

# Can Financial Statement Auditors Detect More Fraud? How Can PCAOB Make that Happen?



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# My Firm's Perspective



- Three-Party Audits
  1. The audit firm (Cotton & Company);
  2. The client who hires the audit firm (usually an independent IG);
  3. The “client” we audit (grantee, contractor, agency, program).
- We enjoy considerably more independence than in a two party audit situation (party 1, the audit firm, is hired by party 2 to audit party 2)
- The parties that hire us WANT us to find fraud if its there.
- We find fraud, because we are incentivized to find fraud. The clients that hire us have an explicit mission to find fraud, waste, and abuse.

# What do we do to maximize the probability of finding fraud if it's there?



- Maintain a high degree of professional skepticism (required by SAS 99)
- Fraud brainstorming (required by SAS 99)
- Fraud inquiries (required by SAS 99)
- Data analysis techniques (not specifically required by SAS 99)

# The Issuer Audit Model Has Changed



- Pre-PCAOB: two party audits (CFO usually on the audit committee)
- Post-PCAOB: three party audits (sort of). (Is the independent audit committee really a third party?)

***A good area in which to conduct some research...***

# Do the CPA firms that PCAOB oversees have the capability to find more fraud?



- Absolutely.
- Why don't they apply that capability?
  - Lack of strong positive incentives
  - Competition and liability concerns

# Lack of strong positive incentives



- Not much good accrues to an audit firm that finds that the entity it is auditing is perpetrating fraud—most especially when the fraud is being perpetrated by senior management.
  - No financial rewards—in fact, more likely significant losses
  - No positive recognition

# Competition and liability concerns



- Performing forensic procedures costs more
- Performing forensic procedures—even inexpensive ones—exceeds what standards require
  - If you perform extra procedures in one audit, you'd best perform them in all audits

# Data Analytics We Use



- Duplicate Payment Review
- Benford's Law Analysis
- Debarred Vendor Check



# Data Analytics We Use



- Others as deemed appropriate, for example:
  - General ledger accounts with unnatural balances
  - Approved transactions that are above credit limits
  - Match employee and vendor databases
  - Transactions posted after-hours or on weekends
  - Creditors that have debit balances
  - Accounts receivable/payable aging by vendor
  - Write-offs by salespeople
  - Invoices that do not have purchase orders
  - Manual journal vouchers (by person, date, or amount)

# Case Studies—Three Examples (In Appendix)



- Data analysis in audit of federal agency financial statements
- Data analysis in audit of claim in litigation
- Benford's Law use in a performance audit of construction management

# Additional Possibilities to Consider



- **Continuous Auditing (CA) for fraud**
  - Transactions routed to outside auditor before final entry to GL or journals
  - Outside auditors use CAATs to run (secret) tests on transactions
  - Anomalous transactions are subject to further analysis

# Additional Possibilities to Consider



- Artificial Intelligence (AI) and data mining
  - SAS 99 requires identification of Fraud Risk Factors (FRFs)
  - Historically-known fraud schemes can be used to develop a database of scheme and FRF correlations (when this scheme occurred, these FRFs were present)
  - Develop software that correlates FRFs identified during an audit with historically recognized fraud schemes

# Additional Possibilities to Consider



- Artificial Intelligence (AI) and data mining
  - Software alerts auditors to specific fraud schemes with high degree of correlation
  - Software predicts vulnerable accounts
  - Software suggests additional audit procedures to consider

# Additional Possibilities to Consider



- Require specific evaluation and testing of anti-fraud controls (as a supplement to IC testing)
- Anti-fraud control *suitable criteria* are contained in *Managing the Business Risk of Fraud: A Practical Guide* (See Appendix)
- Require expanded audit procedures when anti-fraud controls are missing or not working

# Fraud Risk Management



- Internal control is a management responsibility
- Fraud risk management is a management responsibility
- Revised COSO Framework now explicitly requires an assessment of fraud risk (Principle #8)
- Auditors should be explicitly required to evaluate management's fraud risk assessment/management
- Easy revision to SOX 404 Regulation to explicitly require fraud risk to be addressed by management (and auditor)


# Additional Possibilities to Consider



- Most common means of fraud detection: tips from employees of the victim organization—more than 40% of cases (*2014 ACFE Report to the Nations*)
- Require establishment of a fraud hotline as part of the audit process
- Entity employees are informed of the hotline and encouraged to report known or suspected questionable actions by management



# Additional Possibilities to Consider

- 
- Require an assessment of the governing board's oversight of management
  - Does the board actively carry out procedures designed to assure that management is not circumventing controls? (See *Management Override—The Achilles' Heel of Fraud Prevention*) (See Appendix)
  - Residual benefit: boards will become more actively involved in fraud prevention and detection—AND convey to auditors that the board wants them to find management fraud

# Additional Possibilities to Consider



- Focus on changing the dynamics associated with auditors detecting fraud
  - Finding that a client committed fraud can have deleterious impacts on the auditor
  - Until auditors are *rewarded* for finding fraud, not much will change
- Why don't CPA firms run ads saying that they are tough, and good at finding fraud?

# Two Overarching Challenges



1. There are disincentives for auditors to carry out more fraud detection procedures
  - Many firms believe that going beyond what GAAS requires exposes them to liability
  - Fraud detection procedures can be time-consuming and expensive; audits are viewed as a commodity—i.e. why pay more for an audit than you have to; so price competition makes extra procedures commercially impractical
2. If you put *specific* fraud detection testing procedures in a standard, it negates the effectiveness of the procedures

# Recommendations



1. Work to create an environment where audit committees want to hire tough auditors and hire on a best value basis rather than a low bid basis
2. Revise auditing standards to require use of data analysis tools
3. Require auditor's to specifically evaluate the entity's fraud risk management procedures
4. Require auditors to specifically evaluate the board's oversight of management override risks
5. Pilot test continuous auditing
6. Pilot test auditor use of hot lines

# Contact Information



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# APPENDIX



- Data Analysis Case Studies
- Managing the Business Risk of Fraud: A Practical Guide
- Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention

# Data Analysis in Federal Agency Audit



- Tests for duplicate payment to funding recipients identified two duplicate payments: one for \$289,499 and another for \$36,216
- The agency recovered \$325,715 (an amount equal to approximately half of our audit fee)
- Just as important were the internal control improvements that resulted from this finding

Data Analysis Case Study:  
*Claim Against the United  
States*



# Auditing the Claim

- Using data analysis techniques, we identified duplicated, triplicated, and scrapped equipment in the claim totaling *at least* 3% of the claim.

# Contract Claim against the United States

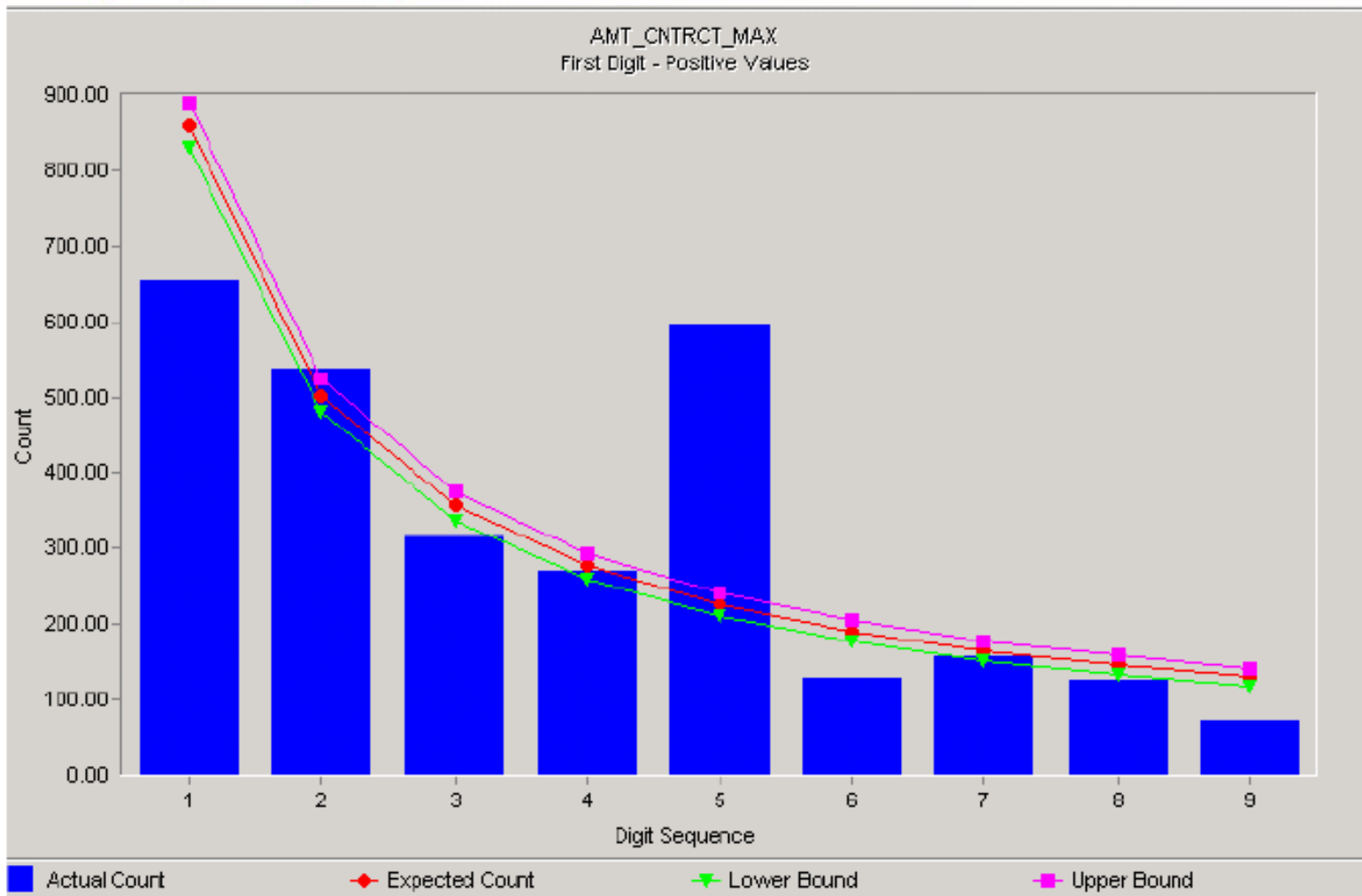
- ALL of the claim was denied
- The Court entered judgment in the Government's favor under fraud counterclaims pertaining to:
  - The fraud provisions of the Contract Disputes Act
  - The False Claims Act
  - The Special Plea in Fraud (Fraud Forfeiture)
  - Fraud in the Inducement (bait & switch)
- The contractor was ordered to pay the Government approximately 79% of the claim
- The contractor's appeal was denied
- The contractor reached a settlement with the Government to get removed from the excluded party list

# Benford's Law use in a performance audit of construction management

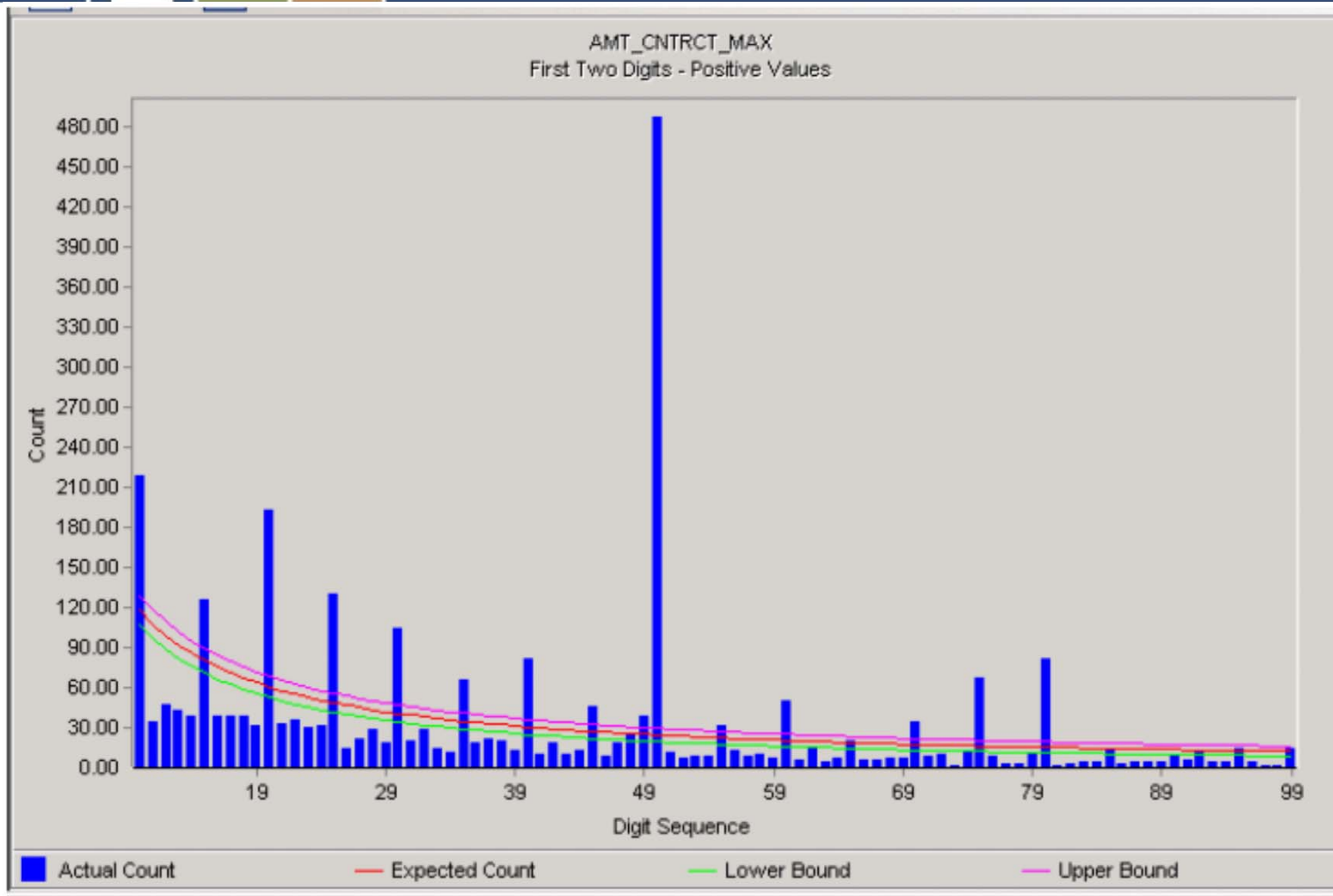


- Performance audit of a local government's Construction Management
- The policy allowed sole source contracting up to \$50,000; limited (3 bids) competition from \$51,000 to \$200,000; and full and open competition above \$200,000
- Benford's Law analysis of contract amounts revealed anomalies

# Benford's Law use in a performance audit of construction management



# Benford's Law use in a performance audit of construction management



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## Managing the Business Risk of Fraud: A Practical Guide

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Published in 2007;  
Currently being updated and  
modernized

Cotton &  
Company  
*Answers Questioned*

# *Managing the Business Risk of Fraud: A Practical Guide*



# Guidance for Audit Committees





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## MANAGEMENT OVERRIDE OF INTERNAL CONTROLS:

The Achilles' Heel  
of Fraud Prevention

The Audit Committee  
and Oversight of  
Financial Reporting



Published in 2005;  
12 pages; 19 pages with  
appendices