No 2007-001, 22 January 2007) 4, available at <http://www.pcaobus.org/News_and_Events/News/2007/01-22.aspx>.

from a fraudulent conspiracy by the three most senior members of management would be considered immaterial.

Of course, in this hypothetical case, no misstatement was identified, which leads to the somewhat circular proposition that, if it could be argued that appropriate auditing standards had been followed (which might be challenging), the auditors could not be responsible for failing to find the fraud as it was less than their materiality threshold, even though it would have caused a misstatement that would probably have been considered material based on subjective criteria, had it been identified as having been caused by fraud. If, however, the circumstances subsequently came to light, the absence of any evidence of a substantive business arrangement might lead to an accusation, perhaps with the benefit of inquisitorial hindsight, that these were circumstances that should have sounded alarm bells and the auditors should have extended their procedures. Had they heard the alarm bells and extended their procedures, perhaps other evidence might have emerged. Perhaps the auditors would have reported the circumstances to the audit committee and the audit committee might have instigated an investigation. The company might say it would have moved right away to recover the money and would probably evaluate with counsel a cause of action against the auditors.

Of course senior management would raise defences. Management would show that the funds were still actually in a lawyer's trust account at the year-end so that the financial statements were not misstated. The CEO and CFO would say they knew nothing of any improprieties and the COO would say he had been deceived by the foreign company but had been so embarrassed by having been duped and had been threatened with dismissal by the CEO that he had been obliged to resign. The foreign company would say that they did not draw down the money from the trust so they

cannot be held responsible, and the trustee would say that a well-dressed business man came and presented impeccable credentials as being the CEO of the business venture and knew all about the arrangements. The trustee honestly believed he was legitimate and released the funds to the business venture bank account. There turned out to be some ambiguity in the agreement about whether the foreign electronics company or the business venture could draw down the funds. There would be exit strategies for all parties because the entire scheme had been planned. Perhaps the auditors would be the only party without an exit strategy.

XI CHANGING AUDITING STANDARDS

Auditors approaching an annual audit of a client's financial statements are now required to consider specifically the risks of fraud and the risk factors that would elevate the likelihood of fraud occurring, and design their audits to respond to identified risk factors. It is instructive to see how the auditing profession is responding to these circumstances and how PCAOB's inspections have found auditors are dealing with these requirements. In November 2006, the Global Public Policy Symposium, comprising the CEOs of the six largest accounting firms, released a paper titled *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks*. The paper states:

there is a significant 'expectations gap' between what various stakeholders believe auditors do or should do in detecting fraud, and what audit networks⁵ are actually *capable* of doing, at the prices that companies or investors are willing to pay for audits.⁶

Additionally, the paper states that: 'What is sorely needed is a constructive dialogue among investors, other company stakeholders, policy makers and our own

⁵ Audit 'networks' is the term used in this document to describe the six largest global auditing organisations.

⁶ (2006) 12 (emphasis in original).

professionals about what should be done to close or at least narrow the “expectations gap” relating to fraud.”⁷ In January of 2007 the PCAOB felt it necessary to issue a 14 page report commenting on over 20 shortcomings it had observed in the way auditors were addressing their responsibilities with respect to fraud. A selection of the comments follows:

- Auditors failed to expand audit procedures when addressing identified fraud risk factors.
- Auditors were unable to demonstrate that the required fraud risk brainstorming sessions were held as part of the audit planning process.
- Key members of the audit team did not attend the brainstorming sessions.
- Auditors failed to respond appropriately to identified fraud risk factors.
- Auditors failed to calculate planning materiality properly and/or the threshold for posting proposed audit adjustments to a summary schedule. As a result, certain uncorrected misstatements were not evaluated, or were not evaluated appropriately, both individually and in the aggregate, with other misstatements because the summary schedule was incomplete.
- Auditors had not addressed the risk of management override of controls appropriately with respect to journal entries and accounting estimates.
- Auditors performed tests of journal entries, but failed to demonstrate that they had appropriately assessed the completeness and integrity of the population of journal entries.

⁷ Ibid.

- No evidence in the audit documentation, and no persuasive other evidence, that an appropriate examination and evaluation of journal entries was performed.
- Auditors excluded journal entries with lower dollar amounts from the examination. Setting the scope in such a manner fails to appropriately address the risk of fraud occurring as a result of the frequent use of low dollar entries.
- Auditors have failed to test, or failed to document their testing of, management's assumptions and other aspects of issuers' accounting estimates.
- In using analytical procedures auditors failed to establish expectations, establish thresholds for identifying significant differences, or investigate differences from the expectations that were greater than the established thresholds. Moreover, some auditors failed to obtain corroboration of management's explanations for differences in excess of the established thresholds.

While this is not necessarily representative of all audits by all auditors, it is also hardly a ringing endorsement. Auditors are saying they do not believe they can meet expectations under the current model and the PCAOB is saying they are falling short on execution of current standards.

XII CONSIDERATION OF CHANGES THAT MIGHT HELP

A *Acknowledging a Problem*

It is a truism that the first step in treating a problem is acknowledging its existence. The events that gave rise to *Sarbanes-Oxley* were collusive subversions of

financial reporting controls by the most senior members of management. While it would be an overstatement to say that the tidal wave of effort in documenting, certifying and attesting to internal controls in response to s 404 of *Sarbanes-Oxley* has been without merit, its focus was directed at almost everything but the most threatening risk. The purchasing agent who takes kickbacks, the clerk who falsifies the payroll records, the project manager who sets up fictitious vendors are all defrauding the corporation and bleeding away the stakeholders' interests. While reprehensible and worthy of attention, these risks are unlikely to bring the corporation to its knees.

The overwhelming risk is that senior management will subvert the financial reporting controls and misrepresent the state of the corporation's affairs and results of operations. It is hard to see how a corporate governance structure can discharge its stewardship responsibilities effectively when the responsibility for internal control over financial reporting remains the domain of the very management whose actions have illustrated the catastrophic consequences of their collusive frauds through subversion of the internal controls over financial reporting. It is also hard to see that auditors can efficiently discharge the responsibility of protecting a corporation's stakeholders from collusive fraud by senior management. The costs required to investigate the evidence in a significant financial reporting fraud case are many multiples of the cost of the annual audits. Detection of fraud at this level is almost not an option. That means it has to be prevented. While auditors can make contributions to mitigate these risks, they are not the only party whose contribution could be improved. Another party with an opportunity to improve its contribution is the board.

B *Spreading the Load*

In 1992, the Committee of Sponsoring Organisations of the Treadway Commission ('COSO') identified the board as one of the parties responsible for giving effect to internal control. It also stated:

Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have knowledge of the entity's activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.⁸

The SEC's 9 April 2003 final rule on *Standards Relating to Listed Company Audit Committees* states, inter alia:

The assistance of outside advisors also may be needed to independently investigate questions that may arise regarding financial reporting and compliance with the securities laws. Accordingly, as proposed, the final rule specifically requires an issuer's audit committee to have the authority to engage outside advisors, including counsel, as it determines necessary to carry out its duties.⁹

As much as auditors have been castigated for their ineffectiveness, the boards of directors of the corporations involved in the financial reporting scandals since the millennium have also been ineffective. While there may be defences, the boards failed in each case to protect their corporation from its management.

For boards to make a more substantive contribution to the effectiveness of governance and oversight of senior management it is, in my view, time to consider the need for professional directors, along with some measure of standardisation of procedure for execution of board responsibilities, greater prescription of the time commitment required and a significantly greater investment in the funding of board activities. Before senior management fraud becomes an audit problem it is a stewardship problem.

⁸ get pp

⁹ Available at <<http://www.sec.gov/rules/final/33-8220.htm>>.

As noted in this chapter and as acknowledged by the PCAOB in its standard AS2, collusive fraud is less likely to be detected by an audit. While auditing standards have become more focused and prescriptive about auditors' responsibility for finding material fraud, I have no confidence that auditors will be able to fulfil expectations today any more than in the last hundred years within acceptable cost tolerances. If, as I would tender, senior management cannot be responsible for establishing and maintaining internal controls over itself, there is only the board that can rationally fill that role. If the audit committee, for example, rather than senior management, took responsibility for the management of the risk of fraudulent financial reporting by senior management and processes were established that were aligned with the risk of management subversion, such a construct would have the potential to be a plausible deterrent that would mitigate the risk for the corporation. Upgrading boards is not something that can happen overnight, but upgrading audits is also not an overnight job. It is interesting to see that a variety of business schools are offering educational programs for directors. The regulatory requirements for financial literacy and expertise on audit committees are also moving in the direction of greater relevant expertise.

C *Controls Aligned with the Risk*

The most threatening risk is that senior management will subvert financial reporting controls and manipulate the financial reports. What controls exist to mitigate the risk of such subversion? Audit committees could file reports on such controls. Auditors could make a supporting contribution by attestation to the controls established by the board to mitigate the risk that senior management could manipulate the financial reporting process. There is a traditional line, whose brightness has faded

in recent years, between governance and management. If there is no other steward but the board who can fulfil the role of guardian against ethical misfeasance by senior management, then the development of controls to mitigate the risk of collusive subversion of financial reporting by senior management must become part of the governance model. If arguments were to be made that such activity would be tantamount to the board engaging in management, then perhaps the boundary is a sacred cow that needs to be put out of its misery. Would the Enron pensioners have cared about the division of governance and management responsibilities as between the board and management of the corporation if the consequence had been to save their pensions?

D *Weakening the Defences*

People do not commit fraud with the expectation of getting caught. Getting caught is not the same as evidence of fraud being discovered. Getting caught is being proved to be the perpetrator or one of the perpetrators. To the extent that popular defences can be made unavailable the chances of getting caught increase. The audit committee is, in my view, the logical agency to have this responsibility.

E *Plausible Deniability*

Plausible deniability — ‘It wasn’t me, I knew nothing about it. I was misled by my subordinates’ — is a defence probably as old as fraud itself. In the mid-1970s the US Church Committee (named for its Chair, Senator Frank Church) conducted an investigation of the US intelligence agencies. It noted:

The Committee finds that the system of Executive command and control was so inherently ambiguous that it is difficult to be certain at what level assassination activity was known and authorized. This creates the disturbing prospect that assassination activity might have been undertaken by officials of the United

States Government without its having been incontrovertibly clear that there was explicit authorization from the President of the United States.¹⁰

It would be relevant, in my view, for the audit committee to understand the mechanics, style and protocols of communication and responsibilities within the chain of command of management of the organisation. Senior officers who neither send or receive emails, who give direction by telephone without written confirmation, or via assistants, to their subordinates and peers, who have incoming communications filtered through assistants, who use vague and euphemistic language, are offering themselves plausible deniability defences. The Church Committee also reported that: “Plausible denial” increases the risk of misunderstanding. Subordinate officials should describe their proposals in clear, precise, and brutally frank language; superiors are entitled to, and should demand, no less’.¹¹ In the same vein, a board should reasonably expect its senior management to have and follow a policy of clarity in communications. As the audit committee is authorised to retain advisors this may be an area where advice might be valuable.

CONCLUSION

I do not believe, based on 20 years experience in each case as auditor and investigative and forensic accountant, that auditors can be reasonably assured that financial statements are not materially misstated due to fraud, without revolutionary changes to the audit model whose cost and intrusiveness may be hard for corporations to accept. Alternatives under current debate contemplate the incorporation of forensic audits into the routine of annual financial audits. Further definition of what a forensic

¹⁰ Church Committee II, section B, 11; Church Committee IV, *Findings and Conclusions*, section C subsection 1, 261.

¹¹ Church Committee IV, section C subsection 5, 277.

audit would entail how often it might be conducted, and other relevant information would be relevant in assessing the efficacy of such proposals.

It is encouraging to see the CEOs of the leading auditing firms calling in unison for global standardisation of accounting, financial reporting and auditing. And perhaps the call for dialogue will indeed engage the other players, including the financial intermediaries. If the capital markets are to restore and maintain level of confidence and trust, all the parties within the governance framework have to be at the table. Auditing appears to be in the throes of a difficult metamorphosis and, under whatever model it emerges, the transition will not be easy.