Fraud Risks for 2009 Engagements

Published by Ohio Society
Reprinted/Forthcoming….
Maine Society
South Dakota Society
Washington Society
Arizona Society
Massachusetts Society
Montana Society
Oklahoma Society

Gary D. Zeune, CPA

Much has been written about auditing in compliance with the Risk Assessment Standards – most of it focusing on financial statements. But there's a fundamental flaw in focusing almost exclusively on the statements. Think of business as a ball game. The financial statements are like the scoreboard, they tell you who won and lost the game, but the statements don't tell you how the game was played. How the game is played is reflected in financial statements. So, failure to understand how the game is played results in clean opinions on materially misstated financial statements.

In response, the Auditing Standards Board adopted the Risk Assessment Standards[1], which require the auditor to understand the entity and the environment. There are two requirements to issue an opinion. First, the numbers have to be 'right,', i.e., not materially misstated in GAAP-speak. Second, the auditor must be qualified to issue the opinion. Many CPAs, however, disqualify themselves from issuing an opinion by failing to understand the entity and its environment, as required by the Risk Assessment Standards.[2]

SAS 109, paragraph 24, requires the auditor to obtain an understanding of relevant industry, regulatory and other external factors, including industry conditions, competitive environment, supplier and customer relationships, technological developments, regulatory, legal and political issues, and general economic conditions. Note that all of these risks are outside the financial statements.

Further, paragraph 15 of new SAS 115 (effective for 2009 audits) states that **ANY** fraud by senior management is a material weakness. Why? Management can't run personal expenses through his or her entity without willfully and deliberately violating internal controls. Fraud is material because of the nature of the item, not the amount. So, putting all those little, immaterial amounts on your passed adjustments list is not only a violation of an auditing standard, but it is also aiding and abetting tax fraud. How are you independent if you facilitate a client's tax fraud?[3]

Because of economic turmoil, 2009 engagements will be extremely dangerous for the profession. Nearly every entity has been affected – only a few favorably. Examples include Wal-Mart and pawn shops. But the vast majority are negatively affected, including public companies, private companies, government entities and nonprofits. CPAs may be exposed to malpractice for failing to recognize risks that are different than pre-recession engagements.

Legal risks for 2009 engagements

Although you probably don't have clients with any of the legal risks

©Gary D. Zeune, CPA, 2009. *Zeune is a nationally recognized speaker and writer on auditing and fraud. He's the founder of The Pros & The Cons, the nation's only speakers' bureau for white-collar criminals. He can be reached at www.TheProsAndTheCons.com, gzfraud@gmail.com or 614.761.8911.*

discussed, the point is to instill a questioning attitude and skeptical mindset to conduct every audit every year.

Payday Lenders
In 2008, Ohio voters were asked to limit the interest rate of ‘payday’ lenders to 28%. News reports quoted these business owners saying such a rate would put them out of business. Now pretend you audit an Ohio payday lender. How can you not give a going concern opinion when your client says the new law will bankrupt it?

Illegal Acts
In April 2009, the Obama administration reversed the Bush Adminstration’s stance on illegal aliens. Homeland Security Secretary Janet Napolitano has directed ICE (Immigration and Customs Enforcement) to focus on “the criminal prosecutions of employers who knowingly hire illegal workers….to target the root cause of illegal immigration.”[4] So any client that uses illegal aliens is an audit risk. Why? Because you can’t give a clean opinion on financial statements where the revenue is generated by the client breaking the law. Think construction, cleaning companies, landscaping and food service. This is NOT theory. Here are a couple of examples.

Sholom Rubashkin, former manager of the Agriprocessors plant in Postville, Iowa, is facing 91 criminal counts, including bank fraud, wire fraud, mail fraud, money laundering, making false statements to a bank and willful violations of an order by the Secretary of Agriculture.

In May 2008 federal immigration officers raided the plant and arrested nearly 400 undocumented workers. The Assistant U.S. Attorney [proper nouns, not adjectives……..gdz] said that Rubashkin "repeatedly lied" to his lender about his company's financial health and "reassured the bank that Agriprocessors was in full compliance with the law."

The company filed Chapter 11 bankruptcy protection in November 2008, leaving the U.S. with a temporary shortage of kosher meat. His trial on bank and other fraud charges started in October. Mr. Rubashkin is then expected to be tried on an additional 72 charges involving his alleged hiring of illegal immigrants.[5]

There is also the case of a controller going to prison over illegal workers. The top three executives of Rosenbaum-Cunningham International (RCI) are in prison for operating a nationwide janitorial service that was staffed almost exclusively with illegal aliens. President Richard M. Rosenbaum got 10 years, VP Edward Scott Cunningham 51 months, and Controller Christina A. Flocken 30 months. Plus, each has an approximately $16 million restitution order. So pay attention. If a client has revenue, are the employees that earn it legal?[6]

An example closer to home is Columbus developer Larry Brunsorek, president and founding partner of Anchor Management Group. Brunsorek pleaded guilty to hiring undocumented workers for his many properties to do renovations, construction, landscaping and maintenance. He could be sentenced to five years because the company was operating illegally.[7]

Sholom Rubashkin
[Note picture is not in Ohio Society article.]

In the largest crackdown ever, the federal government announced in late November it will audit 1,000 U.S. employers for immigration violations. The entities weren’t named but every one is associated with critical infrastructure, including utilities, transportation or communications. “The Obama administration is getting very serious about punishing employers,” says Tom Roach, who represents employers.[8]

Illegal acts aren’t limited to undocumented workers. Cincinnati-based Pfizer recently paid $430 million and has agreed to $2.3 billion fines for illegal off-label marketing of drugs. Watch the story at www.TheProsAndTheCons.com/videos/fraud by scrolling to Pfizer Whistle Blower.

All of these are “Other illegal acts” under SAS 54, *Illegal Acts by Clients*. Other illegal acts are generally operational. Remember, just because the money is in the company’s checking account does NOT mean it was obtained legally.

Economic audit risks

KPMG recently reported that 1/3 of surveyed executives expect irregularities to increase this year. "Statistically, any time you have a recession or some type of tremendous decline in an economy, you're going to see financial pressures on companies," said Bruce Dorris, program director at the Association of Certified Fraud Examiners. Corporate employees can sometimes be motivated to be overly aggressive with accounting or commit outright fraud to meet financial targets, particularly in difficult economic times.[9]

If the risk is this significant at public companies, what are the odds small organizations are exempt? What procedures do you have in your audit program to address the two major economic risks for 2009: The credit crunch and the auto industry.

Credit crunch risk

It's common knowledge that banks are tightening the screws on credit availability. A lot of entities are running out of options. Many will be unable to borrow to fund their needs. Even if 2009 numbers are okay, inability to borrow is a going concern issue. And, because economic risks are universal, every audit program better have a requirement to assess credit availability risk.

Auto industry

Something like one out of every eight jobs is tied directly or indirectly to the auto industry. When the manufacturers, like GM and Chrysler, close thousands of dealerships, tens of thousands of little businesses are adversely affected. How does that play into audit planning? Suppose that you have a cleaning company client (hopefully not using illegal workers). Can you tell me what percentage of the revenue that is auto dependent? If not, how do you maintain you understand the entity and its environment?

Shipping company DHL

The U.S. facility in Wilmington, Ohio recently closed. With a population of 8,000 and 3,000 of them out of work, every business in Wilmington is an audit risk, plus area non-profits and government entities.

Technological audit risks

The Internet is a disruptive technology. More than 120 newspapers have gone under since the beginning of 2008. Newspapers are NOT in the newspaper business. They're in the news business delivered on paper. Now that readers can get their news almost immediately, and free for the most part, printed news and paper companies are going bankrupt, and thousands of small vendors are at risk.

What's the most profitable part of the paper per square inch? Classifieds. Noticed how many fewer pages of ads there are now compared to five years ago. Why? Visit craigslist.com. This free Web site is killing the most profitable part of the industry.

Regulatory risks

Due to revenue shortfalls, states are cranking up unclaimed property audits. Some states are going back 20 years. To facilitate recovery, states are hiring private firms to conduct audits. Every audit should address five questions:

1. Are the clients' systems adequate to even know what the number is?
2. If the client included the unclaimed funds in revenue, is a restatement required?
3. If so, does the restatement violate any legal covenants, such as bank loans?
4. Does the client have the funds to fork over to the state?
5. If not, does the client have access to funding?

GAAS is not the 'gold standard'

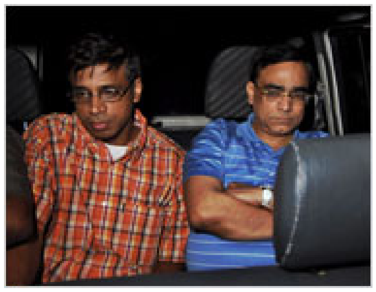
"The vast majority of serious cases brought against accounting firms allege failures to comply with generally accepted auditing standards,"[10] writes Daniel Goldwasser, a malpractice defense partner at Vedder Price LL and a former member of the Auditing Standards Board. Goldwasser further said that the "vast majority" means 90% of all suits where the claim is greater than $10 million.

If an auditor misses a material fraud and can show he or she put all the check marks in the right boxes on the check list, is the jury legally required to find the CPA not liable? No. Why not? Because GAAP and GAAS are not the law. So a CPA can't say, "But I did what the law requires."

Further, malpractice defense attorney John Eickemeyer says, "GAAS is 'standard of care'…but a majority of courts…have said jurors are free to consider other factors in determining what a reasonable auditor would have done under the circumstances."[11] Of course, by this time the jury has 20/20 hindsight how the audit failed, making the firm's defense problematic.

Auditing standards are the CPA profession's version of best practices. Just like health care organizations that violate their professions' best practices, failure to comply with auditing standards exposes a firm to liability. It is estimated that 98,000 deaths could be prevented if hospitals followed proper protocol.[12] CPAs are no different. When auditors miss a material fraud the usual defense is "But we followed the rules." Rules won't protect you when you violate common sense. For example, we take it as common sense to observe material inventory. But auditors started observing inventory in the late 1930s only after the McKesson & Robbins fraud.

For example, Satyam Computer Systems is being termed "India's Enron." In January 2009, Ohio University MBA and Satyam CEO, B. Ramalinga Raju, notified the board of directors that he'd been cooking the books for several years. Ironically, Satyam means 'truth' in Sanskrit. Raju's letter said more than $1 billion of cash on the balance sheet was fake, along with 13,000 of 53,000 employees.[13] Reports now put the fraud at more than $2.5 billion.[14]



Mahesh Kumar A./Associated Press
Managers from Price Waterhouse India, Srinivas Talluri, left, and S. Gopalakrishnan, being taken to a prison after having been detained in connection with the accounting at Satyam. [Note picture is not in Ohio Society article.]

Satyam's auditor, Price Waterhouse (PW), the Indian affiliate of PricewaterhouseCoopers, audited Satyam's financial statements from mid-2000 to late 2008. The firm said it was unaware of Satyam's inflated financial figures until Raju revealed them. Although Satyam's former Chief Financial Officer S. Vadlamani said auditors weren't complicit in the fraud, the PW managers have been arrested.

In their defense, the PW auditors told the Chartered Accountants of India that they had performed their duties in compliance with auditing standards. But that raises a perplexing question. If the auditors did in fact comply with auditing standards, and yet missed a fake $1 billion bank account, then what's wrong with the standards? If true, how long will it be before standards setters are sued for promulgating and maintaining defective auditing standards?[15]

So if GAAS isn't the gold standard, what is? Twelve ordinary citizens decide if you did your job. Will your actions stand up to their scrutiny?

---

1 Collectively Statements on Auditing Standards No. 104-111.
2 Are clean opinions materially misstated? Warning! Reading this article will be painful. ON BALANCE, Wisconsin Institution of CPAs, March/April 2009, Gary Zeune, CPA
3 Are Immaterial Amounts Ever Material?, Gary Zeune, CPA, Published by the Ohio, Oregon, Georgia, Idaho and Wisconsin Societies of CPAs, AuditNet.com, and Association of Government Auditors
4 "ICE immigration crackdown to go after employers—not undocumented workers", *Business Management Daily*, October 14, 2009.
5 "Federal Trial Starts for Ex-Manager of Kosher Plant", *The Wall Street Journal*, October 15, 2009.
6 "Leaders of multi-million dollar immigration and tax scam sentenced to hard time", The SOP, March 6th, 2008.
7 "Developer hired illegal workers", *The Columbus Dispatch*, Friday, November 6, 2009.
8 More Employers Face Immigration Audits, *The Wall Street Journal*, November 20, 2009.
9 "Accounting irregularities may be on the rise in U.S.", Reuters.com, Oct 29, 2009.
10 *Accountants' Liability*, Daniel Goldwasser, Practicing Law Institute, p. 2-18. Goldwasser is a malpractice defense partner at Vedder Price LLC and a former member of the Auditing Standards Board that adopted the Risk Assessment Standards.
11 Accountants' Liability in the Madoff Scheme, *The CPA Journal*, August 2009, p. 25.
12 Patient Safety in American Hospitals, Health Grades 2004.
13 In India, Clues Unfold to a Fraud's Framework, *New York Times*, January 26, 2009 and More Staff Arrested at Satyam. *The Wall Street Journal*, April 7, 2009.
14 Satyam: Media Reports on Fraud Don't Reflect Financial Position, *The Wall Street Journal*, December 2, 2009.
15 Watch video of the Satyam audit failure at www.TheProsAndTheCons.com/videos/Fraud, scroll to Satyam.