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I appreciate this opportunity to participate in the Fifth Annual Auditing Symposium sponsored by The University of Kansas. Not only is it a personal honor but it will also be very helpful to me as a member of the AICPA Standing Committee on Methods of Perpetration and Detection of Fraud.

First of all, I want to compliment the authors on their study. I personally believe it was a study long overdue, and I can share their frustration in trying to "get to the facts and issues," so to speak, because our AICPA Task Force has also been frustrated in trying to obtain similar information from various governmental bodies, accounting firms, etc. The authors properly commented on this fact by stating that "many of the agencies and prisons responded they could not comply with our request" (for information) and went on to state that in their review of the 72 past cases of fraud, they attempted to determine the fraud-related variables which were present in each of the cases in order to establish a "red-flag" checklist which could be helpful to auditors in detecting and deterring management fraud. They further stated that in reviewing various articles, etc., it was most difficult to identify these variables because "certainly the authors who wrote about the cases probably had a perspective much different than ours."

Problems Encountered

I think the two aforementioned problems (or limiting factors, as the case may be) are extremely important for all of us who are interested in the subject to understand and be aware of in reaching any conclusions as to where we go from here, whether in terms of further research, using a "red-flag" approach in our auditing practice, or in the teaching environment. I will come back to these problems later but, in any event, I think the authors have done a good job of compiling some excellent research on a very complex issue.

The authors comment on the fact that they used 72 past cases of fraud to validate the fraud-related variables and go on to compare the typical fraud perpetrator to incarcerated prisoners and to college students. However, I could not determine how the 72 cases were selected, nor did I understand why the comparison was made to college students as a control group. Further, I wasn't sure what college students were included; i.e., from a single university or a cross-section of all universities. I think it would be helpful if these points could be expanded.
Objectives

The authors state that there are four objectives to their interdisciplinary study and these need not be repeated here. I find the concept of an interdisciplinary study quite interesting from a research and teaching perspective, but become a little concerned if this concept were contemplated by the authors to establish a similar team approach for conducting audits in the normal ongoing business environment. My reservation does not relate to the current practice of using or relying on other experts, which is covered under the existing auditing literature; rather, it deals with the authors' concept of developing "an early warning system that could be used by auditors in detecting and deterring fraud" which is the fourth objective spelled out by the authors.

I believe that the existing literature (and court cases) now makes it clear that the external auditor has the responsibility to search for fraud which has a material impact on the financial statements presented. However, the authors' stated objective of developing a method (early warning system) which can be used by external auditors to deter fraud (material?/immaterial?) concerns me because I firmly believe that the responsibility for the deterrence of fraud rests clearly with management and the board of directors through the company's system of internal control. It is not practicable or cost efficient for the external auditors to be charged with this responsibility. However, an interdisciplinary approach by management in establishing the appropriate control environment and internal control systems, in the broadest sense of the word, is very helpful and is used by many companies in assessing hiring policies, establishing job criteria, selecting key personnel, etc.

Conclusions and Implications

The authors go on to state that they want to present some conclusions and implications from the study and that two assumptions will be made (by the authors). First, they assume that the reader is familiar with auditors' responsibilities under existing SAS's and, second, that readers agree with their definition of management fraud; i.e., improper actions resulting in a material misstatement of financial statements.

Accordingly, the authors then state that "the remainder of the paper will be divided into three parts:

1. A description or profile of the typical fraud perpetrator;
2. An explanation of why fraud occurs; and
3. Steps that can be taken by auditors to reduce their exposure to management fraud." (See definition above.)

In dealing with "The Typical Fraud Perpetrator," the authors have provided us with an extremely valuable insight but the problem is one which I previously mentioned; i.e., that they had to include embezzlers and (I believe) immaterial fraud perpetrators, and, accordingly, the characteristics of those who commit management fraud (by the authors' definition) could actually produce a different profile. This "identity problem" (of which ones committed management fraud vs. an embezzlement) could not, in my opinion, have been avoided for reasons upon which both the authors and I agree, and my comments are not meant as a criticism; rather, I mention it only to reinforce the fact that the problem does exist, and that as the accounting profession goes forward, we should do everything
possible to correct the situation by making available the necessary information to researchers on actual management fraud cases.

Observations Concerning Cited Cases

At this time, I would like to go back to the point I made previously about the 72 cases reviewed by the authors and their comments as they relate to the perspective of other authors on whose material they relied. The biggest surprises I had in reviewing the material presented (including the more extensive material to be published in book form which was made available to me by Dr. Albrecht) were:

1. there was no direct mention of the problem of collusion between employees against the company or between employees on behalf of the company, and
2. there was no reference to the accounting principles or reporting disclosures involved in the "fraud" which have since been strengthened by new accounting pronouncements (such as profit recognition guidelines involving the sale of real estate) or by disclosure requirements (such as those involving related party transactions).

In other words, in many of these cases there was more than one person involved but there was no mention of the interaction, of how this interaction was addressed, or how it possibly impacted the "profile" of a specific case or individual involved.

Further, if the case involved a related party transaction (or a series of such transactions) including, say, the apparent sale of real estate and yet there were no definitive accounting or disclosures required under GAAP at the time, were these factors considered by the authors in reaching their conclusions? In other words, if there were no specific accounting and disclosure requirements and management made a choice (which may have been the wrong one, for whatever reasons), does this constitute management fraud, or is it poor judgment based on hindsight? If, for example, I were to commission a study of a particular case or series of cases and asked for an evaluation of the cases in light of the "state of the art", so to speak, as it relates to "principles" and "disclosures," what might the answer be? I can assure you that I don't know what it would be but I suspect that it might influence my conclusions. Please don't misunderstand my point. I am fully aware of the concept of "fairness" as to principles and disclosures (notwithstanding the state of the art) and if an expanded study were to address the "fairness" issue, then that is perfectly acceptable to me. But let us not assume that because accusations have been made that it is axiomatic that there is guilt, because many of these cases were not tried in court; rather, they were settled via consent decrees.

My recollection of many of the cases reviewed by the authors was that the above-mentioned factors were key elements in many of these cases, and I would suggest that the authors' research be expanded and interrelated to the points I have mentioned.

I have spent 20 years in public accounting and believe that there is no more difficult problem for auditors to deal with than the problem of collusion. All one has to do is consider the magnitude of "sensitive payment disclosures" (over 400 companies), price-fixing cases, and the purchasing agent/kickback scandal of earlier decades. I would think it would be of significant benefit to the profession if the authors could expand on this point as well as the impact of changed accounting principles and disclosure requirements.
In addition, I would like to see additional objective research on which of the 72 cases involving management fraud (by the authors' definition) involved human (audit) failure; that is, if a careful review indicated that 20 of the 72 cases involved audit failure, would the conclusions reached by the authors have been the same or might they have differed?

Deterrence of Fraud

In reviewing the paper as it relates to "An Explanation of Fraud," I found it quite helpful and observed that it reinforced my earlier comment regarding who has the responsibility to deter fraud to note that the authors point out the social factors that contribute to the incidence of fraud, stating:

Certainly it would be difficult for auditors to change many of these societal factors. Maybe a strong lobbying effort or high-placed connections would help but, generally, auditors must live with those factors.

The Authors' Conclusions

In summary, based on their research, the authors reached two conclusions. First, that it is imperative that auditors make fraud prevention an explicit part of their audit and, second, that they should take two steps to "reduce their exposure to fraud." The two steps which they suggest for auditors to take to reduce their exposure are to: (1) make sure they accept only "clean" clients, and (2) consider adopting a "red-flag" checklist as part of their audit program.

As to their first suggestion, I believe existing literature (SAS No. 16) clearly states that it is the responsibility of the auditor to plan and execute the audit in a manner which will uncover material irregularities or errors and, accordingly, I concur with the authors' conclusion if they are talking about material fraud. I might add that I believe it has always been an explicit part of the audit process via the use of audit programs, physical observations, counts, confirmations, etc.

As to their second suggestion, I don't know of anyone who knowingly accepted a "dirty" client, and the professional literature has been expanded to cover this point (SAS No. 7). However, in a more serious vein, their point is valid and really relates to the individual firm's quality control program and the monitoring thereof which lays down specific guidelines on the acceptance of new clients, including the assignment of personnel who have the necessary industry knowledge. Our firm has had such criteria for many years and I'm sure that other firms have similar programs.

However, their second suggestion causes me real concern for a couple of reasons. First, there is the implication that by coming up with a master checklist, it will solve the problem. I, and other members of the AICPA Task Force, am constantly being asked (in substance) at various speaking engagements, "When are you going to give us a program or checklist which we can incorporate in our workpapers that will uncover fraud?" (and I might add they mean all fraud). My response is that there will be no such program or checklist because there is no program or checklist that could ever be developed to cover all situations. For example, how would you apply a checklist to a multinational conglomerate with, say, 25 operating subsidiaries around the world and having 200 or more operating plants or offices versus a local gas station under audit? The point is that the scope
of an audit is based on the auditor’s knowledge of the risk involved, the adequacy of internal control, his knowledge of the industry, and his prior involvement with the clients in terms of results of prior years’ audits.

Furthermore, what if you couldn’t get (for whatever reasons) objective answers to the questions involving the personal character issues concerning key management personnel? How many unanswered questions do you need before you must have a scope exception in your opinion or cite them in a “no material inadequacies” letter to regulatory authorities? Or, conversely, let’s take a situation where a check on one of the key employees uncovers the fact that he is lacking in certain moral standards (of your choice). The auditor has no power to hire or fire. (As an aside, let me assure you that, in practice, when a serious problem does exist, we have a way of communicating this information to the appropriate level of management in the company and have been doing this for years.) Furthermore, the implications of an auditor collecting personal information on management have serious legal considerations which would need to be examined carefully and which could create serious auditor/client relationship problems that could have a direct bearing on completion of the audit and, accordingly, the cost thereof.

The Red-Flag Checklist

In summary, the incorporation of a standard “red-flag” checklist in the standard audit process, in my opinion, has a number of serious limitations which have to be reviewed carefully as to their long-term implications before any such checklist is adopted as a “standard” audit procedure.

Does this mean that the proposed checklist is without merit? No, it does not. Rather, I think it should be directed at the training effort of the individual firms and made part of either basic or advanced accounting curriculum at the university level. I think back to my early days with Arthur Andersen & Co. and the content of our training, both in a formal classroom sense and the informal “on-the-job” training. This training covered not only general audit principles but also included a great deal of emphasis on specific industries (i.e., banking, brokerage, real estate, etc.). The training was aimed at dealing with “risk”, not only “risk” as it relates to general audit problems but also in “people” auditing. The problem of “high-flying” management, “personal situation pressures”, and other pressures mentioned by the authors is something that I believe is currently being discussed but the importance of which needs to be reconfirmed constantly not only via increased training but also through additional research in the entire area of fraud and fraud detection and deterrence.

In fact, the idea of a “red-flag” checklist was so attractive as a training tool that, as you are aware, the AICPA Task Force, on which I serve, published such a list in 1979 because we believed it would be helpful to the accounting profession in the context discussed in the previous paragraph, so I am totally in support of the authors’ approach.

Another concept I would like to see addressed is the concept of “greed.” Webster’s definition follows:

Excessive desire for getting or having, especially wealth; desire for more than one needs or deserves; avarice; cupidity.

I believe that this concept should be incorporated into a research study dealing
with the many issues raised by the authors. "Greed" is a dirty word, so to speak, but it also seems that it is an attribute applicable to a segment of our population. The authors' concept of what constitutes "management fraud" could be a very interesting study. Consider the possibilities. Let's assume Mr. or Ms. X is highly motivated and ambitious and that he/she is in a position of power. Further, assume that our business person comes from an overachieving background, has access to competent professional advice of all kinds and wants to "get ahead" as fast as possible. Further, assume that this person is very persuasive with a positive outlook as to the outcome of current developments, contracts, the economy, etc.

This description of an individual and the situation is quite common in our free enterprise system and rightfully so. The manager is trying to put his/her best foot forward but, if there is a certain change in circumstances, he/she could be accused of being "greedy" or committing "management fraud" because the decision path he/she followed was aggressive, positive, and to his/her best interest because of compensation agreements; or, on the other hand, was he/she just being an aggressive manager? Conversely, another individual will sometimes construct the worst possible scenario in the worst possible situation and try to convert it into a "positive growth" situation. This to me creates the real difference as to what is reasonable versus what is unrealistic. This is what the auditor has to learn to contend with and dissect and where he must use judgment and experience to reach his conclusions.

Other Comments

There are two other points which I feel should be made. The first deals with the number of audits which are done each year and the incidence of management fraud therein. The second is the composition of the audit team.

I do not know how many audit reports are issued each year but the number has to be in the hundreds of thousands, and while even one case of management fraud would be a sad commentary, I think we have to accept the fact that there are people who, for the reasons suggested by the authors, will commit fraud (of all types). But it seems to me that the incidence of management fraud is relatively small and, in fact, could be infinitesimally small in relation to the number of audits involved. Obviously, the problem of irregularities, embezzlements, etc., is a much larger problem from the standpoint of incidence and must not be ignored. Accordingly, as the teaching profession and we in public practice constantly emphasize the importance of the adequacy of internal controls, I pray that we not develop a generation of professionals who conceive that "everyone is a crook until proven otherwise." Rather, we must develop a generation who will maintain an attitude of "professional skepticism." We must remember that the majority of clients we represent (both in the public and private sector) are seeking the same goals we are and operate totally within the existing legal and moral framework throughout their business careers.

My final point. In general, each audit team is made up of people at various experience levels, starting with the partner who has the most experience. Most audit partners whom I have talked to (and not just from my own firm) have the healthy skepticism I referred to. They may call it "a gut feeling" based on their experience and industry expertise, but the fact is that they maintain an alertness to the "red flags" identified by the authors and they do not hesitate to expand the audit
scope as the situation requires. This, I recognize, is a very subjective area but I think we must acknowledge that auditing is a combination of art and sciences. While there may be cases of human audit failure, I think it would be misleading to assume that management fraud hasn't been detected and stopped in its infancy on many occasions. The problem is that the "success stories" never make the newspapers or the courts, while the "bad news" makes the headlines.

To illustrate this point, I would like to relate a true story involving an audit I was involved in as a young staffman in the early '60s. As you will recall, there were at that time very few authoritative pronouncements on accounting principles and fewer on disclosure. In fact, it was considered unique if there were footnotes to the financials. In any event, the problem we faced was disclosure to owners and creditors of a number of significant changes in this situation which had occurred in the company during the year. The changes included (among other things) a change in top management, a change in marketing strategy and financing of customers, a change in production arrangements for their only product line which resulted in decreasing profit margins on production, a change in banking relationships, a turnover of key personnel, a change of law firms, and a proposed change of manufacturing locations. In substance, the company had radically changed although they were still selling the same product, in the same market, with the same labor force, and in the same economy.

It was our opinion that the facts had to be clearly spelled out in the proxy statement, as well as in footnotes to the financial statements, including the fact that there were related party transactions involving the new management who had introduced other related party transactions which, I might add, made some business sense. All of these changes resulted in a series of meetings which culminated in a heated discussion over the phone between a partner from our firm (who is long since retired) and counsel for the company. I was fortunate to be included in the discussion via a conference call as an observer, so to speak. After much bickering, I recall, as if it were yesterday, the partner asking counsel if they were aware of the implications of Rule 10 b.5 of the SEC and that he didn't care if there wasn't a specific requirement to disclose certain transactions or accounting practices; rather, he was interested in a fair presentation and fair disclosure. As a result, the accounting policies which we felt necessary were disclosed.

You may ask what is the point of this story. My response is that an auditor can't rely on a checklist approach because circumstances differ; rather, he must also exercise judgment which is a far more critical attribute in any audit.

An Educational Plea

I would also like to make a plea to the colleges and universities who are offering degrees in accounting. I recommend that material such as that developed by the authors, as well as other recently-published material, such as Management Fraud by Robert Elliott and John Willingham, be incorporated into existing or newly-created auditing courses. I believe the public accounting profession has become much more cognizant of the problem of management fraud and has made internal changes in various degrees to deal with the problem. Hopefully, your profession can say the same and lead all of us in doing the necessary research to help solve the problem.