# WHITE-COLLAR CRIME FIGHTER

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YOUR SECRET WEAPON IN THE WAR ON FRAUD

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## IN THE NEWS

### ID Theft Sentence Enhancement: New Deterrent?

The *Identity Theft Penalty Enhancement Act,* about to be signed by President Bush, will require that those convicted of the new crime of "aggravated identity theft" receive a mandatory sentence enhancement of two years.

***Key:*** Aggravated identity theft is defined as ID theft committed in connection with other serious federal crimes such as immigration violations, false citizenship crimes various firearms offenses .

***Important:*** The new bill also targets for stiffer penalties employees and company directors who abuse positions of trust and privileged access to sensitive information in order to commit identity theft or fraud.

The new law also directs the U.S. Sentencing Commission to toughen guidelines for punishing individuals who commit identity theft with the ultiimate objective of carrying out terrorist acts.

***White-Collar Crime Fighter* sources:**

Official U.S. House and Senate legislative documents related to the Identity Theft Penalty Enhancement Act.

## IN THIS ISSUE




Stephen A. Pedneault, CPA, CFE, *Haggett Longobardi. LLC*


# YES, AUDITORS CAN STOP FRAUD

## If They Know What to Look For

SAS 99, Sarbanes-Oxley and a host of other proposed new audit standards aimed at detecting financial statement fraud and other unethical or unlawful activity, have greatly increased the work load for auditors in all industries.

***Unfortunate:*** The new pronouncements fall short of providing auditors with specific and practical tools needed for foiling corporate fraud…

SAS 99 does reiterate the requirements contained in previous standards that, instead of relying on the internal controls and accounting procedures of the client to detect fraud, auditors must assess for the fraud risk factors, and then tailor their planned audit procedures to address the fraud risks that they identified.

***Result:*** SAS 99 clearly resolves any remaining misconceptions of auditors that fraud detection isn't their job. In fact, SAS 99 states that auditors should presume the risk of financial statement fraud and should do thorough analysis of revenue accounts to screen for illegal activity.

***Continuing problem:*** Like its predecessors, SAS 99 omits specific guidance for ferreting out actual fraud once the fraud risk factors are identified.

While some new anti-fraud procedures are contained in SAS 99, the standard does not require all procedures to be followed. Instead, it merely "suggests" that auditors "consider" implementing them. Our firm reads "consider" and "suggest" as "required."

### GO IT ALONE FOR NOW…

Though the audit profession is working to change auditing and financial reporting standards to include more mandatory testing and reporting, it will be a year or more before we see any of these additional requirements enacted. In the meantime, many in the profession are moving toward risk-based audits on their own…and placing less reliance on internal controls unless they're thoroughly tested.

Following the theme of SAS 99 and other changes within the profession, here is a three-part formula to include in any audit plan focusing on fraud detection…

**1. Identify motivations/incentives for executives to cook the books.** Focus on the users of the statements, and any pending transactions. Determine if there are any reasons why the financial statements could or would be distorted. If you find none (unlikely), then the risk of financial manipulation is reduced.

***Key:*** Use the resources available, such as the AICPA Audit Guides or *PPC Guide to Audits of Small Business* to focus your attention on actual fraud risks. These publications provide lists of such motivations, as…

- ☐ Strained relationship between management and the current or previous auditor.
- ☐ High vulnerability to rapid changes in technology, product obsolescence or interest rates.
- ☐ A credit line that is "maxxed out."
- ☐ The company's industry is declining with growing number of business failures and slumping customer demand.
- ☐ The company is not generating adequate cash flows from operations, even though it is reporting earnings growth.
- ☐ The company's financial records indicate unusually rapid profit growth, especially as compared with other companies in the

industry.

☐ The company is subject to new regulatory or legal burdens that could undermine its financial stability.

☐ The company is under heavy pressure to generate fresh capital to stay competitive.

☐ The company's ability to make debt payments is declining.

☐ The CEO and/or other senior executives have a significant direct stake in the company and stand to lose substantially if the company fails to raise new capital or secure additional credit.

***Key:*** The more items on the list that the auditor finds may apply to the audited organization, the greater the risk that the CEO, COO or CFO is orchestrating a book-cooking scheme.

**2. Determine how the CEO or CFO might carry out a financial statement fraud if the motivation is there.** The motivation and methods used will vary by industry and by client.

***Example:*** If the auditor is working for a construction contractor, and financial fraud motivations are present, the auditor must know that one of the common ways construction contractors can fudge the numbers is by fictitious accounting for work in progress—to inflate reported revenue and profitability.

The auditor's job is to actively screen for indications beyond the mere line items of the company's balance sheet and to meticulously examine all accounts receivable, accounts payable and inventory records, with the *expectation* that fraud is occurring. If none is found, great. However, if no fraud is found because the auditor never specifically looked for it, and wrongdoing is identified *after* the statements are issued, the audit firm could be in hot water both legally and under professional rules.

**3. Design audit procedures to actively dig for "dirt."**

The key to successful fraud auditing is to link your audit procedures to the fraud risks you identify during the planning of the audit, and modify your procedures as other risks arise.

***Aim:*** To leave no stone unturned in the search for financial statement fraud in the clients' records.

### CASE STUDY...

A company being audited has increased sales volume, inventory levels and accounts receivable this year, consistent with each of the prior three years.

**In the first step** of his or her risk-based audit strategy—identifying motivations to commit fraud—the auditor discovered the company had…

☐ A revolving credit line based on eligible receivables and inventory and is maxxed out.

☐ The owners have personally guaranteed the debt.

☐ Tight financial covenants on the remaining financing, personally guaranteed.

☐ Incentive-based compensation.

☐ Inventory susceptible to obsolescence due to industry and market shifts.

***Second step:*** **Determine how the CEO or CFO would carry out a financial statement fraud if the motivation is there.** Based on the fraud risk factors identified, the auditor

## Lying to Suspects: Where to Draw the Line

Deceiving suspects is a common, and widely acceptable interviewing tactic. But—investigators must know where acceptable deception ends and impermissible lying begins.

Case law says that interviewers can tell the suspect that the evidence indicates that he committed the crime, even if that is an exaggeration. They can also compliment the suspect by saying that he appears to be a conscientious and caring individual, even though there is no truth to the statement.

***Key:*** These false states are often effective in creating an environment where the suspect feels comfortable telling the truth.

***When to stop:*** Never fabricate evidence in the course of an interview. In a Florida case, police created a fictitious crime lab report which indicated that the suspect's DNA was found on the victim. After reading the report, the suspect confessed. At trial his confession was suppressed because of the court's concern that such bogus evidence may find its way into a court room and undermine the integrity of the evidence management system.

***Critical guideline:*** Distinguish between false assertions and manufacturing evidence. In the Florida case, the suspect's confession might have been upheld had the investigator only made a false statement, such as "We have a crime lab report and your DNA was found on the victim."

***White-Collar Crime Fighter*** **source:** John E. Reid & Associates Inc., pre-employment screening, loss prevention and criminal interviewing training consultants, Chicago, IL, www.reid.com.


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### Mission Statement

*White-Collar Crime Fighter* provides information of maximum practical value to organizations and individuals involved in all facets of investigating, detecting and prosecuting economic crime.

This community includes law enforcement officers…regulatory officials…corporate security professionals…business owners and managers…private investigators…and many more.

The editors of *White-Collar Crime Fighter* strive to gather and compile the most useful and timely information on economic crime issues.

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screened for the following potential acts of wrongdoing…

☐ Inflating or recording fictitious "eligible" accounts receivable—thereby increasing borrowing limits.

☐ Booking premature revenue recognition—to increase borrowing ability and meet tight financial ratios.

☐ Understating or maintaining inadequate Allowance for Doubtful Accounts —another way of increasing borrowing ability.

☐ Inflating or entering fictitious "eligible" inventory—still another way to boost borrowing ability.

☐ Understating reserve for obsolescence, obsolete or overvalued inventory—to increase borrowing ability and/or meet financial covenants.

☐ Understating accounts payable and accrued expenses/showing improper expense cut-off—to meet financial covenants.

***Third step:* Design audit procedures to actively screen for fraud.** Based on the fraud risk factors and methodologies identified, the auditor's next steps correctly included…

☐ Assigning the risk areas to a more senior member of the audit team.

☐ Exercising increased skepticism and awareness of any unusual or unexpected transactions, entries or results, especially at or near the end of a period.

☐ Expanding accounts receivable testing to include more emphasis on "eligible" receivables at the end of the audit period, to ensure no presence of "churning"—refreshing old accounts by re-invoicing—or other manipulation of accounts receivable aging.

☐ Intensifying accounts receivable testing to ensure subsequent credit memos are scrutinized and traced to original transactions to ensure legitimacy of the original invoice and credit memo.

☐ Reinforcing inventory testing by extracting inventory details and importing them into a data analysis program such as IDEA or ACL.

☐ Extracting and scrutinizing all journal entries posted at or near the end of the audit period, with emphasis on any entries effecting accounts receivable, inventory, accounts payable, accrued expenses and revenue.

***White-Collar Crime Fighter* source:**

Stephen A. Pedneault, CPA, CFE, is the Manager of Forensic Accounting Services of Haggett, Longobardi, LLC, a Connecticut public accounting firm, www.hlcocpa.com. Steve can be reached at pedneault@hlcocpa.com.