

How Professional Responsibilities Can Lead to Personal Liability

When Auditors Commit F.R.A.U.D.

December 5, 2017

Enjoying Music City

1. I Changed Her Oil; She Changed my Life
2. I Fell In A Pile Of You And Got Love All Over Me
3. She Got the Ring and I Got the Finger
4. My John Deere Was Breaking Your Field, While Your Dear John Was Breaking My Heart
5. I'm The Only Hell My Mama Ever Raised
6. She's Actin' Single and I'm Drinkin' Doubles
7. I'm So Miserable Without You, It's Like Having You Here
8. Get Your Biscuits In The Oven And Your Buns In The Bed
9. I Still Miss You, Baby, But My Aim's Gettin' Better
10. Her Teeth Were Stained, But Her Heart Was Pure

Agenda



- **Recent Case Highlights**
- **Standards Overview**
- **When Auditors Commit F.R.A.U.D.**

The new single year high for SEC enforcement actions for the calendar year included

1. Reached new highs for FCPA enforcement actions (25) including suing 8) individuals.
2. Most money distributed to whistleblowers (\$57 million) in a single year
3. The agency did bring more individual areas in other areas of corporate crime. A grand jury indicted six current and former Volkswagen AG executives over their alleged role in the company's emissions fraud.
 - One of the men is in custody; the others are overseas and have not yet responded to the allegations. The company pleaded guilty in connection with the investigation.

SEC Recent Actions

Enforcement Results: Fiscal Years 2014-2016

Fiscal Year	2014	2015	2016
Independent or Standalone Enforcement Actions	413	507	548
Follow-on APs	232	168	195
Delinquent Filings	110	132	125
Total Actions	755	807	868
Disgorgement and Penalties Ordered	\$4.16 billion	\$4.19 billion	Over \$4 billion

Source: SEC press release 2016-212

The Department of Justice announced the Yates Memo in September 2015, reinforcing its focus on proactive corporate cooperation and voluntary disclosure and all relevant facts about individual misconduct, in exchange for corporate cooperation credits. The objectives:

1. Deter corporate conduct by putting **individuals** at risk of criminal prosecution or civil action.
2. Encourage government lawyers to most effectively pursue the **individuals** responsible for corporate wrongs.

Chief Compliance Officers/Internal Auditors:

- Fined the CCO of an Investment Firm failing to adopt and implement policies and procedures for outside activities of employees.
- Charged the CCO of a Financial Advisory Firm for failing to implement policies and procedures that would have detected an alleged fraud by an executive at the firm.
- Fined a CCO and a chief AML officer, and suspended them 90 days for supervisory and AML violations.
- Sanctioned a consultant of an oil and gas company for improperly evaluating the severity of the companies internal control deficiencies (along with charges against the company, senior executives and the external auditor)

In 2016, we gained insight into allegations regarding the largest accounting negligence lawsuit in history: \$5.5 billion

- ▶ The Plaintiffs argued that auditors owe a duty to the public:
 - » *The auditor, in essence, functions as a public watchdog. A negligent watchdog rarely damages the property it guards, rather, it falls asleep and thus allows a third party to do the damage.*¹
 - » *Public auditors are responsible in our country when they certify fraudulent assets.*²
- ▶ Defendants argued that collusion between executives made any fraud particularly difficult to detect.
 - » *As the professional audit standards make clear, even a properly designed and executed audit may not detect fraud, especially in instances when there is collusion, fabrication of documents, and the override of controls, as there was at the bank.*⁴
- ▶ The auditor settled the lawsuit in the middle of trial.

1. \$5.5B Trial May Widen Target on Audits Over Fraud, Law 360, June 5, 2017.

2. CVN to Webcast \$5.5B Accounting Negligence Trial Over Audits of Failed Bank, posted by David Siegel on July 28, 2016.

In that same case, the FDIC initiated a complaint against a second firm that provided of internal audit services

- ▶ The complaint states that⁵
 - » *Pursuant to annually executed engagement letters, auditor agreed to provide professional consulting services including internal audit functions and services.*
 - » *The firm consistently overlooked serious internal control issues and failed to identify non-existent assets*
 - » *The audits fell short of governing professional standards⁶*
- ▶ The firm claims that they reported to management, and their agreement expressly prohibits other parties from relying on their work. As of September 2016, those arguments have been denied.

5. Complaint filed on October 31, 2012 at US District Court for the Middle District of Alabama Northern Division.

6. FDIC Hits Auditors With \$1B Negligence Suit, Law 360, June 5, 2017

Audit, Review or Neither?

- ▶ In the SEC's \$200 million fraud case against Lynn Tilton, the founder and CEO of Patriarch Partners, Tilton said she relied on an outside accountant's advice in drafting the financial statements.
- ▶ The outside accountant claimed that he performed only ministerial accounting work. The accountant testified that he:
 - » was not employed to do a comprehensive **review** of the firm's financials statements – only to check for “*silly mistakes*.”⁷
 - » merely checked the financials for clerical accuracy and did not **audit** or **review** them.

7. The CPA & the Diva – Did Tilton Accountant See More Than Her Books, The New York Post, October 28, 2016.

Audit, Review or Neither?

- ▶ Evidence included email sent by Patriach employees that referenced the accountant **“reviewing”** or **“approving”** the financial statements. Among others:
 - » CFO emailed accountant and Tilton, and attached financial documents *“reviewed and approved by [accountant].”*
 - » Accounting employees emailed accountant documents and asked
 - *“for [his] review and approval”*
 - *“review the financials and workpapers and let me know of any errors, issues or concerns.”*
- ▶ Accountant said he could not recall speaking with CFO or other employees to correct them, but that he believed they understood he was not reviewing the financials in the technical accounting sense of the word.
 - » *“There was never an instance where I commented otherwise [than for clerical accuracy]. Was I not careful enough in challenging their use of those words?” he said, “That’s a possibility that that’s what happened here.”*⁸

7. The CPA & the Diva – Did Tilton Accountant See More Than Her Books, The New York Post, October 28, 2016.

8. SEC’s Tilton Trial Gets Steamy Over Accountant’s Emails, Law 360, by Carmen Germaine, October 27, 2016.

Accountant's relationship with his client too personal?

- ▶ When asked about his relationship with Ms. Tilton, accountant was shown several emails he sent in 2003.⁹
 - » “I know it goes without saying but, I do truly care about you and [Tilton's daughter] CJ,” and
 - » “be smart,” “be gorgeous” and “have a good time.”
 - » “So I guess this means we're not having dinner this week,”
 - » In her reply to that email, Tilton said her week had been busy and that “[w]e will do dinner when I can smile across the table at your pretty blue eyes.”
- ▶ Attorney pressed accountant on a dinner he had with his wife and Tilton in 2003, asking whether his wife confronted him and Tilton and accused them of having an affair.
 - » Accountant denied and Kirsch produced an email he sent: “Will we ever get over that unfortunate evening?” Accountant denied this allegation.

9. SEC's Tilton Trial Gets Steamy Over Accountant's Emails, Law 360, by Carmen Germaine, October 27, 2016.

2017 - MoneyGram's former chief compliance officer resolves dispute

- ▶ The U.S. authorities had sued in 2014, seeking a \$1 million civil penalty and to hold him personally responsible for failing to stop fraudulent transfers and other violations of the Bank Secrecy Act.
- ▶ He admitted, acknowledged, and accepted responsibility for the following, among other things¹⁰:
 1. Failing to terminate specific MoneyGram outlets after being presented with information that strongly indicated that the outlets were complicit in consumer fraud schemes;
 2. Failing to implement a policy for terminating outlets that posed a high risk of fraud;
 3. Structuring MoneyGram's anti-money laundering (AML) program such that information that MoneyGram's Fraud Department had aggregated about outlets, including the number of reports of consumer fraud that particular outlets had accumulated over specific time periods, was not generally provided to the MoneyGram analysts who were responsible for filing suspicious activity reports with FinCEN.
- ▶ Paid \$250K penalty and is barred from working as a compliance officer for any money transmitter for three years

10. United States Department of the Treasury Financial Crimes Enforcement Network (FinCEN) news release "FinCen and Manhattan U.S. Attorney Announce Settlement with Former MoneyGram Executive Thomas E. Haider, May 4, 2017.

Standards Overview

CERTIFIED FRAUD EXAMINER (CFE)

► Integrity and Objectivity

- » Conduct themselves with integrity at all times
- » Prior to accepting an engagement any potential conflicts of interest should be identified
- » Maintain objectivity
- » Not commit acts discreditable
- » Shall not knowingly make a false statement when testifying under oath in a court of law

► Professional Competence

- » CFE shall be competent and not accept assignments he or she is not practiced to implement
- » CFE shall maintain the minimum required hours for continuing professional education required by ACFE

Standards Overview

Management

► **Sarbanes Oxley – Civil Certifications**

- » They are responsible for internal controls and have evaluated them within 90 days prior to the report.
- » They have disclosed material weaknesses, and fraud, whether material or not that involves management or other employees with a role in internal controls.

► **Sarbanes Oxley – Criminal Certifications**

- » Officers who unknowingly violate the certification requirements are subject to fines up to \$1m and up to ten years imprisonment. (willfully - \$5m and 20 years)

The key is “*to their knowledge*”.

Standards Overview

CERTIFIED FRAUD EXAMINER (CFE)

► **Due Professional Care**

- » Diligence
- » Critical Analysis
- » Professional Skepticism
- » Conclusions Based on Evidence that is Relevant, Competent and Sufficient
- » Adequate supervision of Personnel

► **Understanding on Scope, Limitations and Responsibilities of Each Party**

- » Before the fraud examination begins the scope, limitations, and responsibilities should be defined
- » Significant changes to set scope, limitations, or parties will require a new understanding between the client and examiner be reached

Standards Overview

CERTIFIED FRAUD EXAMINER (CFE)

- ▶ **Communications of Significant Findings**
 - » Shall be communicated to those who retained the examiner within the normal course of the examination

- ▶ **Confidentiality**
 - » Privileged information obtained during the examination shall not be disclosed

Standards Overview

EXTERNAL AUDITORS: International Ethics Standards Board
for Accountants (IESBA)



- ▶ Further action by the professional accountant in public practice may include “disclosing the matter to an appropriate authority even when there is no legal or regulatory requirement to do so” if the client or those charged with governance do not respond to a non-compliance with laws and regulations with appropriate measures, per the IESBA pronouncement on Responding to Non-Compliance with Laws and Regulations (NOCLAR) recently became effective in July 2016.
- ▶ The pronouncement further states that when the auditor determines disclosure to be the appropriate course of action after considering specific factors, such disclosure will NOT be considered a breach of the duty of confidentiality under Section 140 of the IFAC Code of Ethics, Confidentiality.

Standards Overview

**EXTERNAL AUDITORS: International Ethics Standards Board
for Accountants (IESBA)**



- ▶ AICPA Professional Ethics Executive Committee (PEEC) considers converging the AICPA Code of Professional Conduct with the pronouncement by the IESBA.
- ▶ Other countries may be working towards adoption of the pronouncement. Some countries such as Brazil faces significant challenges to immediate NOCLAR adoption due to current legislation.

Commonality of Standards

Standards	CFE	CPA	IIA
Integrity and Objectivity	X	X	X
Independence		X	X
Professional Skepticism/ Critical Analysis	X	X	
Due Professional Care	X	X	X
Confidentiality	X	X	
Professional Competence/ Proficiency	X	X	X
Acts Discreditable	X	X	
Communication of Significant Findings/Reporting	X	X	X

Fraud-Related Standards

EXTERNAL AUDITORS: AU SECTION 240

AU Section 240:

Consideration of Fraud in a Financial Statement Audit

Purpose:

To “establish standards and provide guidance to auditors in fulfilling” their 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.”



Fraud-Related Standards

EXTERNAL AUDITORS: AU SECTION 240

► Engagement personnel discussion

- » Planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud
- » Understanding the causes and signs of fraud
- » Assigning responsibilities to personnel with sufficient experience and training

► Obtaining audit evidence

- » Auditing large, unusual, or complex transactions
- » Evaluating the significance of differences between the accounting records and the underlying facts

► Identifying risks

- » Determining whether significant accounting policies are acceptable
- » Accumulating potential audit adjustments and evaluating the combined effect on the financial statements

Fraud-Related Standards

EXTERNAL AUDITORS: AU SECTION 240

► **Communicating possible fraud**

- » Reporting all instances of fraud to the appropriate level of management
- » Insisting that financial statements affected by a material fraud be modified or providing a qualified opinion

► **Documenting consideration of fraud**

- » Withdrawing if uncertainties about fraud cannot be resolved and management cooperation is unsatisfactory
- » Disclosing fraud to outside agencies in limited circumstances



Fraud-Related Standards

EXTERNAL AUDITORS: AU SECTION 315

AU Section 315 *requires auditors to obtain an understanding of each of the five components of internal controls, as well as:*

- ▶ Relevant industry, regulatory, and other external factors, including the financial reporting framework
- ▶ The nature of the entity including its operations, ownership, types of investments, and the entities structure
- ▶ The entity's accounting policies and whether they are appropriate for the business line
- ▶ The entity's objective and strategy
- ▶ The measurement and review of financial performance

Fraud-Related Standards

EXTERNAL AUDITORS

External auditors are not responsible for:

- ▶ Authenticating documents
- ▶ Uncovering intentional misstatements concealed by collusion
- ▶ Ensuring or guaranteeing that all misstatements are discovered
- ▶ Reporting most instances of fraud to outside agencies or parties
- ▶ Detecting and reporting errors and irregularities in areas beyond the scope of a financial statement audit

Standards Overview

EXTERNAL AUDITORS: International Ethics Standards Board
for Accountants (IESBA)



External Auditors when responding to non-compliance with laws and regulations (NOCLAR), the objectives of the auditors are:

- ▶ To comply with the fundamental principles of integrity and professional behavior;
- ▶ By alerting management or, where appropriate, those charged with governance of the client, to seek to:
 - ▶ Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or
 - ▶ Deter the commission of the non-compliance where it has not yet occurred; and
 - ▶ To take such further action as appropriate in the public interest.

Practice Guide: Internal Auditing and Fraud

- ▶ Consider fraud risks in control design and audit steps
- ▶ Be alert to opportunities that could allow fraud
- ▶ Evaluate management's performance with respect to fraud risk management
- ▶ Evaluate the indicators of fraud
- ▶ Recommend investigation when appropriate
- ▶ They are **not** held to the same fraud-fighting standards as CFEs or those primarily tasked with finding fraud

When Auditors Commit F.R.A.U.D.



F – Forgetting the Present

Red Flags

- Leadership role, but not authority
- Lack of a personal risk assessment
- Refusal to commit to continuous learning

F – Forgetting the Present

SEC aims to get tougher on fraud through the pursuit of individuals

“We need to be certain our settlements have teeth and send a strong message of deterrence.”

- » Insisting on admissions of guilt as a condition in settlements
- » Pursuing more charges against individuals – “wherever possible” – if they believe management was complicit in the wrongdoing.

“Today, we have an entirely new commission.”



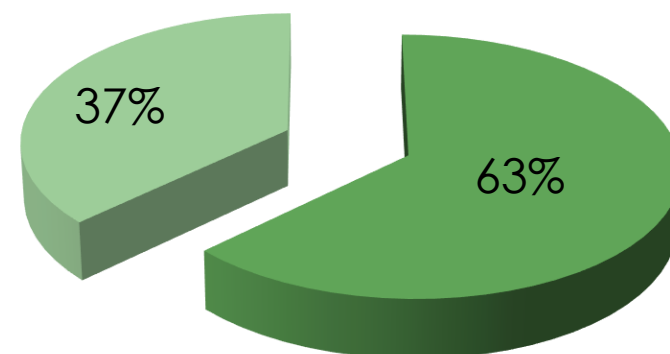
F – Forgetting the Present

“In all but a few cases, an individual or group of individuals is responsible for the corporation’s wrong-doing. The prosecution of culpable individuals – including corporate directors – for their criminal wrongdoing continues to be a high priority for the Department.”

- Assistant US Attorney General Caldwell

DOJ Actions Levied Against Individuals

■ Individuals ■ Corporations



F – Forgetting the Present

Prevention:

Consider a “Personal” Risk Assessment

- ▶ Which standards are applicable?
- ▶ Where are you possibly exposed?
- ▶ How have you addressed the gaps?
- ▶ Who will likely inquiring?
- ▶ How well are you prepared to address their questions?
- ▶ What are YOUR industry trends?



R – Relying on Others

Red Flags:

- ▶ Cost over-runs
- ▶ Constant quality issues by same employees
- ▶ Utilizing employees solely based on availability not skills
- ▶ Executives playing an insignificant role in assignments

R – Relying on others



R – Relying on others



R – Relying on others



R – Relying on others



R – Relying on others



R – Relying on others

The City of Dixon

- » The City of Dixon, Ill., whose former comptroller embezzled almost US \$54 million, sued its long-time accounting firm for failing to detect the fraud. The firm audited Dixon's books and performed other duties. Although the firm officially resigned as Dixon's auditor in 2005 so it could keep other city business after the city received federal funds that required an independent auditor, the lawsuit claims the firm continued to conduct and get paid for the annual audit, while hiring a certified public accountant from a nearby town to sign off on the work. **The CPA also is a defendant in the suit.**
- Dozens of fictitious invoices, containing misspellings and no letterhead
 - Bank allowed comptroller to open account without authorization, and allowed her to deposit checks written to "Treasurer"
 - Firm also did comptrollers personal tax returns and there was no documentation to support her extra income

A – Accepting, not Verifying

11/14/17: Former KIT Digital Inc. finance executive Robin Smyth told a New York federal jury Tuesday that he helped create bogus revenue streams for Kaleil Isaza Tuzman, the former head of the fallen tech concern.

He admitted to engaging in financial crimes valued at “tens of millions of dollars” while acting as CFO from 2009 until late 2011.

“Why did you do it?” prosecutor Damian Williams asked the 64-year-old Smyth.

“Kaleil asked me to do it,” he said. *“I wanted the company to be successful and to ultimately make money.”*

R – Relying on Others

Prevention

- ▶ **Know your role**
- ▶ **Performance reviews**
- ▶ **Internal policies and procedures**
 - » What percentage of time did you spend on the assignment?
 - Time-sheets
 - Budgets
 - Billings
 - » Please explain your role in this project?
 - Proposals
 - Reports



When Auditors Commit F.R.A.U.D.

A – Accepting, not Verifying

Red Flags

- Cozy relationship with client
- Questions asked, not answered
- Fear of the Unknown

A – Accepting, not Verifying

Lack of Detail and Supporting Data

Weiner v. Snapple Beverage Corp., 2010 WL 3119452

Breach of contract: expert calculated premium paid by the plaintiff for a product based only on one of the characteristics of the product. Expert **did not rely on all the information available** and the court deemed the expert's testimony to be unreliable.



A – Accepting, not Verifying

Acting on Information

November 13, 2017: A Booz Allen Hamilton investor on Monday sued the government contracting giant's top brass after the company announced it was being investigated by the U.S. Department of Justice for its accounting and cost charging practices.

The complaint says multiple audits and at least one internal employee had flagged deficiencies in the company's practices, but that the leaders "willfully or recklessly" didn't disclose those issues

A – Accepting, not Verifying

Prevention

- Act on **ALL** information provided
 - Many times it's the decision making process that is challenged, not the decision.
- Ask tough questions
- Recognize pushback

U – Underestimating the Effort

Red Flags

- Scope Restrictions
- Fee Limitations
- Assignments Outside of Experience

Considerations Unique to External Auditors

In instances of scope restrictions, AS No. 5 requires auditors to:

- ▶ Express an opinion only if the auditor has been able to apply the procedures necessary in the circumstances
- ▶ Otherwise, auditors should withdraw from the engagement or disclaim the opinion

U – Underestimating the Effort

Over-Extending

Madoff used the small New City, N.Y., accounting firm Frierling & Horowitz, which reportedly had:

- » Offices in a strip mall
- » Three employees, including a secretary and an accountant
- » A partner in his seventies who lived in Florida



**Madoff
Accountant
Pleads Guilty,
Faces 114 Years**

But denies knowing
about Ponzi scheme



**Accounting Firm Faces \$2B in
Lawsuits in Madoff Scam**

Over-Extending

All experts in the Lance Armstrong False Claims Act case have been challenged:

- » Mr. Armstrong's expert has been challenged by the government:
 - » *Mr. [Expert] is not competent to testify about earned media in general, much less in the context of the facts of this case," government attorneys wrote in a court filing, according to USA Today. "The Court should not permit this testimony to be presented to the jury.*
- » Mr. Armstrong challenged the government's witnesses:
 - » *The government would like to offer Mr. [Expert's] **counting exercise** and allow the jury to speculate that the USPS suffered harm as a result of the summary and that such harm exceeded the benefits the USPS enjoyed under the sponsorship," government attorneys wrote. "The jury cannot be allowed to speculate on this critical issue.*



U – Underestimating the Effort

Over-Reaching

Stokes v. John Deere Seeding Group, 4:12-CV-04054-SLD-JAG, February 21, 2014

Workplace discrimination: plaintiff's expert testimony was excluded as **unreliable** because it was not shown that the expert had any more reliable insight than an average layperson



U – Underestimating the Effort

Prevention

- ▶ Avoid fixed fees and fixed hours engagements
 - » When unavoidable, propose carve-outs around areas deemed high-risk
- ▶ Carefully consider the creation of written:
 - » Document requests
 - » Work plans



U – Underestimating the Effort

Prevention:

- ▶ Have a formal process in place to assess the firm/expert's competency prior to the engagement's acceptance
- ▶ Have the client “accept” the proposed team
- ▶ Do not be afraid to turn down an assignment
- ▶ Ok to say “I don't know,” if you follow with: “I will find out”
- ▶ Monitor headcount
 - » Requisitions
 - » Overtime review

D – Determining the Outcome before Proceeding

Red Flags

- ▶ Proposed audit adjustments ignored
- ▶ Internal audit findings ignored or minimized
- ▶ Working solely for one client or one side of case
- ▶ Accepting any and all clients

D – Determining the Outcome

- ▶ Skepticism is defined as a “*questioning mind.*” Failure to show skepticism in an assignment is a clear violation of standards.
- ▶ The SEC has identified lack of professional skepticism as a primary contributing factor to malpractice claims against auditors.
- ▶ This can manifest itself in the form of bias.
 - » **Affinity** Bias – *people who make me comfortable*
 - » **Confirmation** Bias - *tendency to search for, interpret, favor, and recall information in a way that confirms one's preexisting beliefs or hypotheses*
 - » **Availability** Bias - *decisions are unduly influenced by information that is most memorable or easily accessible*
 - » **Anchoring and adjusting** bias - *tendency to rely too heavily on the first piece of information offered (the "anchor") when making decisions*

D – Determining the Outcome

Objectivity Challenged

Question: *Isn't it true that this is the 5th assignment you've taken for Law Firm?*

- » What percentage is that of business?
- » So a disagreement with Law Firm could be devastating to your business, correct?

Question: *Isn't it true that you work for the Plaintiff more than 90% of the time?*

- » How can you demonstrate objectivity when you only represent Plaintiffs?

Question: *Is it possible for legal and/or management to alter the wording of your report that contained fraudulent allegations?*

POTENTIAL VIOLATIONS

- » Due professional care
- » Professional skepticism
- » Integrity and objectivity

D – Determining the Outcome

Cozy Relationship with Auditor

*"I think for all the relevant periods, the chief accounting officers at Waste Management came from Arthur Andersen," said one SEC regulator. "The relationship is too cozy."
- (CNN.com Europe 1/11/2002)*

- » Andersen was fined \$7 million by the SEC in connection with the Waste Management audits
- » Three audit partners were fined individually
- » The company admitted it had overstated its pretax earnings by \$1.43 billion in 1992 to 1996
- » Until 1997, every chief financial officer and chief accounting officer in the public company's history had been employed at Arthur Andersen



D – Determining the Outcome

Prevention:

- Acknowledging is the first step to countering bias.
- Use an independent peer
- Know when to recuse yourself
- Review ALL relevant material.
- Be comfortable, being uncomfortable.



Questions?

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Insights blog – weaver.com