WHITE-COLLAR CRIME FIGHTER

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YOUR SECRET WEAPON IN THE WAR ON FRAUD

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IN THE NEWS

Federal ID Theft Law: Pros and Cons

The 1970 Fair Credit Reporting Act (FCRA) was replaced by an updated law just in time for the January 1, 2004 expiration of the 33-year-old statute.

Benefits: The new law gives consumers easier access to their credit reports…requires credit reporting agencies to quickly correct any inaccurate credit information resulting from identity theft…enhances the effectiveness of fraud alerts requested by consumers for their credit files.

Potential drawback: The new law prohibits states from enacting legislation that would conflict with most anti-ID theft provisions of the new federal law. That applies retroactively as well. *Example:*

California Senator Diane Feinstein's law enacted earlier this year in California to prohibit financial institutions from sharing personal identifying consumer information with their affiliates is nullified along with several other state anti-ID theft laws.

For more details about the new Act, visit:

•http://search.ftc.gov/query.ht ml?qt=FCRA &col=news.

•http://www.namb.org/government_affairs/front/2003-11-06_fcra.htm.

IN THIS ISSUE

Gary Zeune, *The Pros and the Cons*

AUDITORS' ALERT

How NOT to Get Sued Under New Fraud Auditing Standards

The new "Statement of Auditing Standards" (SAS) 99 will result in major improvements in the detection of financial fraud *before* future WorldCom, Enron and Adelphia-like schemes blow up.

However, the standards aren't perfect. Auditors need to be aware of potential flaws that could get them into serious legal trouble.

Example: The audit work required to comply with SAS 99 must still be paid for by the client. That again raises the question of how an outside auditor can function independently and objectively to force compliance with the new standards if the client is footing the bill.

If you think you are unbiased in making judgments in connection with SAS 99 compliance, ask yourself…

•**Are you a better than average driver?** Research shows that around 90% of us think we are.

•**Are your kids smarter than average?** Of course. .

For more on how fees bias auditor judgment, see "Why Good Accountants Do Bad Audits," *Harvard Business Review,* November 2002.

Potential solution: A funding plan that gets a third party to finance corporate audits.

SAS 99: FRIEND OR FOE?

One of the great benefits of SAS 99 is that it provides auditors with much more guidance on how to detect fraud than they were getting from the earlier SAS 82. *But, weighing against this benefit, SAS 99 presents such drawbacks as…*

•**Providing the same guidance to plaintiffs' attorneys.**

•**Making it much easier to sue an outside audit firm if it misses a fraud.** The client company's attorney simply has to hand the firm's representative a copy of SAS 99, go down the list of procedures required or suggested, and ask, Did you perform XYZ on the audit?

Every time the auditor says "No," the attorney will then ask, "Why is it that you're smarter than the 24 people who sit on the Auditing Standards Board… because you didn't do this step and missed the fraud?"

•**Like its predecessor, SAS 82, SAS 99 still allows auditor practices that make it easy for clients to commit fraud.**

Example: SAS 99 suggests that auditors "consider" conducting surprise procedures. Why not *require* auditors to vary their procedures to keep the client off balance and thereby deter shenanigans?

•**With SAS 99 in place, many audit firms may be motivated to drop their riskiest clients,** trusting the remaining ones because of their honest track records.

Trap: Auditors may become complacent. Suddenly, a year or two down the road, one of these "squeaky clean" clients might cook the books and the audit firm will be forced to deal with an undetected fraud.

Problem: SAS 99 is crystal clear in emphasizing that trust is *not* an internal control.

•**SAS 99 could widen the "expectation gap,"** which is often the primary cause of malpractice liability.

What it is: The expectation gap occurs when auditors believe that SAS 99 represents the maximum level of work required. Thus, auditors often perform work *below* the level required. But judges, juries, the SEC and other legal or regulatory bodies have said over and over again that auditors' standards meet only the *minimum* level of acceptable performance.

Result: When an auditor performs below a jury's acceptable minimum and misses a fraud, it's difficult for him or her to deny responsibility for detecting the fraud.

NO MORE "REACTIVE" AUDITING

Paragraph 1 of SAS 99 states that auditors have a responsibility to "obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."

Significance: The new standards clearly state that auditors have a "positive, affirmative, duty to detect fraud." Auditors can no longer say fraud detection isn't their job.

Today's fast-growing frauds can no longer be the subject of mere lip service

WHAT TO EXPECT

Likely characteristics of the future of auditing under SAS 99…

- **All fraud committed by executives is classified "material" because it signals that management lacks integrity.**

Example: If a manager cheats on his or her expense reports, why wouldn't he or she also find it easy to cook the books…especially if the company's financial stress is so intense that a bank loan is essential to keep the company afloat until the economy rebounds? Even a fraud involving small dollar amounts can be material because of the reason it happened: Dishonesty in the executive suite.

Key: Under the SEC's Staff Accounting Bulletin 99 (SAB 99) a small amount is material if it fraudulently results in something significant, such as getting a bank loan renewed or propping up the company's stock price.

- **Malpractice cases are litigated with 20/20 hindsight,** with all the facts out for the world to see. If auditors don't aggressively sniff out the red flags of fraud—regardless of whether or not they're listed in SAS 99—odds are they will be held held liable for any resulting losses.

- **Significantly changed auditor-client relationships.** Auditors can no longer assume that their clients are honest just because they have been in the past.

Caution: Auditors should never try to win business or keep clients by promoting themselves as their clients' "financial partner."

- **Higher audit costs.** Clients may attempt to save money by either terminating their current accountant or by asking for a compilation or review instead of an audit.

Essential: If a client does that, the auditor should think about printing, in large, bold, type at the top of the compilation or review reports, "NOT AN AUDIT OPINION".

- **Auditors will no longer wait until they have identified a potential material fraud to perform appropriate procedures.** SAS 99 will spur auditors to perform the procedures in order to identify the risk…before the fraud occurs.

That also means explaining to all audit staff members the specific purpose of an audit: To detect potential fraud before it's too late.

THE BOTTOM LINE

Getting an audit is a privilege…not a right. The best way to protect yourself and your firm is to very carefully select those with whom you do business. Don't accept clients just because they are willing to pay for the work.

Example: In the infamous ZZZZ Best Carpet Cleaning fraud, (see *White-Collar Crime Fighter*, TK, 2000, page 1) management picked its auditors because it believed the firm would be the easiest to fool.

Best: If you don't know anything about a potential client's business, take a pass. In this new environment, the fees are simply not worth the risk.

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

Comments, suggestions and questions are welcome. Please fax us at 203-431-6054, or E-mail us at editor@wccfighter.com. Visit us on the Internet at www.wccfighter.com.