



**3rd Biennial Forum of Central Region  
Government Auditors**  
*Innovative Techniques for Governmental Auditors*  
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**The War Against Fraud & Abuse:  
Are We Winning?**

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Dave Cotton is chairman of Cotton & Company LLP, Certified Public Accountants. Cotton & Company is headquartered in Alexandria, Virginia. The firm has a practice concentration in assisting Federal and State agencies, inspectors general, and government grantees and contractors with a variety of government program-related assurance and advisory services. Cotton & Company has performed grant and contract, indirect cost rate, financial statement, financial related, and performance audits for more than two dozen Federal inspectors general as well as numerous other Federal and State agencies and programs.

Cotton & Company's Federal agency audit clients have included the U.S. Government Accountability Office, the U.S. House of Representatives, the U.S. Small Business Administration, the U.S. Bureau of Prisons, and the U.S. Marshals Service. Cotton & Company also assists numerous Federal agencies in preparing financial statements and improving financial management and accounting systems.

Mr. Cotton received his BS in mechanical engineering (1971) and an MBA in management science and labor relations (1972) from Lehigh University in Bethlehem, PA. He also pursued graduate studies in accounting and auditing at the University of Chicago, Graduate School of Business (1977 to 1978).

Mr. Cotton is presently serving on the Advisory Council on Government Auditing Standards. He is a member of the Advisory Council of the Academy for Government Accountability. He is also a member of the advisory board of the Institute for Truth in Accounting. He is serving on the Institute of Internal Auditors (IIA) Anti-Fraud Programs and Controls Task Force, and is a former member of the American Institute of CPAs (AICPA) "Group of 100." He served on the AICPA task force that wrote *Management Override: The Achilles Heel of Fraud Prevention*. He is the past-chairman of the AICPA Federal Accounting and Auditing Subcommittee and has served on the AICPA Governmental Accounting and Auditing Committee and the Government Technical Standards Subcommittee of the AICPA Professional Ethics Executive Committee.

Mr. Cotton served on the board of the Virginia Society of Certified Public Accountants (VSCPA), and on the VSCPA Litigation Services Committee, Professional Ethics Committee, Quality Review Committee, and Governmental Accounting and Auditing Committee. He is member of the Greater Washington Society of CPAs (GWSCPA) and is serving on the GWSCPA Professional Ethics Committee. He is a member of the Association of Government Accountants (AGA) and is past-advisory board chairman and past-president of the AGA Northern Virginia Chapter. He is also a member of the Institute of Internal Auditors and the Association of Certified Fraud Examiners.

Mr. Cotton has testified as an expert in governmental accounting and auditing issues and fraud issues before the United States Court of Federal Claims and other administrative and judicial bodies.

Mr. Cotton served as a technical reviewer for the 1999 through 2003 editions of the AICPA Audit and Accounting Guide *Audits of Federal Government Contractors*.

Mr. Cotton is the author of the AICPA continuing education courses *Fraud in Governmental and Not-for-Profit Audits—the Auditor's Responsibilities Under SAS 82* and *Joint and Indirect Cost Allocations: How to Prepare and Audit Them*. He has lectured frequently on auditors' fraud detection responsibilities under **SAS 99, Consideration of Fraud in a Financial Statement Audit**. He also has been an adjunct instructor at the Inspectors General Auditor Training Institute (*Auditing the Federal Contracting Process* and *Contract and Procurement Fraud*) and currently teaches at the George Mason University Small Business Development Center (*Fundamentals of Accounting for Government Contracts*).



# Notes

## Winning the War Against Fraud & Abuse

- Should auditors be expected to find fraud?
- If not auditors, then who?
- How about management?
- How about "those charged with governance"?
- Maybe the government should do it?
- How about more standards?
- The Answer

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## Should auditors be expected to find fraud?

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## The four possible audit outcomes with respect to fraud ...

1. There was no material fraud
2. There was material fraud, and *the auditors discover the fraud*
3. There was material fraud, and the fraud is discovered through some other means *after the audit is completed*
4. There was material fraud, and *the fraud is never discovered*

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# Notes

Fraud happens.  
 Should we expect auditors to find it?

Financial statement fraud is characterized by ...

➤Chicanery	➤False entries
➤Collusion	➤False exculpatories
➤Concealment	➤False pretenses
➤Cover-up	➤Falsification
➤Deceit	➤Guile
➤Deception	➤Lies
➤Deliberate distortions	➤Misdirection
➤Dishonesty	➤Misrepresentation
➤Evasion	➤Trickery

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Finding fraud is not an even contest

- Auditors have limited powers, tight schedules, constrained budgets, high visibility, and much to try to examine
- Auditors begin their work unaware that a crime has been committed
- Perpetrators know that a crime has been committed and how it was committed
- Perpetrators will take as much time and exert as much effort as necessary to avoid detection

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Finding fraud is not an even contest

- Perpetrators know exactly what needs to be concealed
- Perpetrators know exactly who is trying to find their fraud and how they plan to go about doing it
- Perpetrators will work round-the-clock to avoid detection
- In most cases, the perpetrator's desire to avoid detection far exceeds the auditor's desire to find fraud

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## Notes

Here's what the current standard  
(SAS 99) requires

"the auditor has a responsibility to plan  
and perform the audit to obtain  
reasonable assurance about whether  
the financial statements are free of  
material misstatement, whether  
caused by error or fraud."

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Are auditors getting the job done?

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How about management?

- After all, we all know that it is management's responsibility to design, implement, and maintain a system of strong internal control to prevent fraud, waste, and abuse
- Yes, let's all agree that management should be responsible ...

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# Notes

Quiz #1: What do all of these entities have in common?



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Most of the recent high-profile fraud cases have been management fraud cases ...

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Is management preventing fraud?

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# Notes

## How about "those charged with governance"?

- This is what we're trying under Sarbanes-Oxley for publicly-traded companies
- Old question when fraud happened: Where were the auditors?
- New question when fraud happens: Where was the audit committee?
- Essentially a recognition that management cannot be trusted in all situations

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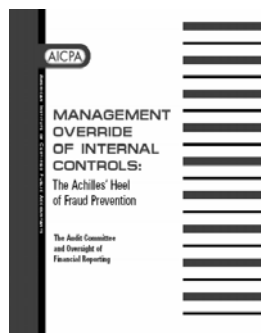
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## New Guidance for Audit Committees



Download at:  
[http://www.aicpa.org/audcommctr/spotlight/achilles\\_heel.htm](http://www.aicpa.org/audcommctr/spotlight/achilles_heel.htm)

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## Management Override: *The Achilles Heel of Internal Control*

- Section A: Management Override and the Audit Committee's Responsibilities
- Section B: Actions to Address the Risk of Management Override of Internal Controls

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## Notes

### **Management Override: *The Achilles Heel of Internal Control***

- Maintaining Skepticism
- Strengthening Committee Understanding of the Business
- Brainstorming to Identify Fraud Risks
- Using the Code of Conduct to Assess the Financial Reporting Culture
- Cultivating a Vigorous Whistleblower Program

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### **Management Override: *The Achilles Heel of Internal Control***

- Developing a Broad Information and Feedback Network
  - *Communications With Internal Auditors*
  - *Communications With Independent Auditor*
  - *Communications With the Compensation Committee*
  - *Communications With Key Employees*
- Appendix: Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks

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### **How about "those charged with governance"?**

- Too soon to tell at the SEC level ...
- There are about 17,000 publicly-traded companies
- There are about 450,000 private companies, not-for-profits, and state/local governmental entities .... Most do not have audit committees, some do not have boards
- How good is the typical non-SEC board?

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# Notes

## The Smithsonian Board

- John G. Roberts, Jr., Chief Justice of the United States
- Richard B. Cheney, Vice President of the United States
- Thad Cochran, Senator from Mississippi
- Christopher Dodd, Senator from Connecticut
- Patrick J. Leahy, Senator from Vermont
- Xavier Becerra, Representative from California
- Sam Johnson, Representative from Texas
- Doris Matsui, Representative from California
- Eli Broad, Chairman of AIG Retirement Services, Inc.
- Anne d'Harnoncourt, Chief Executive Officer, Philadelphia Museum of Art
- Phillip Frost, former Chairman and CEO of IVAX Corporation
- Shirley Ann Jackson, President of Rensselaer Polytechnic Institute
- Robert P. Kogod, former CEO of the Charles E. Smith Companies
- Walter E. Massey, President of Morehouse College
- Roger W. Sant, Chairman Emeritus of The AES Corporation
- Alan G. Spoon, Managing General Partner of Polaris Venture Partners
- Patricia Q. Stonesifer, President of the Bill & Melinda Gates Foundation

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Can we rely on "those charged with governance" to stop fraud and abuse?

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Maybe the government should do it?

- Sure, let's let the government do it
- The government's doing a real good job at other things ...
- Like crime-prevention, education, spending money ...
- Look at the great job the SEC has done to prevent fraudulent financial reporting since 1934 ...

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# Notes

Can we trust the government to stop fraud?

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How about more standards?

- Sure, this *HAS* to be the answer
- We need more auditing standards and more accounting principles

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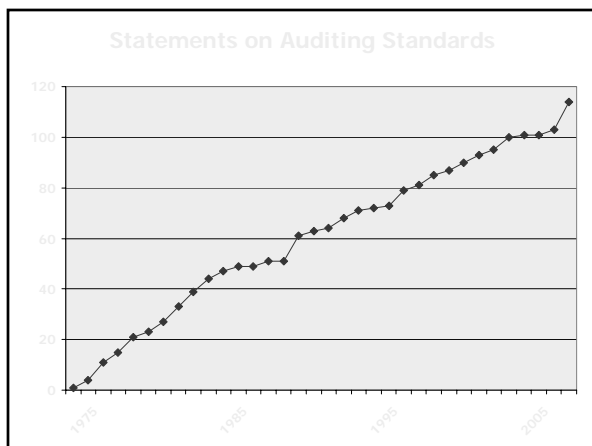
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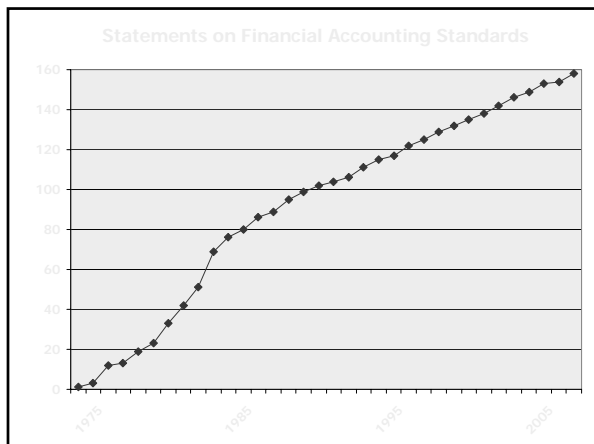
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# Notes




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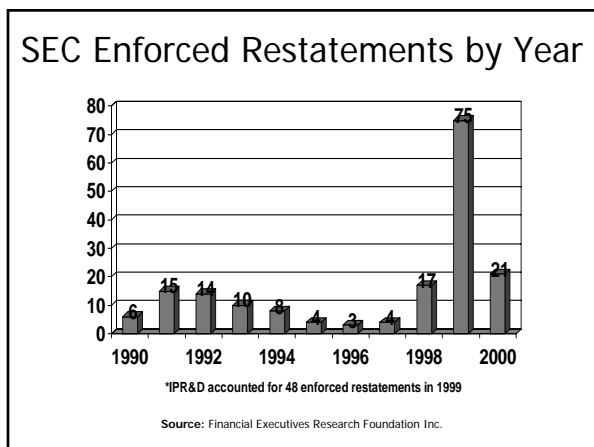
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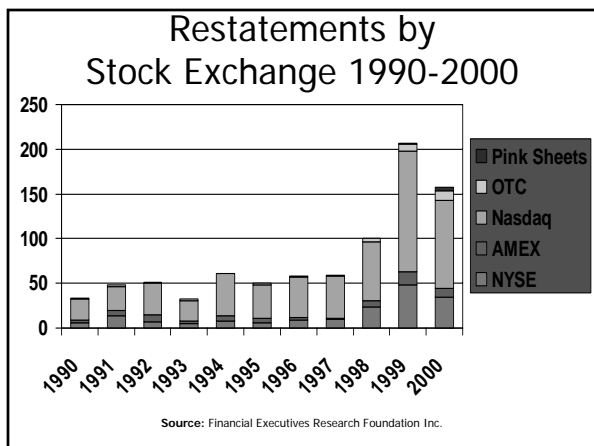
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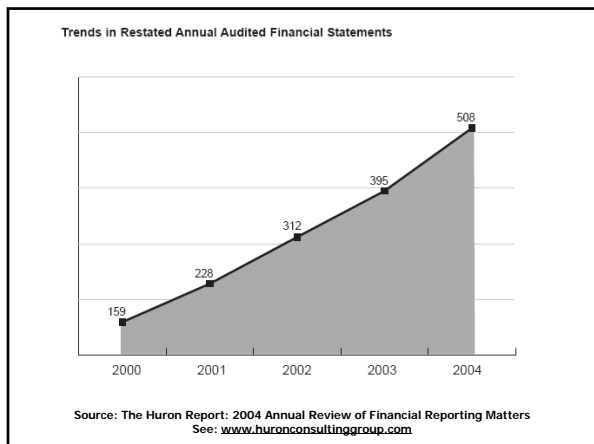
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# Notes




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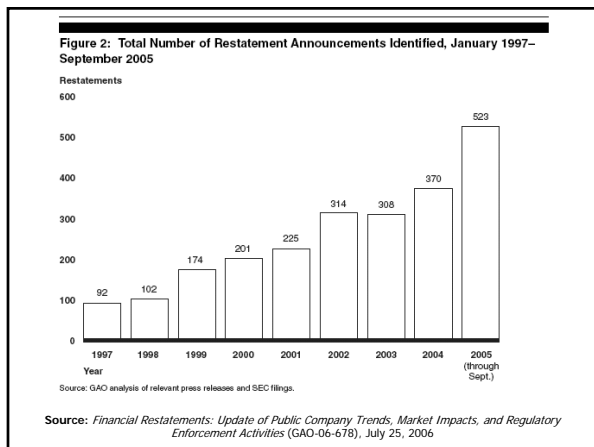
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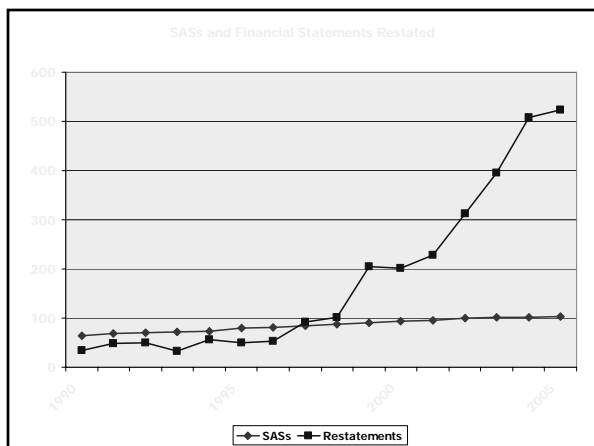
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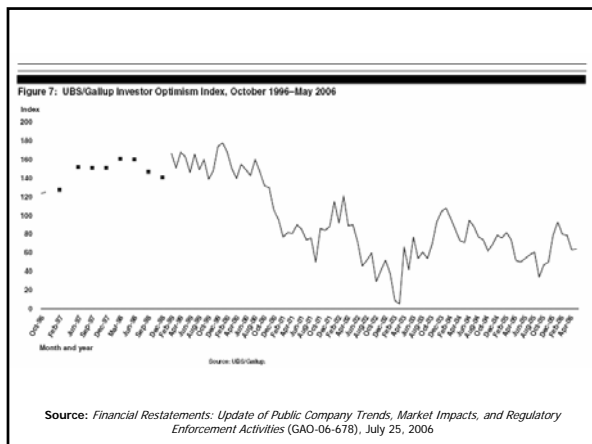
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# Notes




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Will adding more standards put an end to fraud?

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One more thought on all those auditing standards ...

- We have had 114 SASs since the ASB was formed in 1973
- How many dealt specifically with fraud and illegal acts?
- Just 5: SAS 16, 53, 54, 82, and 99 (just 2 still in effect)
- So, we've had 109 SASs focused on finding mistakes?

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## Notes

### One more thought on all those auditing standards ...

- In the Bob Kratchet, green eyeshade accounting era, maybe 109 SASs focused on finding errors was a good idea ...
- But, in the age of automated accounting and electronic data processing????
- Maybe we *COULD* use a few more SASs focused on finding fraud
- Just a thought ...

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### The Answer: Comprehensive anti-fraud programs and controls

- Deterring, preventing, and detecting fraud needs to be a comprehensive and concerted effort by all involved

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### The IIA Anti-Fraud Task Force

- Chaired by Dave Richards, IIA CEO, and Ron Durkin, KPMG Forensic Partner
- Developing a comprehensive guide for organizations committed to implementation of the strongest anti-fraud measures possible
- Currently being drafted
- Expected to be vetted by endorser and supporter groups by September 2007
- To be issued by November 2007

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## Notes

### Working Title: "Managing Fraud Risk"

- 1: Introduction
- 2: Governance, Ethics, And Fraud Prevention
- 3: Risk Assessment
- 4: Prevention
- 5: Detection
- 6: Investigation
- Appendices

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### The IIA Anti-Fraud Task Force

- Send me any comments, suggestions, questions, or suggested titles:  
[dcotton@cottoncpa.com](mailto:dcotton@cottoncpa.com)

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### End Thoughts

- Fraud is VERY difficult to prevent
- Even harder to detect
- No single player in our free market system should be held singularly responsible
- We ALL need to be involved in the fight

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# Notes

## End Thoughts

We have the strongest capital market in the world.  
It is the engine of productivity and progress.  
Imagine how much stronger it will be when we stamp out fraudulent financial reporting and draw more capital from totally confident investors around the globe.

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