



FORENSIC INSIGHTS

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FRAUD VS. THE AUDITOR: “NO CONTEST”

It is no secret that auditors are not well suited to deal with white collar crime which is firmly rooted in fraud. The auditor’s mind set and training leave them ill prepared to discover the malicious intent that distinguishes between the honest mistake and fraud. This article introduces the auditor to a fraud in hopes of developing an awareness of this complex problem and guidance on how to deal with it.

The Genesis of White Collar Crime

White collar crime has become a national epidemic since its genesis in the early 1970s. Its legacy is untold losses suffered by businesses, individuals and the government. The cost of white collar crime is included in everything we purchase. Three of the factors contributing to the proliferation of white collar crime are:

- (1) It is extremely profitable;
- (2) Complex schemes by sophisticated individuals make detection difficult; and
- (3) The remote likelihood of prosecution and the resulting punishment encourages such activity.

Plainly said, the payoff far exceeds the realistic imposition of fines, penalties or prison sentence. White collar criminals live in an opulent lifestyle while the “con” is operating. They bankroll their legal defense fund as well as their next scheme. In many cases their next “enterprise” is launched before the present scheme is put to rest. Long range planning is an integral part of white collar crime.

The absence of any “smoking gun” type evidence is typical. More importantly, the culprits involved are not generally recognized as criminals. For example, a masked gunman in a bank puts everyone on notice that a crime is being committed. Detection is not a problem in a bank robbery. However, when the culprit wears an expensive suit and diverts the assets of a corporation through a maze of complex transactions detection is another matter. Compounding the problem is the schemes often use the auditor’s inability to detect fraud as part of the fraud. Audit opinions are routinely provided as evidence that everything is on the “up and up”.

Fraud Is Deception

Fraud is the cornerstone of white collar crime and plainly stated it is a perversion of the truth, with concealment, for one’s own gain or advantage. This deceit almost always includes the contrived appearance of the criminal as a good upstanding business person who is sincere and trustworthy. This ruse is the first assault on the victim and the last resort used against the jury who struggle perceiving the accused as a criminal.

Although white collar crime is often disguised as a legitimate business failure, it is intentional and as criminal as a coldly calculated bank robbery. Every facet of the fraud is carefully planned and “camouflaged” by complex transactions and financial records. Collusion among co-conspirators cripples the effectiveness of control procedures and thwarts the reliability of independent audits. Fraudulent schemes are engineered

to avoid detection by anticipating each counter measure or control procedure.

Detecting fraud requires a unique blend of auditing and investigative skills. Investigators lack the necessary auditing expertise to analyze complex transactions and financial records.

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On the other hand, auditors do not have the investigative skills, such as interviewing, required to establish intent.

A typical scenario is one where the auditor faces a culprit who is very credible, sophisticated, and intelligent. Fraudulent schemes are designed to wear the auditor out by continuously placing obstacles in their way. Great pains will be taken to “create” evidence which tends to legitimize an otherwise fraudulent transaction. Schemes take into consideration the “mind set” of the typical auditor and provide enough apparently legitimate documentation to satisfy their professional curiosity.

Forensic Accounting

Forensic accounting bridges the gap between the auditing and investigative disciplines and provides the necessary resources to effectively deal with fraud. What is forensic accounting? Unfortunately the term is commonly used and often misunderstood. The key element to forensic accounting is the development of evidentiary material that establishes intent. Intent is the motivation behind a particular act and is evidenced by material which frequently is beyond the scope of a routine audit. A good example is the testimony of individuals having knowledge of a particular transaction or relationship. A routine audit does not question why a representation is made or a transaction occurs. There is much more to a forensic accounting than “debits on the left and credits on the right”, the inquiry does not conclude when things balance.

Routine audit procedures are not effective in dealing with fraud. The purpose of routine audit procedures is to gather competent and substantial evidence in order to render an opinion on the fairness of management’s representations. Fraud attacks the reliability of this basic financial information. Misrepresentations and falsehoods are used to distort the truth. Informed decisions cannot be made based on jaundiced information colored by fraud. Many times these informed decisions would include looking into the affairs of the culprit and thus fraud avoids detection.

Detecting Fraud

Fraud generally is a continuing endeavor, causing more damage with the passage of time and therefore must be detected as soon as possible. The auditor can improve his or her ability to detect fraud by recognizing certain indicators which are generally present.

1. First the auditor must change his or her mind set or perspective, remain alert for fraud, and ask the following questions:
 - A. What incentive is there to misrepresent a particular situation?
 - (i) monetary advantage,
 - (ii) continued control, or
 - (iii) continued regulatory approval.
2. How susceptible is the transaction or situation to fraud?
 - A. Misappropriating cash as opposed to selling real estate, or
 - B. Adequate internal controls
 - C. Is the information independently reviewed.
3. What is the likelihood of collusion?
4. What are the ramifications of a defalcation?
5. What is the big picture (not necessarily the details)?
6. Is there any hesitancy on the part of management to provide information.
7. The following documentation may provide valuable insights.
 - A. Financial statements, annual (audited preferably), quarterly or monthly, especially those near year end when manipulations are more common. Pay particular attention to footnote disclosure for pertinent details, such as related party transactions of bogus assets.



A common mistake made by auditors in fraud examinations is too much emphasis on documentary evidence. Fraud depends on deceit which frequently translates to false documentation

- B. Regulatory filings such as 10Q and 10K reports or tax returns.
- C. Select audit workpapers, including management letters, proposed audit adjustments, internal control

evaluations, pending or threatened litigation confirmations, and predecessor auditor contacts.

D. Board of Directors minutes of meetings.

E. Accounting records such as the cash disbursements ledger, general journal, and general ledger. In conjunction with these records the source documents, such as monthly bank statements, cancelled checks and deposited items are very important.

F. Internal management or audit reports.

Trust Your Instincts

A basic rule is to trust your instincts. Many times a situation does not seem right. This appearance may be based on a combination of factors. The following may indicate fraud and should be investigated further.

1. Material changes in:
 - A. The capital or equity structure,
 - B. Liquid assets, particularly where cash or cash equivalents are converted to notes, obscure securities or investments in affiliates,
 - C. Revenue, expense or net income (especially increases),
2. Unusual or extraordinary events disclosed in the footnotes to the financial statements,
3. Related party transactions with officers/directors, shareholders, or affiliates,
4. Related accounts balances which do not agree, for example:
 - A. Investments compared to interest/dividend income,
 - B. Accrued income as opposed to actual income,
 - C. Accounts receivable compared to sales, or cash collections.
 - D. Real estate value compared to historical cost.
5. Expenses for legal expenses, consulting or management fees, or unusual expenditures.

Developing Intent

The key ingredient in detecting fraud is the ability to prove the intent of the culprit. A common mistake made by auditors who embark on a fraud examination is placing too much emphasis on the documentary evidence. It is important to remember that fraud depends upon deceit which frequently translates into false documentation. Much of the auditors ability to identify fraud will depend on testimony elicited from witnesses, both cooperative and hostile. This places tremendous importance on interviewing skills that allow the auditor to pick up on biases and even gage the veracity of the witness. Testimony will show inconsistencies in the documentary evidence which is the starting point in unraveling a fraud.

As we can see, performing a fraud examination is very different from routine audit work. It requires a completely different perspective and the ability to identify intent.

SPOTLIGHT



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JUST THE FACTS.

Today, more than ever, you need to know the facts. Dishonesty and deception have become commonplace. Complex financial transactions and representations often mask the truth and are used to defraud or gain an unfair advantage. A unique blend of investigative and accounting skills is critical to obtaining the truth. At Weaver, our seasoned Forensic Accounting professionals have what it takes to get you the facts you need to make informed decisions.

Our team is backed by the technical and industry-specific knowledge of our professionals. We have the resources to address your litigation or internal investigative needs. And with the Weaver Forensic Accounting Team, your case is not relegated to inexperienced staff and then only subjected to a cursory review by the testifying expert. You get the A-Team.



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