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AUDITORS AND AIRPORT SCREENERS HAVE SIMILAR BLIND SPOTS

But Terrorists Don't Pay the Screeners

By Gary D. Zeune

Even though the items and information are right in front of them, airport screeners miss banned items, according to a December 30, 2005, article in The Wall Street Journal. Auditors miss fraud for the same reasons screeners miss weapons. To test terrorism readiness, British authorities digitally inserted images of guns, knives and other banned objects into luggage. Initially the screeners' performance was mediocre. But with practice it improved dramatically.

Then the images were changed, and the screeners' performance dropped to no better than when the program started. There are several reasons why.

We "see" what we expect to see. We don't see the bottle of beer on the shelf in our fridge because we're hunting for a can of beer. For accountants, this means that if they haven't received significant training in what the "red flags"of fraud look like, they aren't likely to detect fraudulent financial statements.

"Most auditors look for what they expect to see. After looking at the numbers, they look for support for those numbers, or look for what they are told is there. A good auditor, with an instinct, just looks for the facts. He listens to what he is told, but looks under the rock to find what is there," says Ralph Dickson, a certified financial examiner in Columbus, Ohio.

"Distractions" or "noise" render some things invisible. The more items in the luggage, the more likely the screeners failed to detect the weapon. The ability to pick out a single item declines when it's part of a complex scene, loaded with similar items.

Likewise, auditors look at hundreds or even thousands of transactions, journal entries, and events. So finding a few fraudulent items is difficult at best.

Cognitive scientist J. David Smith at State University of New York, Buffalo, used origami-like items to test recognition. The 88 participants eventually spotted up to 76 percent of the targets. Then Smith slightly changed the target and performance fell off a cliff.

Just as screeners have trouble applying their knowledge to new situations, might auditors fail to recognize fraud or a misstatement because they haven't previously seen it, or been trained to look for it?

Auditors are creatures of habit. They do the same thing over and over. A good set of audit work papers looks just like the prior year's papers. Knowing this, the client realizes if the fraudulent information can be made to look like what the auditor is used to seeing, the auditor will likely accept the information as true. So the client makes everything look "normal."

"Auditors are taught to identify things that look unusual – ratios, account relationships, trends, variations," says Patrick Turner, former Arthur Andersen partner and now senior lecturer in accounting at Ohio State University. "Sophisticated financial statement fraudsters also know what things would draw the attention of the auditor, and hence conceal their frauds by manipulating data in a way that such relationships don't pop up. They can reconfigure the data to conform to an auditor's expectation. It takes extensive training and a thorough understanding of the business to create an appropriate framework for expectations, and to always remain skeptical even when things do conform with your expectations."

David Dennis, Otterbein College, Westerville, Ohio, says: "For years I have been telling accounting students, and anyone else that will listen, that the most difficult error or fraud-related characteristic is an error, intentional or otherwise, of omission. Even for people who are well trained and fairly experienced, this can be a tough one."

Auditors have a strong disincentive to find fraud. Why? Because the client will likely fire the accountant.

In other words, auditors are really good at auditing what's there, but terrible at recognizing what's not there but should be. They don't recognize something is missing. The oversight is compounded because most auditors let clients prepare audit work papers.

How can you tell? The schedules are marked, "PBC" (Prepared By Client), usually in the upper right corner of the first page of the schedule.

YOU'RE FIRED

Auditors have a strong disincentive to find fraud. Why? Because the client will likely fire the accountant.

"The types of frauds I see are management frauds, and I don't believe that auditors fail to see the frauds. I think, more often than not, they don't want to lose the client," says Colorado attorney Gordon Yale. "Often the issues are clearly documented in work papers, but the auditor comes to the wrong conclusion, chooses the wrong accounting, or simply issues the improper report."

Historically, audits have been viewed as a loss leader to get more lucrative work such as consulting. So the auditors are under tremendous pressure to come in under budget and keep the client happy. As a result, some auditors engage in "false sign-off." False sign-off occurs when auditors don't do the work, but sign off that they did it.

Finally, as a result of the corporate scandals, Congress enacted Sarbanes-Oxley, and the American Institute of CPAs adopted "Statement on Auditing Standards Number 99."

SAS 99 says that the auditor "has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

Thus, auditors have a positive affirmative duty to detect fraud. Given that auditors have a strong reason not to detect fraud, the question is whether auditors will detect methods of cooking the books if they haven't been trained on those methods. Of course, there are many ways to cook the books, but is there any amount of training that will allow auditors to fulfill their obligation under SAS 99?

Auditors are really good at auditing what's there, but terrible at what's not there but should be.

In the final analysis the question is, how do auditors train their brains to generalize their detection skills to recognize fraud indicators that they haven't been trained on? So far, I'm not aware of anyone who has figured out how to do that.

SOLUTIONS ARE PAINFUL

There are several things that auditors can do to minimize the problem. First, there's more to hiring and retaining accounting staff than just debits and credits. Just as some people are better at math or music or art, some people are better at seeing patterns than others, including fraud patterns. So accounting firms could screen employees for their detection ability.

Accounting firms now do a significant amount of training on ethics, which is a good thing. But few firms have any processes to hire ethical employees. Accountants aren't ethical just because they're accountants. And no amount of ethics training will overcome an unethical employee.

It's nearly impossible to be truly independent if you have a vested interest in the outcome. So all the rules and regulations and lawsuits will not solve the fundamental systemic problem, which is auditors getting paid by the client.

There are a number of possible solutions. One is to form a "Federal Department of Auditing." Another would be to have financial statement insurance, and have auditors work for the insurer. Another is for banks to finance audits of their loan clients.

With Sarbanes-Oxley and SAS 99 legislatures, regulators and the public may think they have solved the problem, but corporate scandals are cyclical based on what's happening in the economy. Every time there's a booming economy those in oversight positions, like auditors, let their guard down. It will happen again. Guaranteed.

Gary D. Zeune, CPA, is a nationally recognized speaker and writer on fraud. He is the founder of The Pros & The Cons, the only speakers bureau in the United States for white-collar criminals. He teaches fraud classes for the FBI, bar and health care associations, more than 30 state and national CPA societies, and numerous banks and accounting firms.