REAL-WORLD PERSPECTIVE:
HOW TO BE AN EFFECTIVE GATEKEEPER

With great reliance on auditor reports and the impact of missed financial fraud on an organization’s bottom line, there has been increased focus on auditors to detect potential frauds. This session will look at the consequences of failing to detect fraud, the real victims of fraud (from a government-service-delivery perspective), and how to become effective gatekeepers when detecting and investigating fraud in your organization.

You will learn how to:

- Identify ways auditors fail to detect fraud by reviewing case studies.
- Deploy an effective oversight model.
- Adopt forensically accepted best practices that will lead to effective gatekeeping and fraud detection.

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# REAL-WORLD PERSPECTIVE: HOW TO BE AN EFFECTIVE GATEKEEPER

## Objectives

1. Overview of auditors’ failure to detect fraud
2. Examples of auditors’ failure to detect fraud (case studies)
3. Consequences of auditors failing to detect fraud
4. Deploying an effective fraud-detection model
5. Forensically accepted best practices of effective gatekeepers

## Overview of Auditors’ Failure to Detect Fraud:

### Identifiable Causes of Audit Failures

**Definition of audit failure:**
- A [U.S. Government Accountability Office study](https://www.gao.gov/publication/GAO-14-254) defined the term *audit failure*, in part, as “audits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud.”
- An audit failure is a situation in which an audit wrongly states that a company’s accounts are correct when they contain mistakes or false statements.
- When an audit of a company’s financial records does not find things it should, there could be fraud.
- Basically, it is when the auditor “missed the boat.”

Arthur Levitt, chairman of the Securities and Exchange Commission under President Bill Clinton, said in a speech at New York University in 1998 that corporate managers, auditors, and analysts were taking part in a “game of nods and winks.”

In a recent article, the Public Company Accounting Oversight Board’s chief auditor is quoted by the *Wall Street Journal* as saying, “When we look at an audit, the rate of failure has been in a range of around 35 to 40 percent” (accessed February 27, 2014, on [www.CFO.com](http://www.cfo.com)).

## NOTES

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(Association of Certified Fraud Examiners)
Clearly there is a disconnect with the Expectation Gap.

Public Perception

accounting standards should prevent fraud from being undetected. Public is surprised that presumably the auditors followed the standards and still missed the fraud.
### Examples of Auditors’ Failure to Detect Fraud (Case Studies)

<table>
<thead>
<tr>
<th>Company</th>
<th>Year</th>
<th>Events</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zzzz Best</td>
<td>1986</td>
<td>Barry Minkow ran a Ponzi scheme</td>
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<td>Phar-Mor</td>
<td>1992</td>
<td>Factious inventory on the books to cover operating losses; mail fraud, wire fraud, bank fraud</td>
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<td>Sybase</td>
<td>1997</td>
<td>Inconsistencies in profit reporting from overseas division</td>
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<td>Cendant</td>
<td>1998</td>
<td>SEC charge: they deliberately and fictitiously manufactured about $500 million in fake revenues in a three-year period</td>
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<td>Waste Management, Inc.</td>
<td>1999</td>
<td>Inflated earnings</td>
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<td>MicroStrategy</td>
<td>2000</td>
<td>Earnings manipulation</td>
</tr>
<tr>
<td>Unify Corporation</td>
<td>2000</td>
<td>Overstated sales and revenue</td>
</tr>
<tr>
<td>Computer Associates</td>
<td>2000</td>
<td>Inflated sales</td>
</tr>
<tr>
<td>Xerox</td>
<td>2000</td>
<td>Falsifying financial results</td>
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<tr>
<td>Enron</td>
<td>2001</td>
<td>Overstated earnings</td>
</tr>
<tr>
<td>Adelphia</td>
<td>2002</td>
<td>Excluded billions of dollars of liabilities from its financial statement</td>
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<td>AOL</td>
<td>2002</td>
<td>“Roundtrip” transactions</td>
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<td>Bristol-Myers Squibb</td>
<td>2002</td>
<td>Inflated sales and earnings</td>
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<tr>
<td>CMS Energy</td>
<td>2002</td>
<td>“Roundtrip” energy trades</td>
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<td>Dynegy</td>
<td>2002</td>
<td>Improper reporting</td>
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<tr>
<td>El Paso Corporation</td>
<td>2002</td>
<td>Misleading financial statement</td>
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<tr>
<td>Freddie Mac</td>
<td>2002</td>
<td>Understated earnings</td>
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<tr>
<td>Halliburton</td>
<td>2002</td>
<td>Improper booking of cost overruns</td>
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<tr>
<td>Homestore.com</td>
<td>2002</td>
<td>Improper booking of sales</td>
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<td>ImClone Systems</td>
<td>2002</td>
<td>Samuel Waksal</td>
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<td>Kmart</td>
<td>2002</td>
<td>Misleading accounting practices</td>
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<td>Merrill Lynch</td>
<td>2002</td>
<td>Conflict of interest</td>
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<tr>
<td>Mirant</td>
<td>2002</td>
<td>Overstated assets and liabilities</td>
</tr>
<tr>
<td>Nicor</td>
<td>2002</td>
<td>Overstated assets, understated liabilities</td>
</tr>
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<td>Peregrine Systems</td>
<td>2002</td>
<td>Overstated sales</td>
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<td>Qwest Communications</td>
<td>2002</td>
<td>Inflated revenues</td>
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<tr>
<td>Reliant Energy</td>
<td>2002</td>
<td>“Roundtrip” trades</td>
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<tr>
<td>Sunbeam</td>
<td>2002</td>
<td>Overstated sales and revenues</td>
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<tr>
<td>Symbol Technologies</td>
<td>2002</td>
<td>Overstated sales and revenue</td>
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<tr>
<td>Company</td>
<td>Year</td>
<td>Misdeed</td>
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<td>Tyco International</td>
<td>2002</td>
<td>Improper accounting</td>
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<td>WorldCom</td>
<td>2002</td>
<td>Overstated cash flows</td>
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<tr>
<td>Royal Ahold</td>
<td>2003</td>
<td>Inflating promotional allowances</td>
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<tr>
<td>Parmalat</td>
<td>2003</td>
<td>Falsified accounting documents</td>
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<tr>
<td>Chiquita Brands International</td>
<td>2004</td>
<td>Illegal payments</td>
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<tr>
<td>AIG</td>
<td>2004</td>
<td>Accounting of structured financial deals</td>
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<tr>
<td>Bernard L. Madoff</td>
<td>2008</td>
<td>Massive Ponzi scheme</td>
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<tr>
<td>Lehman Brothers</td>
<td>2010</td>
<td>Failure to disclose Repo 105 transactions to investors</td>
</tr>
<tr>
<td>Olympus Corporation</td>
<td>2011</td>
<td>Tobashi using acquisitions</td>
</tr>
<tr>
<td>Autonomy Corporation</td>
<td>2012</td>
<td>Accounting improprieties, disclosure and financial misrepresentation</td>
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Case Study of Missing the Fraud on Government Audits

A Clean Bill of Health from Auditors
- How did the auditors miss detecting the fraud?
- Are the auditors at fault for missing these massive frauds?
- Did they look but not look deep enough?
- Are auditors in on the fraud, either by looking the other way or actively helping clients hide the deception?

Reasons Why Auditors Fail
If management is determined to hide the fraud, no matter how deep the auditors dig, we might not find it—unless the auditors are just as determined to find the fraud.

- Reliance on control system when controls are weak
- Improper planning including not revising audit plan after the initial assessment of fraud. Not designing test to look for the fraud.
- Inappropriate methodology for selecting sample size
- Lack of training and appropriate supervision
- Audit team lacks skill
- Audit team did not gather sufficient appropriate evidence to support the basis of their conclusion
- Lack of effective quality assurance at the audit shop
- Audit staff failure to exercise due professional care
- Relying on management information and lack of professional skepticism

Auditee-Related Reasons
- Misapplying accounting policies
- Collusion involving high-level officials who circumvent controls
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- Scope limitations
- Audit impairments
- Management not cooperative with the audit

Occupational frauds can be classified in three primary categories:
1. Asset misappropriations
2. Corruption
3. Financial statement fraud

Detection of Occupational Fraud

(Source: ACFE, 2014 *Report to the Nations*)
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- Tips are by far the most common way that occupational fraud schemes are detected.
- Management review and internal audit rank second and third, respectively, in frequency of detection.
- External audits rank seventh.

Consequences of Auditors Failing to Detect Fraud

- How affects us:
  - Negative impact on investors’ confidence; investors’ confidence is vital to a healthy market
  - Impact on our financial structure
  - Impact on government programs and service delivery—OSC case study of MTA (result of that fraud’s impact on service delivery and passenger safety). Fraud comes in all sizes and shapes
  - Reputational harm to the audit firm
  - Legal and regulatory consequences
  - Expense associated with attempted recovery of stolen asset
  - Expense associated with investigation

The typical organization loses 5 percent of revenues each year to fraud. If applied to the 2013 estimated Gross World Product, this translates to a potential projected global fraud loss of nearly $3.7 trillion.¹

New York State Comptroller Audit Report (1/12/2015)
The Comptroller’s annual report on preschool audits finds fraud and inappropriate billing of $20 million in questionable costs in 2014:

- About 81,000 preschool students with disabilities receive Special Education Itinerant Teacher (SEIT) services in New York annually at a cost of more than $1.4 billion to the state and localities. Preschool

education services in New York are predominantly provided by for-profit and not-for-profit private contractors rather than the school districts themselves.

- NYS Comptroller released 11 new audits that identified more than $6.7 million in public funds that special education providers misspent or misused, including cases of possible fraud that have been referred to law enforcement for further investigation.

**Deploying an Effective Fraud Detection Model:**
**Balancing Auditors’ Principles and Organizational Independence**

- The auditor’s responsibility is to provide reasonable assurance. This is accomplished by reducing audit risk to appropriate levels. The auditor needs to keep detection risk low so that he or she can provide reasonable assurance. The auditor might fail to detect material misstatements caused by fraud but it does not preclude auditors from detecting fraud.

SAS 99 (as amended, AU Section 316) requires brainstorming sessions to discuss how and where the entity’s financial statements might be susceptible to material misstatement due to fraud. Have the discussions of fraud at every stage of the audit. This is done at the NYS Comptroller’s Office:

- One objective is for the audit team to share their experiences with the client and discuss how a fraud might be perpetrated and concealed.
- The second objective is to set the proper tone at the top for the engagement.

During the brainstorming sessions, auditors must exercise professional skepticism. Professional skepticism plays a great role in detecting fraud. The standards requires the following:
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1. Obtain information from management and others within the organization
2. Analytic procedures
3. Consideration of fraud risk factors
4. Other sources

Taking a deeper look at high-risk areas:
- Consider the human dimension to fraud.
- Remain objective in every engagement with long-time clients. A level of established comfort could threaten auditors’ objectivity. Follow up on areas that indicate red flags.
- The gray area between legitimacy and outright fraud needs to be investigated.
- “Ask the final question and turn over the last rock.” —Frank Patone

Incorporating applicable technology and technological skills:
- Consider the cost-benefit tradeoff in investing in fraud detection technology. This can lead to cost savings from reduced fraud losses.
- Data analysis identifying anomalies and patterns might point to areas that are high risk and require closer attention.

Establishing a principle-based environment and ethical culture:
- A strong ethical culture that includes clearly defined expectations is important for good governance. The audit committee should have a governance framework and internal audit should provide input by making recommendations on the development of the framework. This committee is selected by the board and reports to the board because they evaluate
management’s effectiveness. They do not report to management.

- Establish a whistleblowers’ hotline and periodically assess the hotline and related policies and procedures.
- Gather information from all levels of the organization. This includes the tone in the middle and the tone at the top. The internal audit department should engage middle managers and review employee surveys and whistleblower reports. High turnover rates at the middle-manager level may be an indication of problems at the top level.

Areas to consider:
1. Does the organization have a formal ethics and values policy?
2. Does the organization have an ethics officer?
3. Are employees continuously trained on ethics policies?
4. Does the internal audit plan include a review of the organization’s culture and ethical risks?

Internal audit should work with senior management to make ethical behavior and tone at the top a priority. The audit team should ensure that members are held to the highest ethical standard as required by their organization’s Code of Professional Conduct (Code). For auditors this is usually the AICPA’s Code of Conduct. The ethical standards are essential in achieving public trust and confidence. As such, the public must be confident that the profession can regulate itself and discipline those members who violate or ignore the Code.

**Forensically Accepted Best Practices to Be an Effective Gatekeeper**
- NYS Office of the State Comptroller Case Study #1: Dental Hawkers
- OSC Case Study #2: Special Education Associates
In both cases, the steps performed by the auditors and the analysis done by the software are important. In addition, we need to conduct the following:

- Understanding the complex organizations being audited:
  - Know your client and the environment your client works in.
  - What is your audit universe?
  - What data can you capture from your universe that can be used for your analysis?

- Schemes based on the perpetrator’s department:
  - Within the various departments of an organization, different kinds of fraud risks might exist.
  - A scheme that is common in the Purchasing Department might be relatively rare in Customer Service, or vice versa.
  - By analyzing the types of schemes that occur most often in various departments, management and the audit department can develop controls to specifically address the highest fraud risks in any given area.
  - Tap into your valuable tool: experience gained through working in different areas of the business (regions around the globe).
  - Without a good understanding of how things work in each division, you might not fully understand how to audit the area.

The chart below shows the frequency of schemes in all cases.
(Source: ACFE, 2014 *Report to the Nations*)

- Identify the high-risk areas:
  - Perform an annual update of the high-risk areas and develop an audit plan.
  - Look beyond control weakness; for example, if a check lacks proper approval it does not mean the check is fraudulent. Instead look for double endorsed checks or more than one paycheck made out to the same employee for the same period.
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- Do not look for processes; instead look for outcomes.
- Look for the red flags. Sometimes it is right in front of you and sometimes it requires a little digging.
- Look at areas where there are yearly repeats of deficient internal control. If you made a recommendation the prior year to fix a deficiency and it has not been addressed, design audit steps to look more critically at this area.

- Include fraud-detection steps in your audit program:
  - Design an environment hostile to fraud by implementing fraud-detection processes.
  - Deploy an element of surprise in your audit program. Too often, audits are built around the same permanent file, where the auditee can predict the areas we will target. As a result, the audit test is less effective, and it becomes easy for the auditee to prepare fraudulent documentation.
    - Examples of surprise audit steps:
      * For payroll fraud—Conduct analysis of highest overtime employees
      * Conduct site visits and observations at locations where employees are reporting high overtime to determine whether they are performing work during the time they are paid.
      * For inventory checks—Do not share with the auditee the location for the inventory check.
  - Look for transactions that are on the organization’s bank statement but should not be on the statement.
  - Look for supporting documentation and transactions that should be there but are not.

- The importance of effective audit supervision:
  - New auditors are usually taught to look at last year’s work papers and perform the same audit steps.
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<tr>
<th>REAL-WORLD PERSPECTIVE: HOW TO BE AN EFFECTIVE GATEKEEPER</th>
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<tbody>
<tr>
<td>• Continuously train employees on potential fraud risk factors.</td>
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<tr>
<td>• Have adequate staffing mix. Conduct talent development, recruitment, and succession planning to ensure that responsible employees have the knowledge for today and going forward.</td>
</tr>
<tr>
<td>• Have a subject matter expert on the audit team.</td>
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<tr>
<td>❑ Increasing the sample size might assist in detecting the fraud.</td>
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<tr>
<td>❑ Be mindful of the following:</td>
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<tr>
<td>• Creative or aggressive accounting techniques</td>
</tr>
<tr>
<td>• Income and expenses free from manipulations</td>
</tr>
<tr>
<td>• Manipulation or mismanagement of an organization’s earnings</td>
</tr>
<tr>
<td>• Financial statements and records free of misstatement or omission</td>
</tr>
<tr>
<td>❑ Make inquiries of management and others within the organization.</td>
</tr>
<tr>
<td>❑ Consider fraud risk factors.</td>
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<tr>
<td>❑ Time constraints can increase audit failures. Therefore, the audit program must be designed to cover the established objectives.</td>
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