Preventing Your Firm's "Enron"

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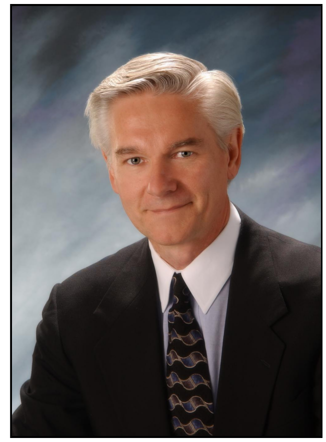

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Enron is the largest bankruptcy in U.S. history. It represented a "shock" to the system. How could a company worth $80 billion go bankrupt in less than a year? Answer: Because it lost credibility. Your personal and firm credibility is the only thing that gives your work value. You can be the most technically competent accountant around, but when people who rely on your work product (called financial statements/tax returns/etc.), don't believe what you say, it has no value. Thus, we must do everything in our power to maintain our integrity. We will explore a number of our standard practices, which makes it appear to a jury of our peers (called 12 citizens—not accountants) that we are not ethical, nor do we have integrity.

Because of a string of high-profile frauds undetected by auditors, the SEC has instituted an independent board to oversee the profession. How did we get into this mess? How did audit work become so price sensitive? How did auditing become such a commodity that firms have resorted to non-attest work, such as consulting, to stay in business? Answer: Just because the audit has to be done, that doesn't mean anyone thinks it's important or valuable. That is, compliance work does not make you valuable. When was the last time a client called you up excited that you were coming out to begin the audit? How many clients do you have that would have the audit done if it weren't required? One or two? What's that tell you about the value your clients put on your audit?

As a result of the "Wal-Martization" of audits, our everyday practices can destroy your firm in just one failed audit. The problem is that these procedures have become habits, just like driving to work the same way every day, and thus we fail to ask if our procedures are correct or even whether we should be doing them.

Think you're not at risk and don't need to adopt the strategies discussed below? Consider the following scenario. Your firm does 100 audits, mostly small private companies, plus a few non-profits and a mid-size company or two. Most are required by bank loan covenants or funding agreements for the non-profits. The economy isn't doing well, and one of your clients gets into financial trouble near the end of the year, but it's not significant enough to materially affect the current year's statements, so you don't detect your client's deteriorating condition with traditional analytic procedures and give a clean opinion. The bank relies on your work and renews the loan. Six months later the client defaults on the bank loan and you get sued.

Sitting on the stand defending yourself and the firm, the bank's attorney asks, "Mr. Smith, how many audits does your firm do each year?"

You answer, "Just over 100."

"Now Mr. Smith, how many audit failures did your firm have last year?"

"One, and of course that's less than a 1 percent failure rate."

"So Mr. Smith, let's explore that line of reasoning. Let's say you put your family on an airline, say American, for the flight to Disney World in Orlando. The plane crashes. Your wife and three children are killed so you sue American. The CEO gets on the stand and his defense is, 'We had 500 flights that day. Only one crashed. That's only a 0.2 percent failure rate. I don't know what the big deal is?' Now Mr. Smith, would that be OK with you?"

Of course it's not OK with you. You don't care about the other 499 flights that didn't crash. They aren't important to you. The only flight that counts is the one that killed your family. Just like the bank doesn't care about the other 99 audits you performed. You don't win 99 to one; you lose zero to one.

There are 35,000 airplane flights every day in the U.S. Can you imagine the outrage if 350 crashed? Would that be acceptable?

Avoid Procedures That Can Lead to Your 'Enron'

Now let's explore some of the things that can lead to your "Enron":

1. **Audit the business**: Statement on Auditing Standards Number 82, "Considering Fraud in a Financial Statement Audit," is a positive affirmative DUTY to detect fraud. Figure 1 depicts the fact that most SAS 82 audit procedures are OUTSIDE the books. Yet many accountants still use the same audit program as they did before SAS 82 became effective Dec. 15, 1997.

How do you explain that a new standard went into effect five years ago, but your audit program hasn't changed? Just one example of audit procedures "outside the books" that is

Figure 1

critical. Does your client do background checks on employees with access to liquid assets? Why are background checks important? Because the easiest way to prevent someone from stealing the company blind is not to hire them in the first place. In addition to criminal checks, check credit history and driving records. Employees behind on their bills are more likely to steal. As are people who get many traffic tickets ... they are risk-takers.

While we're on the topic, do you perform background checks on your firm's employees, especially new hires? In a recent survey, 40 percent of 18- to 35-year-olds said they lived above and beyond their means. What makes you think CPA firm employees are immune? For example, south Florida Alexander Grant partner Jose Gomez spent 41/2 years in prison for his part in the $350 million ESM Government Securities fraud in the late 1980s. He lived above and beyond his means, and borrowed from ESM's CFO. A year later ESM needed to hide a $350 million trading loss suffered by Home State Savings & Loan. Home State was owned by a relative and was ESM's largest customer. So Mr. Gomez helped set up the unconsolidated affiliate to hide the loss.

2. False sign-off of audit work: False sign-off occurs when staff sign-off on work they didn't do.

First: Why would firm personnel say they did work when they didn't?

Answer: Budget pressure, and to get a promotion and pay raise by coming in under budget and keeping the client happy.

Second: How does staff know what to falsely sign-off and not be detected?

Answer: Look at last year's workpapers.

Third: Why doesn't workpaper review detect false sign-off?

Answer: Because we trust staff ... if they sign off the work is done; we assume they did it.

3. Peer review: Peer review is the profession's primary quality control mechanism. Yet it doesn't detect false sign-offs. Why not? Because reviewers don't look at original audit support to determine if the work was actually done.

4. Stop asking the client: When a staff person has a question about an audit step, whom do they sometimes ask? The client, especially if the controller is a former auditor. Why? Because the staff person doesn't want to look stupid. The staff person has lost her independence when she asks the client how to perform an audit step. Make a firm-wide rule: No one is allowed to ask client personnel how to perform an audit. Violation is grounds for dismissal.

5. Listen: When a client's employee is embezzling/stealing/etc., someone in the company usually knows it. Train staff to listen to the grapevine. If top management is cooking the books, some lower-level employees nearly always try to alert the auditors (e.g., Enron VP Sherron Watkins and former AA employee warned the Andersen audit team the company might implode in an accounting scandal).

6. Trust: Do you trust the client because they pay your bills? Big mistake. Of course the client is going to pay your bill if it needs your opinion to consummate a significant pending transaction like a bank loan renewal or other financing or acquisition.

7. Consistency: Doing the same thing is an auditor's worst habit. If the audit is performed so consistent the client knows what you're going to do, you are not independent. Do something different every year to keep the client off balance ... just 5 percent is enough to make people nervous they might get caught.

8. Surprise: Don't tell the client what you're planning. For example, a "surprise" cash count isn't a surprise if you've done it 25 years the first day of the audit the second week in November. But the most common mistake that will get you sued is telling the client where you're going to observe inventory. How much easier can you make it to commit inventory fraud than to tell the client where you're going to check it? Think about it: There are only two reasons you tell the client which locations you're observing. One is you conspired with the client to cook the books. Your only option is the "stupid" defense. Not a very good strategy. Don't think it can happen to you? Ever heard of PharMor? The auditors missed a $500 million inventory fraud because they told the client which four stores out of 325 they were going to observe. The firm settled out of court.

9. Prepared by client: We are very good at auditing what's on the schedule. But we're terrible at auditing what should be there but isn't. If the client prepares the schedules, it's unlikely a staff person will realize the schedule is incomplete. It's tough to say YOU audited the books when the client did your job for you. So, NO PBCs (Prepared By Clients) allowed.

10. Demand an answer: Suppose a staff person comes across something unusual or that just doesn't smell right. He asks the controller, "What's this?" The controller can't tell the truth (a small amount of book cooking). So the controller simply stares at the staff person. What does the staffer do? Gives the controller the answer he wants to hear. Why? Because in our culture, we can't stand silence. And the staffer can show the controller how smart he is by figuring out what happened. So teach staff to stop giving the client the answer they want to hear.

11. Understand the clients' business: So you think you know your favorite client's business? Then write down the top three reasons your clients' customers buy from your client instead of a competitor.

1. ______________________________
2. ______________________________
3. ______________________________

If you can't name the three reasons, you don't understand the client's business and you're auditing in a vacuum. Only if you understand the client's business can you fill in the blanks of what's NOT there.

For example, in the ZZZZ Best Carpet Cleaning fraud, the auditors accepted the client's representation that one insurance job would require 300,000 square feet of carpet to restore the top four floors of the Capitol Bank building in Sacramento. The plaintiff's attorney showed 300,000 square feet would have carpeted a 60- to 80-story building. The numbers multiplied out so they must be OK? WRONG.

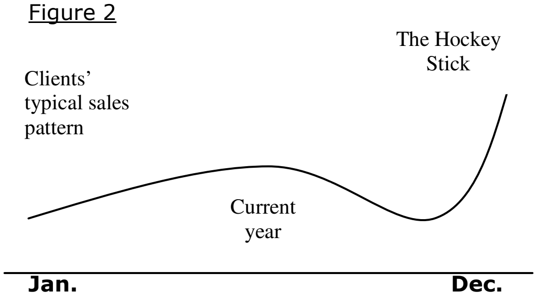
12. Risks: Paragraph 26 of SAS 82 says, "The risk of fraud is ALWAYS present to some degree." (Emphasis added.) So don't design the audit program or begin the fieldwork until you read the AICPA current year's audit risk alert for your client's industry.

13. Unreasonable Compensation: The CEO of ZZZZ Best paid employees more than they could ever earn anywhere else and never let them forget it. California Micro Devices demoted CFO Steven Henke to Treasurer—but gave him a pay raise when auditors found significant cutoff problems. Make sure you understand the behavior the compensation system drives. If a significant portion (30 percent or more) of an employees pay is incentive based, make certain there are proper controls over the measurement system that drives the pay calculation. It's not just how much, but WHY is the pay that much.

14. Attention: Be aware of someone who can't stand NOT being the center of attention. This is way beyond liking to be the center of attention. We all like to be the center of attention. Barry Minkow, CEO of ZZZZ Best, started the company so he could get a date in high school.

15. The Hockey Stick: When suing you for a failed audit, every plaintiff's attorney knows about the "Hockey Stick" data pattern. It occurs when business people are desperate to "make the numbers." Figure 2 is the graph the attorney will show the jury, with a comment such as, "Even a blind man can see it makes no sense." Do you know the sales pattern for each of your clients, so you can recognize when it doesn't look right?

Figure 2



16. Qualify clients: Have you ever asked yourself why clients want you to do the work, when you don't have a client in this particular industry? Has it ever occurred to you that the client hires your firm because you are the easiest one to fool? How will that sound on the witness stand? Especially if you had the low bid for the work and so maybe minimized the hours so you wouldn't lose your shirt on the first year's work.

17. Ethics: Hold up your hand if you think you're an ethical accountant. Do you prepare or review your clients' tax returns? Do you have any clients that treat the company like their own personal piggy bank? YOU DO? Now there's a surprise. So why do you overlook the personal expenses on the company return? Because they are small, insignificant? Just because the deductions are insignificant, they are still illegal. If deductions are illegal, by definition they are unethical. By being associated with such returns you can't say it's not OK the client cheats on their tax return. So what do you say when the attorney asks how big the tax fraud has to be before it's not OK with you? The attorney has backed you into a corner because there's no right answer that will get you out of trouble. Taking or allowing small illegal deductions is not OK.

Protect Yourself

For most of us, independence isn't the complicated stuff in the Enron-type cases. It's the easy stuff discussed above. Don't make it easy for plaintiffs' attorneys to sue you and win. Don't look stupid. Stop thinking you're protected just because you put check marks in all the right little boxes. GAAP and GAAS don't have the weight of law. Juries can do anything they want. Do you REALLY want to take the risk? Is it worth the risk?

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