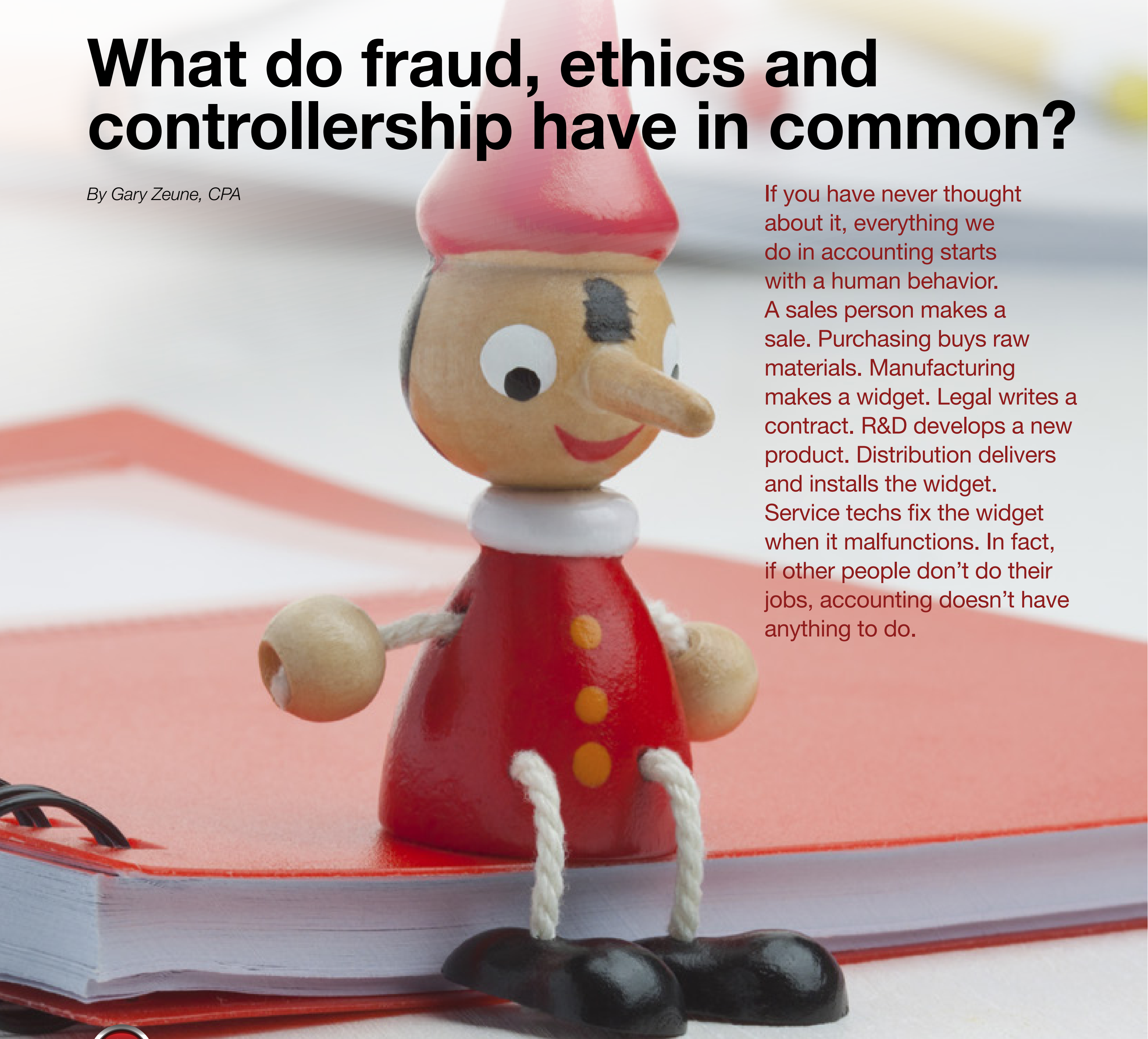
What do fraud, ethics and controllership have in common?

By Gary Zeune, CPA



If you have never thought about it, everything we do in accounting starts with a human behavior. A sales person makes a sale. Purchasing buys raw materials. Manufacturing makes a widget. Legal writes a contract. R&D develops a new product. Distribution delivers and installs the widget. Service techs fix the widget when it malfunctions. In fact, if other people don't do their jobs, accounting doesn't have anything to do.

TAKEAWAYS

- Predictability is one of an accountant's greatest weaknesses; if fraudsters know where you're going to look, they'll commit their fraud someplace else.
- Hire people you trust, but never let your guard down.
- It never "costs too much" to implement effective internal controls.
- Make sure your policies don't create incentives for your employees or others that aren't aligned with your company's ideals (or perhaps even the law).
- Human behavior never stays the same, so don't assume yesterday's controls or audit procedures apply today.

> If consistency is one of our biggest risks, what can you do about it? Answer: Don't do more work; do it differently… just because you do the work does not mean it has any value.

Think of business as a ballgame. Other people play and we keep score. Fraudsters depend on accountants not knowing enough about the game to know the numbers are wrong. So why would fraudsters take the risk? Because we make it easy for them to hoodwink us. How? By doing the same thing over and over.

Predictability is one of our greatest weaknesses. CPAs performing the same procedures or applying the same internal controls is the fraudster's best friend. Why? Because if fraudsters know where you're going to look, they'll commit their fraud someplace else.

This is a simple example to illustrate: Do you ever change your behavior to circumvent a control system? Let's say you drive to work the same way most of the time, and going around a bend in the road there's a side street. There's a police car there every morning when you drive by, so what do you do? You slow down. If you change your behavior to avoid detection of your speeding, what makes you think your clients or staff don't do the same thing to you?

So if consistency is one of our biggest risks, what can you do about it? Answer: Don't do more work; do it differently. For example, if you always vouch the last 10 sales for the revenue cut off test, where is the client NOT going to put fraudulent sales? The last 10. You can still vouch 10 sales, just don't have a pattern of what 10. The lesson is that just because you do the work does not mean it has any value. If the control or procedure doesn't deter fraud then it has no value.

Another major risk is trust. Who are the only people who can steal you blind or cook the books undetected? People you trust. If you don't trust them you won't give them access or have them as a client. So surround yourself and hire people you trust, but don't let your guard down. That's when you'll get burned. Here's a secret: Trust is NOT a control or an audit procedure.

Daniel Wiant was the CFO of the Ohio Chapter of the American Cancer Society. The society had a policy that it would take two people to conduct any wire transfer of $5,000 or more. One would initiate the wire, and the other confirmed it to the bank. One day, while everyone else was out of the office, Wiant wired the entire checking account balance of $7.2 million to himself in Austria. He left his wife a note and she called the FBI. How could he wire the money? He and the Executive Director had given each other their passwords in case of an emergency. I posted a video of his theft called "Daniel Wiant Steals $7+ Million from Cancer Society." http://bit.ly/1r1Eqq4 The video is a composite of his arrest, his wife talking on the court house steps, and an interview with the executive director. Note when a reporter asks the executive director if anyone has been held accountable (meaning him), he doesn't answer the question.

Rita Crundwell started working for the city of Dixon, Illinois while still in high school. Dixon is about an hour west of Chicago and Ronald Reagan's boyhood home. The annual operating budget was about $10 million for a town of around 16,000 residents. Crundwell rose to be the finance director. Her side business was championship horses. She also stole $53 million from the city over 20 years. How did she get caught? Crundwell was gone from work. Her assistant saw a bank account statement addressed to the city but didn't recognize the bank. The assistant showed the bank statement to the mayor, who called the FBI. Crundwell is now serving 20 years. In this video, the mayor explains the fraud: http://bit.ly/1xSQ8Zb

Amy Wilson was the typical bookkeeper at a small private company, and was completely trusted. The owner didn't want to go over financial information, telling Amy, "That's what I pay you for." The company's outside accountant recommended her boss, the owner, move from a compilation to at least a review, and preferably an audit. The boss' reply: Not worth the money.

Amy, like many people, started stealing when she needed $5,000 and didn't have it. The Amys of the world tell themselves "I'll pay it back." So now you have completed the triangle of fraud in SAS 99: Need/pressure/incentive, opportunity (access) and rationalization. In her presentations she shows how she used the demo mode to circumvent the accounting software control system.

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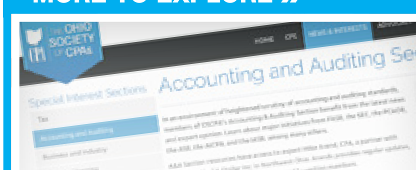

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Amy got busted when her bank called her boss to ask why she was paying her credit card with company checks. After doing prison time, she now mentors other female prisoners on how to put their lives back together after release.

Want to make your management letter real? Include a link to "Amy Wilson Shares How and Why She Stole $350,000" on YouTube. Why? Because most people won't fix things until they're broken. Amy explains how much damage one trusted person in the right position can do: http://bit.ly/1uEz5c4

How many times have you heard "It costs too much" as an excuse not to implement controls? It's not true, either. How do we know it's not true? Because the trucking company owner will spend $500,000 on new trucks, but won't hire a $50,000 person in accounting to segregate duties. So cost is not the reason. One of the reasons clients, or your boss, won't install new controls is because we don't ROI justify the recommendation. If you don't justify the cost of the recommendation, your clients are just making what they think is a rational business decision.

Defective compensation systems cause fraud. Remember Domino's Pizza advertisement, "30 Minutes or it's FREE"? Typically, drivers got a small bonus if they delivered the pizza on time and got docked if they were late. Even though management knew drivers were wrecking their cars and getting speeding tickets, they kept the system. It wasn't until a driver ran a four-way stop sign, hit a woman and killed her that the company quickly suspended the system and has never brought it back.

Question: Was it ethical for a CPA to work at Domino's and do the payroll when the compensation system was causing employees to break the law?

What management and CPAs fail to realize is that any time you change a system, people will always change their behavior to maximize the benefit to themselves. Behavior never stays static. It always changes. Think about the subprime mortgage meltdown. So don't ever think yesterday's controls or audit procedures apply to today's new system.

For example, health care in general and the Affordable Care Act (ACA) specifically provide many opportunities and incentives to commit fraud. To combat the explosion of prescription drug deaths, the Drug Enforcement Agency and Food and Drug Administration now allow pharmacies to take back unused medications. How will you change your analytical procedures to detect when a pharmacy doesn't destroy the meds as required by law and instead resells them? How might you know? Because the pharmacy sells more controlled substances than it purchased. Don't think it can't happen. Pharmacist Robert Courtney diluted 100,000 prescriptions for 4,000 patients. Sales exceeded purchases. How can that happen? Watch "Deadly Rx for Greed": http://bit.ly/1ynCno5

Companies should be careful not to break the law when they reduce employee hours below the 30-hour threshold to provide health care coverage. Why? Because some attorneys are arguing it's a violation of ERISA section 510, which forbids employers from changing hours worked for the purpose of changing their employee benefits.

Pharmaceutical manufacturers have paid billions in fines for illegal marketing. Think about that. Just because an invoice went out and the money is in the company's checking account does not mean the revenue was legally earned.

The Physician Payments Sunshine Act, which was part of the Affordable Care Act, requires medical companies to post on a public website all the monies paid to health care professionals, such as consulting, speaking fees and the value of sales rep's pizza. What's your procedure to match your client doctor's record with publicly available information?

Think CPAs are automatically ethical? Have you seen these cases?

- The New York City tax partner who stole $4 million in tax billings
- The Big Four vice chairman who was released from prison July 2014 over $400,000 of insider trading
- The Big Four audit manager sentenced to 15 years for child porn, some of which was reported to be on his work computer
- The CPA/CFO who stole payroll withholdings from Catholic Schools
- The small firm tax partner who stole $11 million then hired a hit man to kill the clients who owned it
- The staff CPA sentenced to 37.5 to 50 years for killing his sole practitioner boss
- The tax partner who was charged with securities fraud and nearly went to prison because he didn't close his home office door
- The dangerous info of what's not on your staff's annual disclosure form
- The small firm managing partner who went to prison for changing client records
- When under time and budget pressure some staff will falsely sign off that they did work they didn't do
- The A&A partner who was living beyond his means, borrowed from a client, helped the client commit a $350 million financial reporting fraud and served 4+ years in prison

Auditing standards require auditors to assess risk by "understanding the entity and the environment, including internal controls." Do you have to know and analyze all of them? No, but you better know and analyze the ones that might materially affect your clients. I can't list every danger, but I can show you how to find and analyze risk with a few examples of new threats for 2014 engagements:

- Responding with integrity to a client who says, "It's my company and I can do whatever I want."
- Providing guidance to American cheese makers who may not be able to use foreign origin names such as Asiago, Brie, Cheddar, Feta, Gouda, Provolone and Parmesan.
- Properly advising clients who have illegal unclaimed property.
- Dealing with competitive risk when a major competitor comes to town.
- Implementing the forthcoming lease accounting standard.
- Responding to disruptive technologies such as Uber, Lyft and Sidecar and 3-D printing.
- Addressing the ethical challenges of whistleblower rewards.
- Preventing schools from manipulating attendance records and report card grades.
- Addressing issues related to restricted or designated donations.

Controllers and CFOs, you aren't off the hook.

- Do you know how your financial systems cause bad debts?
- Can you write down three ways you help make more money, not just count the money?
- Do you know how an extraordinary guarantee can drive profits?
- Do you know which customers you should fire?
- How do you get customers to do business with you over and over?
- How do you identify competitive threats that cause a going concern condition (that you would disclose to your auditor – right?)
- What is mass customization and should you do it?
- How, by using one flaw in the control system, did a low level employee almost take down the second largest bank in France?
- Do you have a comprehensive yet simple control system that actually makes money?
- Should you replace at least some credit cards with purchasing cards?
- To minimize fraud, are your pay and control systems 'goal congruent' (don't worry it's not nearly as hard as it sounds)?

Parting thoughts

As CPAs you have to pay attention to what's in the accounting records. We hold ourselves responsible to prevent and detect material fraud in financial statements. The problem is that by the time the fraud is material and in the financial statements, it's too late. As you can tell from the above discussion, fraud, ethics and strategy all have human behavior in common. They all begin outside the financial statements. When you look the other way for little frauds (the boss running personal expenses through the company, for example), could you still swear in court that you're an ethical CPA? Think about it.

Gary D. Zeune, CPA, is a nationally recognized speaker and writer on fraud, ethics and corporate strategy. He also founded The Pros & The Cons, the nation's only speakers' bureau for white-collar criminals. You can reach him at gzfraud@TheProsAndTheCons.com.