

# **Ferreting Out Fraud and Abuse: New Tools and Standards for Auditors**

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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 board of the Institute for Truth in Accounting. He is serving on the American Institute of CPAs (AICPA) Anti-Fraud Programs and Controls Task Force, and is a former member of the AICPA "Group of 100." 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 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 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

## The Plan for Today

- ✓ New fraud standards for auditors—  
Dave Cotton
- ✓ New fraud detection tools for  
auditors—John Kelly

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## New Fraud Standards for Auditors

- ✓ Historical overview of the audit profession's  
fraud detection standard-setting "efforts"
- ✓ Quick recap of where we are today
- ✓ The future:
  - ✓ Management override—the Achilles' heel of  
fraud prevention
  - ✓ Fraud standards on the horizon
  - ✓ Anti-fraud programs and controls—attestable  
criteria

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## A Brief History ...

- ✓ Void            In the beginning ...
- ✓ Void + 6        The first auditors
- ✓ Void + 7        The first audit failure
- ✓ 1973            SAS 1 (The Sergeant Schultz era)
- ✓ 1977            SAS 16 (no promises)
- ✓ Oct 1986        House Government Operations  
Committee Report on  
"Substandard CPA Audits ..."
- ✓ Mar 1987        Steinberg Task Force Report on  
Audit Quality

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# Notes

## A Brief History ...

- ✓ Oct 1987 Treadway Commission Report
- ✓ Apr 1988 Expectation Gap Auditing Standards (SAS 52-61)
- ✓ Jul 1988 Revised *Yellow Book*
- ✓ Jan 1990 Mandatory CPE and quality review
- ✓ Dec 1993 Miller Task Force Report (followup on the Steinberg Task Force findings)
- ✓ Jul 1997 SAS 82 Issued
- ✓ Oct 2001 Enron happened
- ✓ Feb 2002 Revisions to SAS 82 exposed by ASB

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## A Brief History ...

- ✓ Feb-May 2002 Congress conducted a bazillion hearings about auditing and audit quality
- ✓ May 2002 Just when everything was starting to calm down ...
- ✓ June 2002 WorldCom hit the fan
- ✓ June 2002 Andersen convicted
- ✓ Jul 2002 Sarbanes-Oxley Act becomes law
- ✓ Oct 2002 Public Company Accounting Oversight Board (PCAOB) formed
- ✓ Oct 2002 SAS 99 issued
- ✓ Nov 2002 Public opinion polls indicated that CPAs rank below lawyers and used-car salesmen (and just above pond-scum) in public trust

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## The Sergeant Schultz Era: SAS 1 (1973)

- ✓ “the ordinary examination ... is not primarily or specifically designed, and cannot be relied upon, to disclose [fraud], although [its] discovery may result.”
- ✓ “the responsibility ... for failure to detect fraud ... arises only when such failure clearly results from failure to comply with GAAS.”
- ✓ I.e. we have no responsibility

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# Notes

## SAS 16 (1977)

- ✓“the auditor has the responsibility, within the inherent limitations of the auditing process, to plan his examination to search for errors or irregularities...”
- ✓“the auditor is not an insurer or guarantor; if his examination was made in accordance with GAAS, he has fulfilled his responsibility.”
- ✓I.e. we provide no assurance

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## SAS 53 (1989)

- ✓“the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.”
- ✓“because of the characteristics of irregularities ... a properly designed audit may not detect a material irregularity.”
- ✓I.e. we provide reasonable assurance

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## SAS 82 (1997)

- ✓“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.”
- ✓“even a properly planned and performed audit may not detect a material misstatement resulting from fraud.”
- ✓I.e. we provide reasonable assurance

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# Notes

## SAS 99 (2002)

- ✓ “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.”
- ✓ “even a properly planned and performed audit may not detect a material misstatement resulting from fraud.”
- ✓ I.e. we provide *reasonable assurance*

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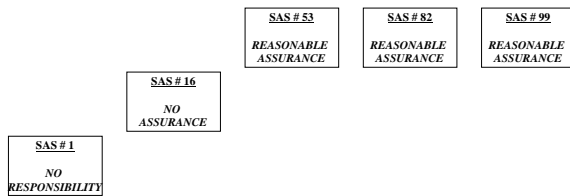
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## Fraud Standards Evolution

1973                  1977                  1989                  1997                  2002



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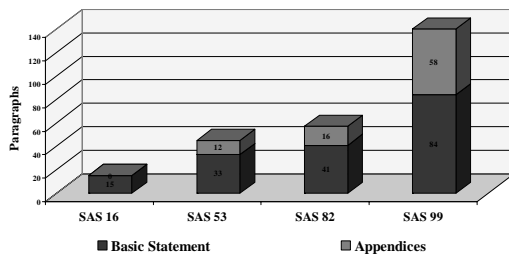
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Evolution of the Fraud Standard: Number of Paragraphs



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# Notes

## Is There a Void in Existing Standards and Guidance?

Most of the existing guidance discusses fraud, in general, and misappropriation of assets/employee fraud; with little emphasis on fraudulent financial reporting/management fraud

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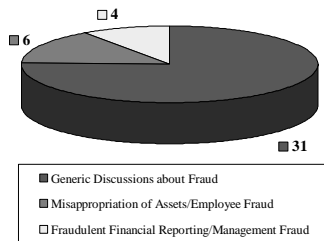
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SAS 82 Paragraphs



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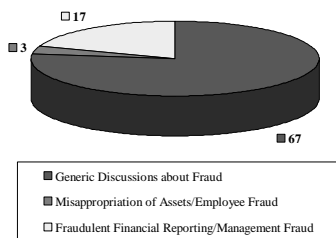
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SAS 99 Paragraphs



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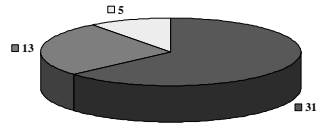
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# Notes

## Management AntiFraud Programs and Controls Paragraphs



- Generic Discussions about Fraud
- Misappropriation of Assets/Employee Fraud
- Fraudulent Financial Reporting/Management Fraud

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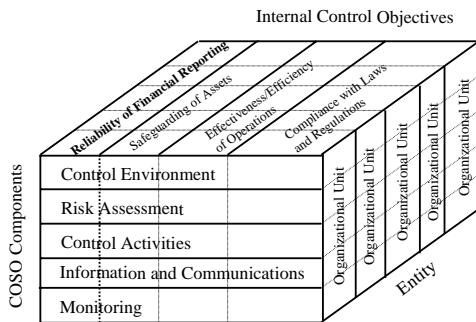
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## The COSO Framework



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## COSO Enterprise Risk Management Framework



“Fraudulent and questionable financial reporting” is mentioned just once in this 152-page document; “management fraud” is not mentioned at all.

↪ FFR is a smaller slice of this slice

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# Notes

## SAS 99: Highlights

- ✓ More emphasis on professional skepticism
- ✓ Discussions among engagement personnel
- ✓ More inquiries about fraud
- ✓ Reorganized *fraud risk factors* (the **Fraud Triangle**)
- ✓ Revenue recognition
- ✓ Dealing with management's ability to override controls
- ✓ Communications (no change)
- ✓ Documentation

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## Dealing with Management's Ability to Override Controls

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What do all of these entities have in common?

Adelphia

MCI WORLD.COM

Barings Bank

ZZZZBest

Qwest

Global Crossing

MiniScribe

Orange County

Sunbeam

MicroStrategy

Arizona Baptist Foundation

RITE AID

WMA

tyco

XEROX

PHARMOR

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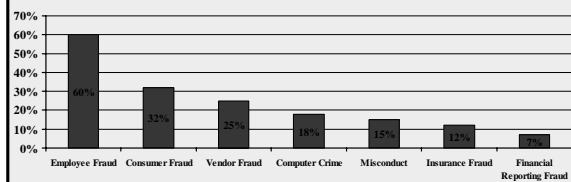
# Notes

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

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## KPMG Fraud Survey 2003

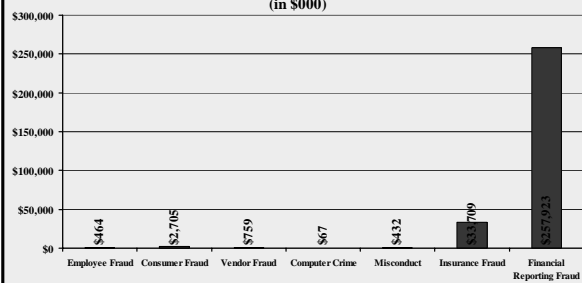
Percentage of Frauds by Type



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## KPMG Fraud Survey 2003

Average Annual Cost by Fraud Type  
(in \$000)



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# Notes

## Is There A Void In Existing Standards and Guidance?

Most of the existing guidance discusses fraud, in general, and misappropriation of assets/employee fraud; with little specific emphasis on fraudulent financial reporting/management fraud

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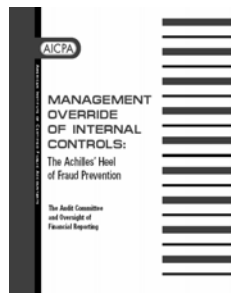
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## The Durkin Task Force's Initial Product



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 <sup>29</sup>

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## **Fraud Standards on the Horizon?**

- ✓ From AICPA/ASB?
  - ✓ Nothing specific in process
  - ✓ SAS 99 still considered a strong standard
- ✓ From GAO?
  - ✓ New yellow book will include sections emphasizing the importance of SAS 99
  - ✓ But, no new requirements

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# Notes

## Fraud Standards on the Horizon?

- ✓ From PCAOB?
  - ✓ Staff published a paper, *Financial Fraud*, in September 2004 that sets a framework for a PCAOB auditing standard on fraud detection
  - ✓ Staff published a paper, *Risk Assessment in Financial Statement Audits*, in February 2005 that discusses risk-based auditing in general, but does not focus specifically on fraud risk
  - ✓ These are on the PCAOB web site ([www.pcaobus.org](http://www.pcaobus.org)) or email me ([dcotton@cottoncpa.com](mailto:dcotton@cottoncpa.com))

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## Fraud Standards on the Horizon?

- ✓ From PCAOB?
  - ✓ Possible fraud detection standard
    - ✓ Would embrace SAS 99 concepts
    - ✓ Remove much if not all of the exculpatory language
    - ✓ More of an inspection focus
    - ✓ Possible mandatory involvement by forensic accounting specialists

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## New Anti-Fraud Guidance on the Horizon

- Attestable criteria for assessing the existence, operation, and quality of an entity's antifraud programs and controls
- Started as an AICPA Achilles' Heel Task Force effort
- Will likely be taken over by IIA and (hopefully) become a COSO-endorsed product
- A new practice area for CIAs, CPAs, and CFEs?
- A "good governance" seal of approval by IIA, or AICPA, or ACFE?

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