In Focus

Auditors' Responsibility

Putting Ethics and Morality First





for Detecting Fraud

By Richard H. Kravitz



The public accounting profession has been held virtually blameless for its role in the events that led up to the recent global financial meltdown—which, to many, seemed to be a "crisis with countless victims but no perpetrators" (Francesco Guerrera, "Crisis with Countless Victims but No Perpetrators," *Financial Times*, November 15, 2010). The destruction of wealth in excess of over $30 trillion has resulted in permanent losses for some and a decade of recovery for others. Some might characterize these failures as the breakdown of ethics and morality within the profession (William Stephens, Carol Vance, and Loyd S. Pettegrew, "Embracing Ethics and Morality: An Analytic Essay for the Accounting



Profession," *The CPA Journal*, January 2012). This author, however, suggests a more practical and reasoned explanation: generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) are not designed to uncover fraud, and auditors are not taught that they have a responsibility to protect society and the public interest. (The *Exhibit* shows the number—or lack thereof—of fraud, ethics, and social responsibility courses at 10 accounting schools.)

The following discussion asserts that the profession is no less ethical or moral than in the past, but that it has abandoned the vision of one of America's founding fathers of auditing, George May, in his "zeal to protect the public trust" and to "use accounting as a social force" (*Twenty-Five Years of Accounting Responsibility: 1911–1936*, Price, Waterhouse & Co., 1936). The profession has abdicated its responsibility to the public it serves.

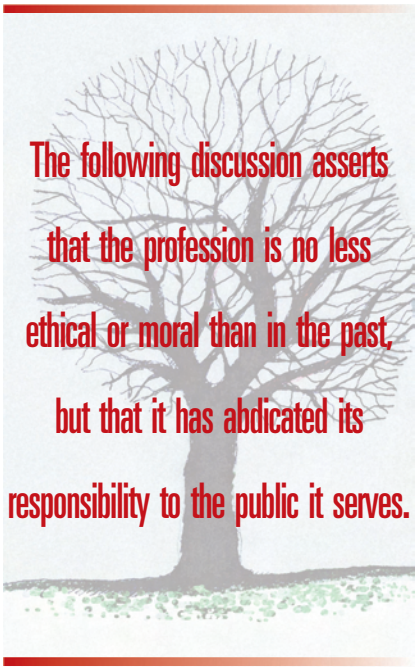
A Young and Honorable Profession

It is easy to forget that the public accounting profession is also a new profession. Unlike the evolution of medicine, engineering, or law, which took place over thousands of years, the attest function of the public accounting profession is barely more than 100 years old. The foundation of our knowledge is primarily rules- and principles-based, unlike the fields of medicine and law, which are primarily case-based.

The accounting profession's newness is demonstrated by the fact that it has not yet formally codified a single set of professional standards, defined by the AICPA and Public Company Accounting Oversight Board (PCAOB), relating to auditing, attestation, quality control, ethics, and independence. In fact, according to the most recent PCAOB Standards and Related Rules, as of January 2011:

> The AICPA has not made conforming changes to the PCAOB's Interim Professional Standards to reflect the requirements and intent for standards issued by the PCAOB and approved by the SEC. Therefore, there may be conflicts between a PCAOB standard and the PCAOB's Interim Professional Standards (AICPA, Release No. 2003-006).

Furthermore, no comprehensive global accounting framework for presenting financial statements currently exists. While billions of dollars of investment capital cross borders daily and the largest U.S., U.K., Japanese, and French corporations do business in a global environment, basic convergence (or, more recently, condorsement) between U.S. accounting principles and practices and the newly empowered International Financial Reporting Standards (IFRS) is not expected until 2015 or later under the new SEC timetable (unanimously approved in February 2010).



Institutional ethics have not broken down; the profession and its members remain highly ethical. A CPA's institutional role is to serve as the moral and ethical compass within our democratic society, to ensure that financial disclosure and reporting of government and private enterprises are truthful, honest, fair, accurate, and responsible (Richard H. Kravitz, "Socially Responsible Accounting: A Call for Reform in the Profession," *The CPA Journal*, November 2009). The AICPA clearly defines a CPA's role in society as one characterized by a "commitment to objectivity, integrity, competence; excellent performance on behalf of clients, employers, and the public; and accountability for the highest professional and business ethics" (AICPA Annual Report, 2007–2008).

The Reality of Fraud

Opposing this promise is the reality of the past four years, during which formerly healthy businesses obtained unqualified audit opinions literally months before they failed, most recently MF Global (which received an unqualified audit opinion in May 2011 and went into bankruptcy in early autumn with $1.2 billion allegedly pledged as collateral and missing from customer custodial accounts); the Federal National Mortgage Agency; the Federal Home Loan Mortgage Corporation; Lehman Brothers (seven-year alleged Repo 105 fraud); Olympus Camera (alleged 11-year goodwill write-down fraud); American International Group (AIG, the largest corporate failure in history); Washington Mutual; the hurried acquisition of Merrill Lynch by Bank of America; Countrywide Savings; and 67,190 suspicious activity frauds reported to the FBI, with a projected record-breaking loss in excess of $4 billion in 2010 (Jorina Fontelera, "FBI Agent Speaker: Mortgage Fraud on the Rise," *The Trusted Professional*, January 2011).

But the magnitude and extent of fraud is even more extensive than these examples imply. The earlier frauds that included Dennis Kozlowski at Tyco and Bernard Ebbers at WorldCom have been superseded by Calisto Tanzi at Parmalat in 2004; Kanebo, which claimed $2 billion of nonexistent profits between 1996 and 2004 (Howard Schilit, *Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports*, McGraw-Hill, 2010, pp. 36–37); Satyam in 2009, where the auditor failed to detect inflated cash and bank balances on the order of $1 billion (Schilit 2010); Allen Stanford, who is currently on trial; Bernard Madoff; Westridge Capital in 2009; Sky Capital in 2011; Marc Dreier (2004–2008); and others.

More troubling is that financial fraud continues to grow, according to the FBI. Statistically, "since 2007 [through 2009] there have been more than 1,700 FBI pending corporate, securities, commodities, and investment fraud cases, an increase of 37% since 2001" (http://www.fbi.gov/stats-services/publications/facts-and-figures-2010-2011/investigative-programs). This fraud occurs despite accelerated oversight of the accounting profession, including the following measures:

- The creation of "white shoe" commissions, such as the AICPA's Fraud Research Steering Task Force

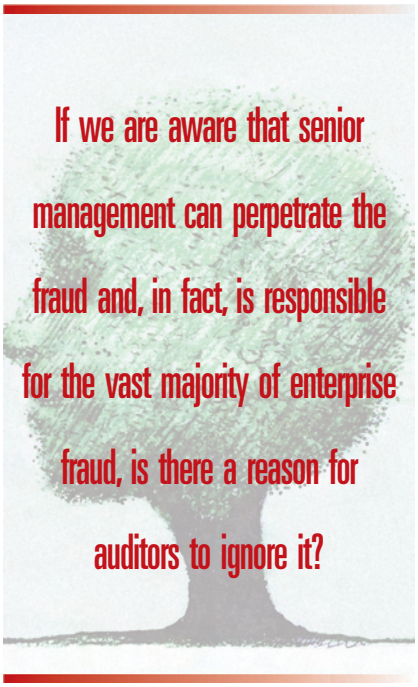
- The AICPA's sponsorship of academic research relating to fraud
- New Statements on Auditing Standards (SAS), including SAS 99, *Consideration of Fraud in a Financial Statement Audit*—issued in late 2002 by the Auditing Standards Board (ASB), which brought the concept of "professional skepticism" to the fraud debate—and subsequent auditing standards released in January 2011 that addressed audit risk
- The establishment of a new oversight committee and the issuance of new auditing standards by the PCAOB, beginning in 2004
- International Standards on Auditing (ISA) on an auditor's responsibility to detect fraud, such as ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
- The Committee on Sponsoring Organizations' (COSO) guidance in late 2005 (COSO, however, chose not to include a discussion on the prevention and detection of fraud, according to the *Practitioner's Guide to GAAS 2009: Covering All SASs, SSAEs, SSARs, and Interpretations*, by Michael Ramos [Wiley, p. 63].)
- The passage of arguably the most sweeping financial reform legislation in more than 70 years, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, leaving the licensure and professional conduct of CPAs to individual state boards
- The upholding of the PCAOB's constitutionality in 2010 (*Free Enterprise Fund v. PCAOB*, 561 U.S. _, 2010).

The Gap in GAAP

The chairman of the International Accounting Standards Board (IASB) Advisory Council, Paul Cherry, said, "We have an antiquated conceptual framework … it is like substance abuse; you have to admit you have a serious problem. Chipping away at the edges isn't going to solve it" ("Accounting Leaders Discuss Simplifying Financial Reporting," *Journal of Accountancy*, July 2009). The SEC's chief accountant of its corporate finance division, Wayne Carnell, echoed this sentiment when he said, "If we could step back and look at issues on a longer term basis, it would help" (*Journal of Accountancy* 2009).

Auditors don't audit for fraud. GAAP and GAAS provide the tools, techniques, and audit processes to ensure the accuracy of financial statements and the financial condition of the enterprise. The GAAP and GAAS rulebooks do not, however, answer the question: "Why are auditors not responsible for uncovering fraud?"

That CPAs are not ultimately responsible for uncovering material misstatements in financial statements is the greatest disparity between the public's perception of an auditor's responsibility and the auditor's actual responsibility to professional institutions. This 100-year-old issue continues to plague the accounting profession in the eyes of the public.



Although fraud is a broad legal concept, for the purposes of GAAS, an auditor is primarily concerned with fraud that causes a "material misstatement in the financial statements, resulting either from fraudulent financial reporting or misappropriation of assets" (SAS 99, redrafted and effective on or after December 15, 2012). In the revised January 2011 auditing standards (not effective until 2013), an audit in accordance with GAAS provides no assurance that illegal acts will be detected or that any contingent liabilities that follow will be disclosed. Even if an audit is properly planned and performed in accordance with GAAS, the inherent limitations of the audit may not detect material misstatements in the financial statements (SAS 99 redrafted, para. A54–A55, Official Releases, *Journal of Accountancy*, January 2011)

That accountants are not responsible for detecting fraud is also one of the most fundamental gaps in contemporary auditing literature. More than 1,000 pages of codified rules are devoted to the 15 auditing standards that the AICPA, the PCAOB, and the SEC define as authoritative. These range from general auditing standards to fieldwork standards, to financial reporting and disclosure requirements. But a discussion of the responsibility that requires auditors to design audits with the intention of uncovering or detecting fraud remains absent from the authoritative literature.

In addition, there is an extensive discussion (more than 200 pages in the authoritative auditing literature) and dozens of reasons why auditors should not be held responsible for detecting fraud, including the notion that "management is frequently in a position to manipulate accounting records and perpetrate a fraud" (SAS 99 redrafted, para. 7). If we are aware that senior management can perpetrate the fraud—a 10-year SEC study proved that almost three-quarters of corporate frauds were committed by a CEO or with a CEO's knowledge—and, in fact, is responsible for the vast majority of enterprise fraud, is there a reason for auditors to ignore it?

What is even more perplexing is that the accounting literature provides substantial guidance and hundreds of examples of how fraud is committed, where fraud has a high likelihood of occurring, and even the conditions and probability of its occurrence; the literature offers a clear road map to guide an auditor in uncovering fraud. The redrafted SAS 99 discusses the auditor's ability to detect fraud:

> Fraud may involve sophisticated and carefully organized schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor … [On the other hand,] the auditor's ability to detect fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated and the seniority of those individuals involved (para. 6).



Management alone is responsible for the financials. As this author has argued before, management bears responsibility for a company's financial statements. (This section has been adapted from "Why Bank and Financial Service Audits Failed," published by Thomson Media Group LLC, Spring 2011.) Over 100 years ago, the concentration of control within corporations and the absence of checks and balances led to a serious debate among economists and business leaders, who worked to develop the structures of the modern corporation and their governing rules. In his early 20th century textbook, *Principles of Economics*, Harvard Professor F.W. Taussig wrote:

> In the United States, where the tradition of checks and balances continues to shape political organization, directors in great corporations are often no more than figureheads, while presidents are benevolent despots … one-man rule has no doubt promoted boldness, efficiency, progress; but it has also concentrated power in a degree to justify uneasiness [and democratic imbalance of power within the corporate structure].

Against a backdrop of the largest global corporate failures in history and recent government removals of a number of autocratic corporate leaders, auditors continue to rely on "amounts based on informed estimates and judgments of management" (SAS 99 redrafted). Auditors continue to place primary responsibility for the prevention and detection of fraud on "both those charged with governance of the entity and management. … This involves a commitment to creating a culture of honesty and ethical behavior" (SAS 99 redrafted, para. 4). Furthermore, AU section 110.03, "Distinction Between Responsibilities of Auditor and Management," confirms that:

> The financial statements are management's responsibility … management is responsible for adopting sound accounting policies and for establishing and maintaining internal control … the entity's

EXHIBIT
Courses in Ethics, Fraud, and Social Responsibility

University	Degree	Number of Required Courses in:		
		Ethics[1]	Social Responsibility	Fraud
University of Texas at Austin	BBA (accounting)	0	0	0
Wharton School at the University of Pennsylvania	BBA (accounting)	0	0	0
University of Illinois at Urbana-Champaign	BS (accounting)	0	0	0
Brigham Young University	BS (accounting)	0[2]	0	0
University of Notre Dame	BBA (accounting)	1[3]	0	0
Leventhal School of Accounting at the University of Southern California	BS (accounting)	0	0	1[4]
Texas A&M University	BBA (accounting)	1	0	1
Kelly School of Business at Indiana University	BS (accounting)	0	0	0
Broad College of Business at Michigan State University	BBA (accounting)	0	0	0
Stern School of Business at New York University	BS (accounting)	0	0	1[4]
Fisher College of Business at Ohio State University	BBA (accounting)	0	0	0
University of Georgia	BBA (accounting)	0	0	0
Arizona State University	BS (accounting)	0	0	0

[1] A required ethics course for accountants would include formal study of the legal, moral, and ethical obligations of accountants; generally accepted accounting principles (GAAP)-compliant versus legally misleading financials; professional responsibility; and other ethical issues.
[2] Ethics for Management (Bus M 390) is not specific to accountants
[3] Ethics in Accounting (Acct 30750)
[4] Detecting Fraudulent Financial Reporting

Source: Top 10 Best Accounting Schools in America (*U.S. News and World Report*), as compiled by the Center for Socially Responsible Accounting

> transactions … are within the direct knowledge and control of management … fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility … the auditor's knowledge of these matters and internal control is limited to that acquired through the audit.

Whether it was Skilling or Fastow at Enron or Jim Basille at Research in Motion, the search to uncover fraud begins and ends at the top. Based on enforcement actions by the SEC between 1987 and 1999, the company's chief executive was involved about 70% of the time (Ken Brown, "Auditors' Methods Make It Hard to Catch Fraud by Executives," *Wall Street Journal*, July 8, 2002, p. c3).

The pattern has repeated hundreds of times and has become the norm rather than the exception. The pattern is familiar: a dominant CEO emerges and packs the board and the company with like-minded executives who owe their position to him and are reluctant to challenge his judgment (Stewart Hamilton and Alicia Micklethwait, *Greed and Corporate Failure: Lessons from Recent Disasters,* Palgrave McMillan, 2006). Hamilton and Micklethwait also state that:

> The dominant CEO may begin, perhaps unconsciously, to behave as though it is his own creation and—as Kozlowski did at Tyco, Ebbers at WorldCom, and Tanzi at Parmalat—use [the company] as his own piggy bank … [That is when] shareholders and the board become irrelevant.

The herd mentality holds no originality in the corner office. Fraudulent practices like Ponzi schemes and overstatements of earnings that generate huge bonuses can be categorized and identified, and their risk factors can be predicted. The journal entries or questionable accounting treatment initiated, reviewed, or approved by CEOs and CFOs whose jobs are under pressure (and who transfer huge amounts from expense to balance sheet accounts or cause the disappearance of liabilities from the financials) are discoverable (Charles Mulford and Eugene Comiskey, "The Financial Numbers Game: Detecting Creative Accounting Practices," Wiley, 2002).

Predicting and Discovering Fraud

As a fellow of the American College of Forensic Examiners, one of the most eye-opening discoveries in this author's educational training was the realization that not only is fraud discoverable, but there are a finite number of fraud scenarios, schemes, and permutations. Fraudsters are really not all that clever, as shown by the following characteristics of fraud:

- "Each business system has a finite and predictable list of inherent fraud schemes."
- "Each inherent fraud scheme has a finite and predictable list of fraud permutations."
- "Each fraud scheme permutation creates a finite and predictable list of fraud scenarios." (Leonard Vona, *The Fraud Audit*, John Wiley & Sons, 2011, p. 29)

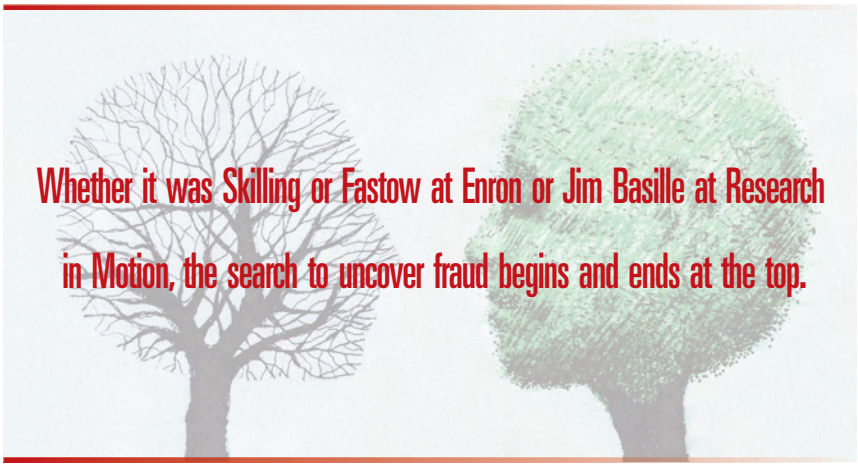
A more reasoned explanation of the failure to uncover fraud is an auditor's lack of training, sophistication, and objectivity, as well as failure of the design of the audit and the auditing firm's standard programs to examine high-risk areas where fraud is traditionally committed. None of the high-profile fraud cases over the past 10 years was highly sophisticated, nor was the perpetrator particularly skilled. (For one example, see "Enron 10 Years Later: Lessons to Remember," by Anthony H. Catanach, Jr., and J. Edward Ketz, *The CPA Journal*, May 2012.)

> A place of defining a difference is that the fraud examiner or fraud-trained CPA would accept less of what they are told by a client or a client's financial team and require more in the way of corroborating documentation, preferably leaning toward third-party evidence. It is perhaps the weighting of evidentiary matter as well as the unrelenting demand of the fraud-trained auditor that keeps looking for clues where the CPA might look less to sleuthing (Eric Kreuter, interview for the Financial Fraud Law Report, February 1, 2011, published April 2011).

Resistance by the Accounting Profession

There exist, of course, additional arguments supporting the idea that the profession cannot assume responsibility for detecting or uncovering fraud; however, if one agrees with George May, one will conclude that none of these explanations relates to the profession's ethical or moral breakdown. Consider the following four arguments:

- Errors in judgment may result in auditors missing fraud.
- Auditors lack the ability to authenticate documents.
- There are substantial legal loopholes (e.g., the *in pari delicto* doctrine of equal fault) that insulate auditors.



- Uncovering audit failures will cost clients too much.

Errors in judgment. "Even with good faith and integrity, mistakes and errors in judgment can be made. … The auditor exercises professional judgment in evaluating the reasonableness of accounting estimates based on information that could reasonably be expected to be available prior to the completion of the field work. As a result of these factors, the auditor has to rely on evidence that is persuasive rather than convincing" (AU section 230.11, "Reasonable Assurance").

It is unconvincing that, for seven years, the treatment of Lehman's repurchase agreements was based solely on information only available prior to completion of



the audit. Having reviewed the 176 pages of MF Global's 10K (issued four months before bankruptcy), this author remains unconvinced that the excessive swings in repurchase agreement arrangements or the CEO's articulation of a radical change in company trading strategy would not have raised some eyebrows with the company's auditors. In another case, that of Olympus Camera, why did it take 11 years to uncover the evidence that a new CEO discovered in his first six months in office?

In addition, many forensic auditors believe that traditional reliance on current auditing practices, such as reviewing internal controls and testing thousands of the company's transactions, are not relevant for detecting fraud and should not be relied on for that purpose; instead, forensic accountants use more effective and efficient practices and procedures.

Lack of ability to authenticate documents. "An audit conducted in accordance with generally accepted auditing standards rarely involves authentication of documentation, nor are auditors trained as or expected to be experts in such authentication" (AU section 230.12, "Reasonable Assurance"). Yet every large public accounting firm has forensic and consulting services designed to provide forensic examination of documents. If documents require authentication, the appropriate services are available. Regardless, document forgery does not seem to be the primary reason why audits over the last three years have failed (other than as one of Marc Dreier's many fraudulent activities).

***The legal loophole of* in pari delicto.** If an accounting firm is deemed complicit in a fraud, the courts in New York State will not intercede. In two major fraud cases, the New York Court of Appeals concluded that the courts would not intercede to resolve a dispute between two wrongdoers ("New York Courts Exclude Auditors from Being Held Liable for Client Actions," *The Trusted Professional*, November 15, 2010, p. 17). In *Kirschner v. KPMG LLP* (15 N.Y.3d 446, 938 N.E.2d 941 [New York, 2010]), a company orchestrated a series of loans that hid hundreds of millions of dollars of uncollectible debt. In *Teachers' Retirement System of Louisiana et. al. v. PricewaterhouseCoopers* (WL 13545, 2011), public accounting firms allegedly participated in carrying out a fraud or were negligent in failing to discover it. The court's conclusion was analogous to the case of an arsonist who, when singed, cannot sue the fire department for failing to put out the blaze (*The Trusted Professional* 2010).

Audit failures will cost too much. In an amicus curiae brief filed on behalf of three of the four largest accounting firms involved in the two cases above, the firms argued that accusing them of failure to uncover fraud would ultimately and improperly transfer the cost to public accountants and would also disincentivize management to police corporate conduct and dramatically expand accountants' liability. In the majority opinion, the court argued that principals, rather than third parties, are best suited to police their chosen agents (*The Trusted Professional* 2010).

The dissent, however, noted that the role played by auditors as gatekeepers serves the public as well as the corporations that contract for such services; thus, it is in the public's best interest to maximize diligence and thwart malfeasance on the part of these gatekeepers. The majority decision invites gatekeeper professionals to neglect their duty to ferret out fraud by corporate insiders because, even if they are negligent, there will be no damages assessed against them for their malfeasance (*The Trusted Professional* 2010).

If one were to add up the cost of audit failures, the total could be in excess of $1 trillion—the lost wages of bankrupt companies (such as MF Global, Lehman, Enron, WorldCom, and others), the value of employee pension funds destroyed, the customer losses aggregated, the losses in mutual funds, and the value of collateralized debt obligations and collateralized mortgage obligations in investor accounts significantly impaired.

The question, of course, is that if auditors can reasonably assess the elements of fraud, then shouldn't they be able to detect it? And if much of the audit work is based on failed audit processes and practices, shouldn't the audit process be changed?



A Watchdog Role

"Confidence in the accuracy of accounting statements is the bedrock of investors' willingness to invest, in lenders' willingness to lend, and for employees knowing that their firms' obligations to them can be trusted" (William McDonough, http://www.sec.gov/news/extra/mcdonough41503.htm). There are no other private or governmental organizations and no global institutions as effective as CPAs when it comes to safeguarding the public interest. Public accounting firms hold one of the most critically important and unique roles in our democratic society as the principal watchdogs of corporate enterprise. Isn't it time to lead rather than follow? ❑

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In Focus





Auditors' Responsibility for Detecting Fraud

Applying Professional Judgment and Maintaining Integrity

By Vincent J. Love

Many forms of government have been tried, and will be tried in this world of sin and woe. No one pretends that democracy is perfect or all-wise. Indeed, it has been said that democracy is the worst form of government except all those other forms that have been tried from time to time.

—Winston Churchill, Speech in the House of Commons, November 11, 1947

Are CPAs who audit an enterprise in accordance with U.S. generally accepted auditing standards (GAAS) responsible for finding material fraud in the financial statements upon which they report? Some say they are, or should be, yet others say that they are not. The first step in addressing this important issue is to answer several questions on the subject.

What Do the Standards Say?

The standards clearly denote that auditors conducting GAAS audits must design audit procedures to obtain reasonable—but not absolute—assurance that the financial statements being audited are free of material misstatement, whether the misstatement resulted from error or fraud. The standards recognize that absolute assurance is not attainable, due to the nature of fraud and the nature of a GAAS audit—that is, testing through various sampling or other techniques, rather than examining all economic events affecting an enterprise's operations, cash flow, and financial position. In addition, the need for an audit to be timely, in order for the financial statements to be useful, and the need for an audit to be performed at a reasonable cost work against an absolute assurance requirement. But this does not mean that an auditor gets a "free pass" when a GAAS audit fails to detect a material misstatement due to error or fraud in the financial statements.



An auditor's performance needs to be evaluated before any blame can be imposed. The auditor's workpapers must demonstrate—based upon an assessment of risk, including an evaluation of internal controls—that the procedures used during the audit were designed to obtain reasonable assurance that the financial statements were free of material misstatement. The standards for a GAAS audit recognize that there is a "high" level of assurance that the financial statements are fairly presented in all material respects in accordance with U.S. generally accepted accounting principles (GAAP) or another accepted accounting framework, and that the risk of the audit opinion being wrong is limited to a "low" level.

GAAP is simply the grammar and vocabulary of the language of accounting, which is used to describe the effect of economic events on an enterprise. It is the framework used in the United States for financial reporting, and it does not establish procedures for an audit or the issuance of an auditor's opinion. If users of financial statements take the time to understand the language and the implications of its use, they will be able to read it, speak it, and thus understand the financial statements. It is not a cause of, nor does it abet, fraud. Circumventing the underlying conceptual principles of GAAP applications can act as the vehicle for committing a fraud, but adhering to bright-line accounting rules is not an element of fraud. The application of reasonable—and not infallible—judgment is required to account for many transactions affecting an enterprise.

Users of financial statements must read and understand the notes to the financial statements to truly understand the numbers and other information displayed on the statements. They are not "footnotes" that give biographical or ancillary information; instead, they are an integral part of the financial statements. The notes should contain all material matters needed for users to understand the statements, including disclosures required by GAAP, GAAS, or SEC rules. GAAP is not a cause of fraud, but the misuse of GAAP by accountants and preparers of financial statements is fraudulent.

It should be understood that procedures applied based on GAAS are not fail-safe; however, they should be sufficiently comprehensive to reduce the risk of issuing a wrong opinion to a low level at an economically reasonable cost. There is a possibility of audit failure, commonly termed "audit risk" (i.e., the risk that the auditor may unknowingly issue a "clean" opinion on financial statements that include material misstatements). If an audit is properly planned and performed, the greater the materiality of the error or fraud, the lower the risk that it will not be detected. The necessary applications of estimates based on judgments increase the risk of error and are fertile ground for anyone seeking to commit fraud.

The standard of due professional care requires that an auditor exercise professional skepticism when conducting an audit. Because management integrity is so vital to the efficacy of a GAAS audit, the audit process needs to be reevaluated—and, in most cases, intensified—regardless of when during an audit a question of management integrity surfaces. A GAAS audit is an iterative process; the discovery of facts or circumstances that lead to questions concerning management integrity, or possible fraud, requires an auditor to reevaluate all areas and phases of the audit process before designing new procedures and proceeding with, or withdrawing from, the engagement. While the standards place significant pressure on an auditor to identify material error or fraud, they also fairly recognize that "fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation" (AU section 316.09, "Description and Characteristics of Fraud"). The standards further recognize the difficulty in detecting fraud caused by collusion among the enterprise's personnel or third parties, forgery, and undisclosed side agreements, among other schemes. This is a realistic assessment of the capability to detect fraud in a GAAS audit.

The major auditing firms have excellent internal programs to train auditors, guidance materials for managing and conducting a GAAS compliant audit, recommended procedures for conducting those audits, and monitoring programs to enforce compliance with the standards and firm policy. When GAAS audits do fail, it is generally because of the recognized GAAS limitations related to testing and deception using forgery, collusion, and other techniques—or the failure of the auditor to adhere to GAAS requirements, most notably in the exercise of professional skepticism and the maintenance of integrity and objectivity throughout the engagement.

In some of the famous financial scandals of the last century, GAAS was either not sufficiently codified or was simply deficient. Recognition of these deficiencies led the profession to make changes in required audit procedures. (*Exhibit 1* identifies the effects of two early cases.)

In this century, Enron and other financial scandals led to changes in auditors' responsibilities related to reporting on internal controls of enterprises regulated by the SEC, as well as the suggestion to consider the use of forensic specialists in certain instances during GAAS audits. The profession has also reacted to public criticism and court decisions by changing its standards.

GAAS has changed and improved in the recent past, especially in areas related to the detection of financial statement fraud and audit risk analysis. This system of reviewing the current standards and suggesting changes to address perceived issues is working. The Auditing Standards Board's (ASB) recent rewriting and clarification of the GAAS standards is an exam-

EXHIBIT 1
Two Early Cases Resulting in Changes to Auditing Standards

Company	Changes to Auditing Procedures
Kreuger & Toll	Helped build support for the Securities Exchange Acts of 1933 and 1934 and, as a result, the requirement that all publicly traded enterprises be audited
McKesson & Robbins	Led to the requirement to confirm receivables and observe inventory, as well as a greater review of internal controls

ple of the resiliency and effectiveness of the established methodology for addressing concerns related to the standards and to fraud detection.

How Does a GAAS Audit Differ from Other Types of Audits?

The performance of a GAAS audit is distinctly different from other types of audits, particularly a fraud audit, investigation, or examination (collectively referred to as a fraud examination).

A fraud examination is an entirely different engagement from a GAAS audit of an entity's financial statements, prepared and presented in accordance with an accepted accounting framework. In a fraud examination, auditors presume that fraud is present. Testing procedures are vastly more intensive than those in a GAAS audit and are designed to detect such fraud. In a GAAS audit of financial statements, the auditor knows that fraud may be present, but focuses on determining whether the financial statements are fairly presented in accordance with an accepted accounting framework.

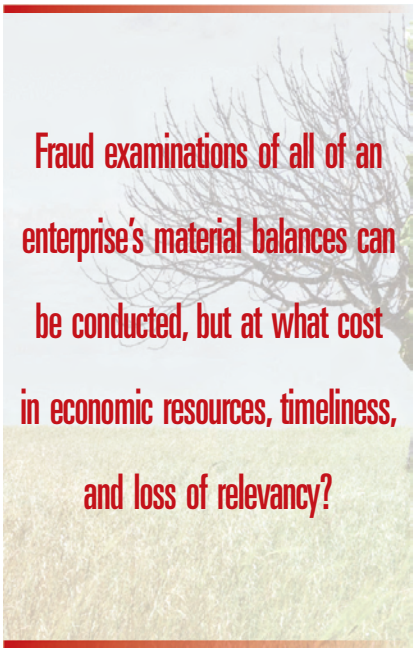
In the preface to *The Fraud Audits*, Leonard W. Vona states:

> I also believe that we need to recognize that fraud auditing is different from traditional auditing by using all the methodologies of traditional auditing, but just applying them differently. … To illustrate the "different" concept, fraud auditing recognizes that the greatest audit procedure in the world will not detect fraud if the sample does not include one fraudulent transaction.

The following sections compare a GAAS audit with a fraud examination, taken from the Association of Fraud Examiner's (ACFE) *Fraud Examiners Manual* and material in AICPA literature. Although fraud examinations and auditing are related, they are not the same discipline. *Exhibit 2* lists some of the principal differences between them.

Both the ACFE and the AICPA agree on the expectations resulting from their members' work—members of the former organization are professionals directly related to the investigation of fraud, and members of the latter are professionals who conduct GAAS audits. The GAAS audit is not directed toward finding fraud, but toward rendering an opinion that the financial statements, taken as a whole, fairly present the enterprise's financial position, results of operations, and cash flows in all material respects. A fraud examination is not a cost-effective alternative to a GAAS audit.

GAAS does give an auditor fraud guidance in the clarified auditing standards under AU-C section 240, "Consideration of Fraud in a Financial Statement Audit." This clarification of the information currently included under AU section 316 sets forth the requirements in a more understandable, logical manner. (AU-C section 240 is effective for audits of financial statements for periods ending on or after December 15, 2012.) Topics covered include insights into the environment that can lead to fraud, evidence to look for in a GAAS audit that may indicate fraud, and the types of additional procedures that can be used to determine if fraud exists. Appendix A to AU-C section 240 includes examples of factors that are conducive to the incidence of fraud. Appendix B includes examples of possible audit procedures to address an assessment of the risk of material misstatements from fraud. Appendix C contains examples of circumstances that indicate the possibility of fraud. GAAS give an auditor guidance to identify, seek, and detect fraud, but it does not guarantee that an auditor fully complying with GAAS will uncover all material errors or frauds due to the nature of fraud and the scope of a GAAS audit.



On February 22, 2007, the Public Company Accounting Oversight Board's (PCAOB) Standing Advisory Group met to discuss forensic audit procedures. This panel found that:

> While AU sec. 316 states that persons with specialized forensic skills may be assigned to the audit in response to an identified risk of material misstatement due to fraud, it does not mandate that forensic accountants participate in audits. As the auditor becomes aware of indications of the possibility of fraud, and as the existence of fraud becomes more likely, the quality of the audit might be enhanced by requiring forensic accountants to participate in the audit process. However, the PAE [Panel on Audit Effectiveness] did not recommend that auditors be required to use forensic accountants, and the Board's interim standards do not include such a requirement (http://pcaobus.org/News/Events/Documents/02222007_SAGMeeting/Forensic_Audit_Procedures.pdf).

In addition, the PCAOB's Auditing Standards (AS) have focused on fraud and ways to detect it in an audit of financial statements—particularly AS 11, *Consideration of Materiality in Planning and Performing an Audit*, and AS 12, *Identifying and Assessing Risks of Material Misstatement,* issued for audits of financial statements for fiscal years starting on or after December 15, 2010.

The general standards require that an auditor exercise due professional care. When faced with an indication of fraud, an auditor should consider involving a forensic specialist on the engagement; however, this is not mandatory, nor is it any different from the requirement for an auditor to apply reasonable professional judgment in the administration and execution of the engagement, including the decision of when to use specialists.

Fraud examinations of all of an enterprise's material balances can be conducted, but at what cost in economic resources, timeliness, and loss of relevancy? To state that a GAAS audit should detect all material fraud, without fail, is to say that the entire audit framework should be changed to presume, at the outset, that fraud has occurred



and to audit accordingly (i.e., to perform a fraud examination). In essence, this places an audit firm in the position of an insurer of the financial statements—a position that has an entirely different and distinct economic structure.

Will Fraud Ever Disappear?

Fraud has existed since the beginning of recorded history. But before asking whether fraud will ever cease to occur, one should examine what fraud actually is. *Black's Law Dictionary* defines it as "a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment." Clearly, knowingly falsifying information presented to a third party in financial statements is fraud.

Fraud has been with us since Biblical times. The talking serpent in the Garden of Eden deceived Eve into eating the forbidden fruit, or so it says in the book of Genesis. One example of early financial fraud from ancient Greek history was related by Isocrates, circa 393 B.C. He told of an Athenian banker who misappropriated deposits, deceived, forged, stole contracts, and bribed others. Instances of fraud occur more frequently today because of the complexity and velocity of business transactions and ever-increasing technological advances.

Fraud will continue to exist, regardless of any economically sound safeguard, because greed is often a part of human nurturing, and human ingenuity knows no bounds. To assume that one can economically audit to find any material or significant fraud in all instances is unsupportable; instead, audit procedures can continually be improved if shortcomings are found—that is what the profession has done and will continue to do. Fraud will never be eradicated or always be detected by performing a GAAS audit, but its occurrence can be reduced substantially.

Who Is Responsible for Fraud?

The answer is simple: the individual or individuals who commit the fraud are responsible for it. But that is not the complete answer. Over the last few years, some individuals have been asking about the auditors' responsibility in the numerous Ponzi schemes that came to light when the sinking economy drained liquidity out of the market. Ponzi schemes differ from other frauds because they usually center on an individual who claims to have something that no one else has (e.g., a methodology or a system). This characteristic goes back to its very namesake, Charles Ponzi. Consider the individual investors in Ponzi schemes. Are they all blameless for their losses? Do they hold any responsibility for their decisions? Not all of them are "widows and orphans"—often, they are well educated or are following the example and advice of those who are supposedly financially sophisticated. Consider the institutions and boards that invested with Madoff: Did they not see the high returns, regardless of market conditions? Was it greed that motivated them? Ponzi schemes exist because of the greed and gullibility of the investors who give their money to the scammer. How much research do they do before making their investments? They share in the responsibility for their own losses.

As for the "red flags" mentioned by those who try to assess blame, one should consider whether they were really red at the time in question. Looking at the Madoff scheme, many commentators mentioned red flags that should have been seen by the feeder fund auditors. One of these claimed red flags was a May 2001 *MarHedge* (a hedge fund trade publication) report by Michael Ocrant, "Madoff Tops Chart; Skeptics Ask How." In this report, Bernard L. Madoff Investment Securities (BMIS) was described as having 600 major brokerage clients and being one of the top three market makers in Nasdaq stocks. The report also stated that if BMIS was mentioned "to anyone working on Wall Street at any time over the last 40 years … you're likely to get a look of immediate recognition." Moreover, the article stated that "Madoff operates one of the most successful 'third markets' for trading equities

EXHIBIT 2
Differences Between Auditing and Fraud Examination

Area	Auditing	Fraud Examination
Objective	The objective is to obtain sufficient competent evidential matter to provide a reasonable basis for forming an opinion on the financial statements.	The objective is to determine whether a fraud has or is occurring, and to determine who is responsible for the fraud. Fraud examinations are performed only with a sufficient basis to presume that a fraud may have occurred.
Scope	The scope of the audit is a general examination of financial data.	The fraud examination is conducted to resolve specific allegations.
Methodology	Audits are conducted primarily by examining financial data using various testing techniques.	Fraud examinations are conducted by examining documents, reviewing outside data such as public records, and conducting interviews.
Presumption	Auditors are required to approach audits with professional skepticism.	Fraud examiners approach the resolution of a fraud allegation by attempting to support or refute the allegation.
Sufficiency of evidential matter	In the majority of cases, auditors rely on evidence that is persuasive rather than convincing.	Fraud examiners attempt to establish proof to support or refute an allegation of fraud.

after regular exchange hours, and is an active market maker in the European and Asian equity markets."

More importantly, this article included a discussion of what some individuals cite as red flags. But how red could those flags have been if they were known to the financial investment community in May 2001 and BMIS continued to grow in size, dealing with the very community targeted by the publication? With 20/20 hindsight, these observations are now tagged as red flags. How can conditions that were obvious to the financial community who dealt with BMIS on a daily basis, yet did not affect BMIS's continuing operations in the financial community, supposedly be a red flag to the auditor of a feeder fund? "Lack of volatility" is specifically addressed in the article: "Even among the four of five professionals who express both an understanding of the strategy and have little trouble accepting the reported returns it has generated, a majority still express the belief that, if nothing else, Madoff must be using other stocks and options rather than only those in the S&P 100."

Qualified and competent investors, among whom were some of the most experienced and well-known leaders in the investment community, looked at the same results, lack of volatility, and operating characteristics of Madoff and BMIS; after evaluating them, they continued to invest with Madoff. In addition, the investors included universities, trusts, and pension and benefit plans, all of which have, or should have, competent investment advice from paid advisors or supposedly competent members of investment or similar committees. There are some questions to consider: Weren't they all looking at the same results? Didn't many of them have in-depth knowledge of investing, and isn't that why they were put on the investment committee? Why didn't they see the red flags that some now claim that the auditors should have seen? This same fact pattern of red flags found in hindsight also existed in many other Ponzi schemes and in allegations against auditors.

In looking at a current financial scandal, some refer to MF Global as an audit failure; however, it is too early to determine what actually happened at MF Global. News reports concurrent with the writing of this article suggest that the diversion of clients' funds occurred in the final days of the company's existence and not throughout its life, where it might have been discovered in a GAAS audit. In many cases relating to recent financial scandals, some individuals have taken the presumptive position that auditors should have detected fraud during their GAAS audits. The work of the auditor, in many of these purported audit failures, has not been fully investigated by an independent organization. Where the failures have been adjudicated, the auditor was either absolved of blame or penalized based on studied analyses of the auditor's adherence to the standards, including the exercise of due professional care.

In many of the publicized business failures, one question that is not always answered or focused on is whether it was a business risk failure that caused the losses. Auditors do not guarantee users of financial statements that the business model is free of risk and not subject to failure. There exists no requirement in GAAS, the auditors' report, SEC rules and regulations, and auditing and business literature for the auditor to be a "guarantor" of the success or failure of a business strategy. It would be impossible to audit a company if the auditor was also responsible for the success or failure of the enterprise's business model.

Has the Accounting Profession Been Held Virtually Blameless?

The accounting profession, far from being held blameless when financial scandals occur, has taken a large share of the blame. But to properly asses blame, one needs to seek the root cause of the fraud. Only in a few rare instances, such as E.S.M. Government Securities Inc. and Wedtech Corporation (and, most recently, the BMIS failure), was an outside auditor actively involved in the fraud. Financial and other officers of an enterprise—that is, the people who perpetrate the fraud—are primarily responsible for the fraud and the resulting third-party losses. The owner-managers of enterprises and others who actively work in the business and are in contact with or supervise the perpetrator(s) might also be responsible.

Auditors should be held secondarily responsible if—and only if—they failed to follow GAAS when auditing the enterprise and did not exercise reasonable professional judgment when planning the audit, designing the audit procedures, and evaluating the audit findings. Consequently, giving an opinion in such circumstances that the financial statements were fairly presented under GAAP or other accepted accounting framework when they were not should subject the auditor to civil or criminal penalties, depending upon the facts.

When evaluating the massive fraud of AIG in *Accounting Ethics … and the Near Collapse of the World's Financial System*, Michael Pakaluk and Mark L. Cheffers state, in part:

> Too often the external auditor is accorded all the blame when circumstances of financial reporting improprieties arise. … Thus any critique of the external audit would have to be focused on actual auditing deficiencies. Yet, while it seems that auditing deficiencies must have existed, the facts and circumstances here point primarily to widespread lack of ethical behavior and professionalism among the internal CPAs throughout the AIG organization.

Many of the individuals who are responsible for deception and misstated financial statements go unpunished, including individuals within the enterprise who turn a blind eye to what is occurring. The enterprise, those directly involved, and the insurer bear the brunt of any civil action; the auditor is also subject to civil litigation for damages and, in some instances, to criminal prosecution.

Should Auditors Be Responsible for Finding Fraud?

A properly executed GAAS audit does not guarantee that the audited financial statements do not contain material error or fraud; a GAAS audit diminishes the risk of material error or fraud existing in the audited financial statements to a low level. The audit should be designed to uncover material error or fraud, should it exist in the financial statements. Auditors must evaluate the reasonableness of management's estimates and judgments in preparing the financial statements to determine if they are indeed "reasonable."

Hindsight is not a proper measure to evaluate the performance of an auditor. The facts and circumstances existing during the audit and at the time the auditor's report is signed need to be evaluated. Moreover, it is true that reasonable people looking at the same set of facts and circumstances can



come to different conclusions. The issue can be framed by the following question: was reasonable professional judgment applied? Simply saying that professional judgment is involved in the process does not mean that an audit failure can never occur; the auditor must rely on reasoned professional judgment soundly based on the facts and circumstances known at the time.

Can the Issue Ever Be Resolved?

The aforementioned quote from Winston Churchill can be paraphrased to describe the world of financial statement auditing: Many forms of auditing have been suggested, and will be suggested in this world of imperfection and fraud. No one pretends that GAAS auditing for financial reporting is perfect or infallible. Indeed, it has been said that a GAAS audit is the worst form of financial statement audit, except all those other forms that have been suggested, but fail to give the desired results—reliable, timely, and economically verified financial data.

Fraud will always be with us, regardless of how much is done to protect against it and detect it. To seek a world where all material fraud will be detected by auditing, whether by following GAAS or other standards or by simply intensifying audit procedures, is comparable to claiming that one can eradicate crime by simply increasing the number of law enforcement personnel. Having the rule of law and auditing to find material fraud substantially reduces the incidence of crime and materially misstated financial statements. No one would suggest that a police state or close examination of every transaction would be a cure for all crime or fraud.

The idea that a fraud examination should set the standard for financial reporting is, at the outset, unrealistic. It is more than just a matter of cost—the timeliness of financial reporting, particularly in today's age of economic transactions geometrically increasing in velocity and complexity, is crucial to its relevancy. Where will all of the auditors who are needed to perform these intense audits in a short timeframe come from? What will they do after the "busy season" is over? What are the real "costs" necessary to develop a sound cost-benefit analysis?

One resolution would be to make the auditor an insurer. Such an auditor could ensure the accuracy of the financial statements, using a given materiality amount to serve as the deductible under the policy and charging a fee for the audit and a premium for the insurance coverage. The insurance fee can vary based on the quality of the financial statements as determined during the audit. The opinion would state the maximum insurance under the policy. The insured amount can be based on a percentage of average market capitalization over a given period, or some other acceptable determination. But will that give the markets and third-party users a better, more reliable and relevant product? This author doubts it.

An auditor is not a guarantor or insurer of the enterprise's financial statements or business model when properly performing a GAAS audit.

A Reliable and Sustainable Methodology

Joseph Wells, the founder and chairman of the ACFE, stated it well when he wrote:

> But these [undetected frauds where accounting firms paid significant sums to settle litigation] don't tell the whole story. CPAs detected countless financial statement frauds, embezzlements and tax offenses *before* they became serious problems ("So That's Why It's Called a Pyramid Scheme," *Journal of Accountancy*, October 2000).

Because of the nature of fraud; human nature and nurture; human ingenuity; the geometric increase in the volume, velocity, and complexity of business and investment transactions; new technological advances; and the need for reliable, relevant, and timely financial reporting, a properly preformed GAAS audit is the best product available or on the horizon, even though in certain instances it can lead to an auditor issuing an erroneous opinion on the financial statements being audited.

When a GAAS audit fails to disclose a material error or fraud in the financial statements, an auditor's performance and implementation of GAAS during the audit needs to be evaluated before blame can be assessed. A GAAS audit is not infallible; however, if it is properly implemented, it does reduce the risk of the auditor issuing an incorrect opinion to a low level. Moreover, an auditor is not a guarantor or insurer of the enterprise's financial statements or business model when properly performing a GAAS audit.

The profession has a reliable and sustainable methodology to address auditing issues and make reasoned changes. In 1931, George May wrote that "the high-minded accountant who undertakes this practice assumes high ethical obligations … none in which the practitioner is under a greater ethical obligation than to persons who are not his immediate clients … to employ accounting as a social force." Despite all that has transpired since, that same spirit is alive today in the AICPA Code of Professional Conduct, specifically in Article III, "The Public Interest."

The profession's standards have been improved significantly since George May and Robert Montgomery practiced auditing. A system is in place that continues to recognize that when change is needed, it will be accomplished. These two giants of the profession would be proud of how far we have come and the quality and efficacy of the current standards. But neither of them professed that auditing could unfailingly detect all frauds, regardless of how sophisticated the fraudulent scheme; they recognized that there were inherent limitations in an audit. ❑

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