Management Override: The Achilles’ Heel of Fraud Prevention

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What do all of the following people have in common?

Andrew Fastow, (former) Enron CFO
Ken Lay, (former) Enron Chairman

Jeff Skilling, (former) Enron CEO

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Robert Allen Stanford, (former) head of The Stanford Group

Bernie Madoff, (former) Chairman of Bernard L. Madoff Investment Securities LLC
Scott Sullivan, (former) WorldCom CFO

David Meyers, (former) WorldCom Controller

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Ben Glisan, Jr., (former) Enron Treasurer

What do all of those people have in common?
Unconscious Bias

➢ Why Good Accountants Do Bad Audits, Harvard Business Review, November 2002, Max Bazerman, George Loewenstein, and Don Moore

➢ “The real problem isn’t conscious corruption. It’s unconscious bias.”

➢ A group of 160 randomly selected CPAs from large firms were presented with a series of audit problems.

Unconscious Bias

➢ Half the group was told at the beginning of the exercise to imagine that they were hired by the company whose financial statements were the subject of the problems

➢ Half of the group was told that they were hired by an outside investor who was considering investing in the target company

➢ Those in the 1st group were significantly more likely to endorse the target company’s accounting treatment than those in the 2nd group
Two-Party Audits

Is this a conflict of interest?

The Old Paradigm …
The New Paradigm …

Management Override: The Achilles’ Heel of Fraud Prevention

- The audit committee’s “new” fraud prevention role
- What does this mean for non-public and governmental entities?
- How good is the typical not-for-profit board?
The Audit Committee’s “New” Fraud Prevention Role

Where have the major audit failures been, and why?
Is there a void in existing standards and guidance?
The Durkin Anti-Fraud Programs & Controls Task Force
Durkin Task Force product …

- Target audiences
- Relationship to SAS 99 and the COSO Framework(s)
- Outline, format, and content
What do all of these entities have in common?

Barings Bank
ZZZZBest
MicroStrategy
Arizona Baptist Foundation
Foundation for New Era Philanthropy

There are two types of fraud …

➢ Misappropriation of assets (aka employee fraud)

➢ Fraudulent financial reporting (aka management fraud)
Most of the recent high-profile cases have been management fraud cases …

Are we doing enough to deter/prevent/detect management fraud cases?
Fraud Types Per SAS 16, 53, 82, and 99

- Misappropriation of Assets
- Fraudulent Financial Reporting

A Better Delineation of Fraud Types

- Misappropriation of Assets
- Management Fraud/Override

- Fraudulent Financial Reporting
- Misappropriation of Assets

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A Better Delineation of Fraud Types

**Misappropriation of Assets**
Management is responsible for designing, implementing and maintaining a system of controls to prevent this.

Who is responsible for designing, implementing and maintaining a system of controls to prevent this?

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Is There A Void In Existing Standards and Guidance?

Most of the existing guidance discusses fraud, in general, and misappropriation of assets/employee fraud; with little emphasis on fraudulent financial reporting/management fraud

The Durkin Anti-Fraud Task Force

- CHAIR—Ron Durkin, KPMG
- Mark Beasley, North Carolina State University
- Toby Bishop, Association of Certified Fraud Examiners
- Dave Cotton, Cotton & Company LLP
- George Fritz, (formerly with the) Public Oversight Board
- Mike Glynn, AICPA Technical Manager
- Dan Goldwasser, attorney
- Ron Norris, The Estee Lauder Companies, Inc.
- Zoe-Vonna Palmrose, University of Southern California

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New Guidance for Audit Committees

FREE at:
www.aicpa.org

Management Override: The Achilles Heel of Internal Control

TARGET AUDIENCE:
Those Charged with Governance
Management Override: The Achilles Heel of Internal Control

The chair of the audit committee of ControlCo was stunned. Company counsel had just advised him that the prior year’s revenue and earnings may have been overstated. “But how could that happen? We have good internal controls and management and the auditors both signed off that they were effective!” he said.

Management Override: The Achilles Heel of Internal Control

Ultimately, the chair learned of the “Achilles’ heel” of any system of fraud prevention: Those who design and implement internal controls – management – can also override or bypass those controls. The chair began to wonder, What might we have done differently? How can an audit committee prevent management from overriding internal controls?
Management Override: The Achilles Heel of Internal Control

A few weeks later, as the fraud became public, the chair felt even worse when reading the headline in the local newspaper:

Where Was the Audit Committee?

Management Override: The Achilles Heel of Internal Control

Then, regulators and class action lawyers begin to ask:

- Was the audit committee sufficiently involved or were the members simply listeners? Did the audit committee’s actions demonstrate an appropriate level of skepticism?
- Did the individual members of the audit committee carefully read the quarterly financial statements? Did they understand the correct key performance indicators?
Management Override: *The Achilles Heel of Internal Control*

- Was the audit committee alert to financial statement fraud risk factors? Did the audit committee members focus on the potential for manipulation of financial statements?
- Were the entity’s code of conduct and whistleblowing processes really important to the entity or was it simply an effort to comply with regulatory requirements?
- Was the audit committee making best use of the entity’s internal auditors and independent auditors?

Management Override: *The Achilles Heel of Internal Control*

- Section A: Management Override and the Audit Committee’s Responsibilities
- Section B: Actions to Address the Risk of Management Override of Internal Controls
Management Override: The Achilles Heel of Internal Control

- Maintaining Skepticism
- Strengthening Committee Understanding of the Business
- Brainstorming to Identify Fraud Risks
- Using the Code of Conduct to Assess the Financial Reporting Culture
- Cultivating a Vigorous Whistleblower Program

Management Override: The Achilles Heel of Internal Control

- Developing a Broad Information and Feedback Network
  - Communications With Internal Auditors
  - Communications With Independent Auditor
  - Communications With the Compensation Committee
  - Communications With Key Employees
- Appendix: Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks
### Management Override: The Achilles Heel of Internal Control

- **Audiences:**
  - *Independent audit committee members* (help in carrying out these new responsibilities)
  - *Other issuer board members*
  - *Non-issuer board members*
  - *(Honest) entity management* (how best to meet the new expectations of the SEC and PCAOB; and the inevitable “trickle-down” expectations for better corporate governance)
  - *Auditors* (how to help independent audit committees and boards; how to rely on the new powers of independent audit committees; how to assess management’s seriousness about preventing fraud)
  - *Forensic consultants*
  - *Regulators*
  - *Institutional shareholders*

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#### Inconclusiveness or Pressures on Management

1. Is the entity’s financial stability or profitability threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
   - High degree of competition or market saturation, accompanied by declining margins?
   - High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates?
   - Significant declines in customer demand and increasing business failures in either the industry or overall economy?
   - Operating losses making the threat of bankruptcy, foreclosures, or hostile takeover imminent?
   - Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and maintaining growth?
   - Rapid growth or unusual profitability, especially compared to that of other companies in the same industry?
   - New accounting, statutory, or regulatory requirements?

2. Does excessive pressure exist for management to meet the requirements or expectations of third parties due to the following:
   - Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are untenable, aggressive, or unrealistic, including expectations created by management e.g., for example, overly optimistic press releases or annual report messages)?
   - Need to obtain additional debt or equity financing to stay competitive—increasing the leveraging of major research and development or capital expenditures?
   - Marginal ability to meet debt repayment or other debt covenant requirements?
   - Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards?

3. Is management’s personal financial situation threatened by the entity’s financial performance arising from the following:
   - Significant financial interests in the entity?
   - Significant portions of compensation (for example, bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flows? (Note: management incentive plans may be contingent upon achieving targets relating only to certain accounts or selected activities of the entity, even though the related accounts or activities may not be material to the entity as a whole.)
   - Personal guarantees of debts of the entity?
Management Override: *The Achilles Heel of Internal Control*

- This “best practices” document should have an immediate and significant impact in terms of detection and prevention of fraudulent financial reporting and management fraud.
- It should be “required reading” for:
  - All independent audit committee members
  - All issuer board members
  - All non-issuer board members
  - All auditors

What does all of this mean for governmental and not-for-profit entities?

- Nothing, because fraud cannot happen in a governmental or not-for-profit entity?

Let’s look at a short case study …
Performance Audit of Port of Seattle Construction Management

- On December 20, 2007, Washington State Auditor Brian Sonntag released a 334-page performance audit report:

  **COST CONTROL, ACCOUNTABILITY, AND TRANSPARENCY ARE NOT PORT OF SEATTLE PRIORITIES AND PORT OF SEATTLE CONSTRUCTION MANAGEMENT IS VULNERABLE TO FRAUD, WASTE, AND ABUSE**

- On January 4, 2007, Jeffrey C. Sullivan, United States Attorney for the Western District of Washington, announced that his office was conducting a criminal investigation of the Port based on the performance audit report’s findings

Major Audit Findings

1. POS Construction Management Lacks Cost Controls and Accountability.
2. POS Frequently Circumvents Competition Requirements in Violation of Its Own Policies and Sometimes in Violation of State Law.
Major Audit Findings

4. POS Construction Management Records are Incomplete and Disorganized.
5. POS Fails to Enforce Basic Contract Requirements, Resulting in Delays, Extra Costs, and an Inability to Defend Against Claims.
6. POS Construction Management is Vulnerable to Fraud, Waste, and Abuse.
7. Other Matters.

Overarching Recommendation I: Chief Procurement Officer

- The Port does not have adequate segregation of duties related to procurement actions
- Relatively low-level project and construction managers—who work directly on a day-to-day basis with contractors—can award and amend contracts, approve change orders, and allow contractors to ignore contract requirements
- This resulted in inconsistent and lax contract management
- Highly vulnerable to fraud and abuse—no controls to prevent or detect bribes, kickbacks, or illegal gratuity fraud schemes

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Overarching Recommendation II: Delegations of Authority

- Resolution 3181 delegates authority from the elected Commission to the Port CEO
- Numerous “redelegations” grant varying levels of spending authority to project managers, construction managers, engineers, and so forth
- Both 3181 and the various redelegations are confusing and unclear and are subject to varying—and changing—interpretations by the Port

Overarching Recommendation II: Delegations of Authority

- E.g.: Resolution 3181 contains a provision requiring Commission approval of changes greater than $50,000 or 15% of the contract value
- When we brought numerous examples of deviations from this requirement to the Port’s attention, they asserted that this provision only applies to “individual work contract authorizations” and not to “project-wide authorizations”
- The Port was unable to identify any “individual work contract authorizations”
- Under the Port’s interpretation, once the Commission approves a major project (such as the $720 million 3rd runway) Port managers have carte blanche authority to spend money up to the authorization ceiling
Overarching Recommendation II: Delegations of Authority

- Further, redelegations from the CEO to lower-level managers limit spending authority to $100,000 or below
- When we brought examples of deviations from *this* requirement to the Port’s attention, they asserted that the redelegations do not apply to “project-wide authorizations”
- Thus, a low level manager who appears to have limited spending authority can—under the POS interpretation—actually approve multi-million contracts and change orders

Let’s look at just three findings where POS management overrode key controls…

- Altered invoices and “steered” contracts
- Benford’s Law and circumvention of competition requirements
- The “steakhouse deal”
Altered Invoices and “Steered” Contracts

- Under the “small works roster” program, the Port can use limited competition for contracts up to $200,000
- The Port failed (we think) to monitor the actual expenditures against contract award amounts, and a contractor exceeded the $200,000 ceiling
- The Port altered the contractor’s invoices and then “steered” a new contract to the vendor to cover the cost overruns
Altered Invoices and "Steered" Contracts

![Image of an altered invoice]

![Image of a constructed contract]

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Altered Invoices and “Steered” Contracts

- We were able to replicate the documentation supposedly supporting this procurement:

Port response to the PFR:

“While the Performance Auditor – by employing feigned intent to commit fraud – may have been able to make the program look as if a contract had been bid, the faked contract lacked the detail that a real contract – for which actual bidders were invited to submit bids – would have. Although copies are not included in the files, the small works roster program in fact keeps a record of its efforts to distribute the invitation.”

- Port provided as an example a different contract than the PFR had discussed
Benford’s Law and Circumvention of Competition Requirements

- Benford’s Law is a digital analysis technique designed to find anomalous amounts in populations of numbers.
- Leading digits in naturally-occurring populations of numbers are not randomly distributed:
  - 1 -- 30.1%
  - 2 -- 17.6%
  - 3 -- 12.5%
  - 4 -- 9.7%
- We performed a Benford’s Law analysis of POS consulting contracts to help assess compliance with POS policies related to competition.

Port Policy for Competition:
- No competition required for contracts < $50,000
- Limited competition (3 proposals) for contracts from $50,001 to $200,000
- Full and open competition for contracts > $200,000
Benford’s Law and Circumvention of Competition Requirements

- Port Policy for Competition:
  - No competition required for contracts < $50,000
  - Limited competition (3 proposals) for contracts from $50,001 to $200,000
  - Full and open competition for contracts > $200,000
- This policy, combined with the lack of independent procurement officials, represents a significant opportunity for abuse and fraud (bribes, kickbacks, illegal gratuities)
Benford’s Law and Circumvention of Competition Requirements

- Port Response: “50K and 200K also coincides with common delegations of authority and therefore contributes to the large amounts contracted within that limitation.”

- Our report cites details of 19 specific examples where the circumvention of competition is clear.
Benford’s Law and Circumvention of Competition Requirements

- More detailed analysis of specific procurements revealed:
  - Instances where consultants were awarded—sole source—multiple sequential $50,000 contracts and $30,000 upward amendments
  - Instances in which $50,000 contracts were awarded on a sole source basis and then amended to higher amounts in violation of policy
  - Instances in which simultaneous sole source $50,000 contracts were awarded to the same contractor for the same services

- One consulting company received 44 sole source contracts in a 24-month period for $1,178,440
- One consulting company received 43 sole source contracts in a 24-month period for $1,530,648
- A contract was awarded (using limited competition) for $75,272 and then amended upward to $5,846,112
Benford’s Law and Circumvention of Competition Requirements

- The Port’s overarching explanation/rationalization:

  The Port of Seattle enjoys substantial flexibility in how it elects to accomplish the purposes for which it exists under Title 53. While designed to ensure compliance with the very limited number of statutes governing its procurement practices, the Port’s procurement policies are voluntarily instituted and may, except when effecting [sic] the requirement of one of those limited number of statutes, be waived. [Emphasis added.]

The “Steakhouse Deal”

*The Seattle Times*

January 25, 2008

Steakhouse deal: How Port allegedly broke laws, hid costs from public
The “Steakhouse Deal”

- Washington State Law prohibits negotiating with a construction contractor prior to award
- Port policy requires Commission “notification” when the Port intends to award a contract for more than 10% above its engineer’s estimate for the work
- The Port divided the embankment work (17 million cubic yards of fill) for the 3rd runway project into two phases
- TTI won the contract for phase 1 (2004-2005)
- The Port’s estimate (in the fall of 2005) for the cost of the phase 2 (2006) contract was $92 million
- Just prior to receipt of bids, the Port learned that only TTI was going to bid on the contract

The “Steakhouse Deal”

- Based solely on this knowledge that only a single bid would be received, the Port increased its estimate from $92 million to $105 million
- The sole bid received turned out to be $125 million (19% higher than even the inflated estimate)
- The Port’s CEO and aviation managing director met with a TTI principal at “Spencer’s for Steaks and Chops” near Sea-Tac. The TTI principal was told that if he wanted the contract, he would need to lower his price by $9.4 million (just enough to get within 10% of the Port’s inflated cost estimate)
- TTI and the Port negotiated a $9.4 million “adjustment” to the contract price
The “Steakhouse Deal”

- The $9.4 million reduction consisted of:
  - A $2 million reduction in mobilization-demobilization
  - A $4 million reduction premised on fuel costs dropping from $2.52/gal to less than $2.00/gal (with the understanding that the $4 million would be added back if the fuel cost did not drop)
  - $3.4 million in reductions based on changes in estimated quantities for several unit-price line items

The “Steakhouse Deal”

The $2 million reduction in mobilization-demobilization seems legitimate on first look, but

- TTI’s bid price for mob/demob: $9,271,485
- POS estimate for mob/demob: $1,500,000
- TTI mob/demob in the Phase 1 (2004-2005) contract price: $3,699,000
The “Steakhouse Deal”

- Apparently, someone at the Port realized that reducing the award amount would reveal that they had negotiated illegally, so they decided to award the contract at the $125 million bid amount with the expectation that TTI would agree to the $9.4 million “adjustment” as a deductive change order.

The “Steakhouse Deal”

- The Port notified the Commission of the planned contract award via a December 27, 2005 memo that was misleading, at best.
- We talked with 4 of the 5 commissioners, supposedly notified.
- None remembered seeing the notification.
- When we showed them the notification, all 4 said they interpreted it as indicating that the award was within 10% of the POS estimate.
The “Steakhouse Deal”

The 12-27-2005 notification:

We received one bid on December 20, 2005 for the above-noted project. The Bidder was TTI Constructors, LLC with a bid of $124,777,042.50 based upon extrapolation of unit prices and estimated quantities. After requesting the Bidder to validate their bid and to verify the unit prices and estimated quantities, an adjusted amount of $115,385,438.50 was provided. The Port’s estimate of construction cost is $105,077,395.00.

The existing Commission authorization to date is adequate to satisfy this contract award. The Port will proceed with the award process on December 30, 2005, and administer an immediate deductive change order to reflect the adjusted quantity/pricing as described above.

The “Steakhouse Deal”

- Following the January 2006 contract award, TTI balked at signing the $9.4 million deductive change order; but finally signed it on June 5, 2006, after the price of fuel had risen to $3.16/gal.
- TTI ultimately was paid back the $4 million for fuel costs and was paid for actual quantities, as the contract required.
- Contract award amount: $124,777,042
- Deductive Change Order #1: $9,391,604
- Final contract amount: $124,765,702
Post-Audit Developments

- Public response
- U.S. Attorney response
- Washington State Legislature response

Public Reaction to the Audit

- **Seattle Post-Intelligencer**
  December 20, 2007
  State audit slams port's waste
  Report: $97.2 million down the drain

- **The Seattle Times**
  December 20, 2007
  State audit blasts Port of Seattle

- **The Seattle Times**
  December 21, 2007
  Nearly $100 million wasted by Port, state says
Government Reaction to the Audit

**Seattle Post-Intelligencer**

January 7, 2008
Feds open criminal inquiry into port

**The Seattle Times**

January 7, 2008
Justice Department to investigate Port

**The Seattle Times**

January 8, 2008
Possible fraud at Port focus of criminal probe

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Legislative Reaction to the Audit

**Seattle Post-Intelligencer**

January 9, 2008
Lawmakers vow to rein in port
Keiser says she'll push to repeal taxing power

**The Seattle Times**

January 7, 2008
Port tells panel it's making changes; auditors disagree
Port Commission Investigation

Report of:
THE SPECIAL INVESTIGATIVE TEAM
DECEMBER 3, 2008

While the investigatory team did not identify any embezzlement or personal gain, it found ten incidents of fraud in port contracting practices and exposed a culture that tolerated suppressing information from the elected commission.

What does all of this mean for governmental and not-for-profit entities?

- Maybe there is room for greater auditor independence …
- And more involved audit committees … in governmental—and not-for-profit and non-issuer—entities
- And a new role for CPAs: attesting to the quality of antifraud programs and controls

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New Guidance for Audit Committees

Did I mention that this is available for FREE?

Let me end with a quote from one of my heroes …

If the confidence of the public in the integrity of accountants' reports is shaken, their value is gone. To preserve the integrity of his reports, the accountant must insist upon absolute independence of judgment and action. The necessity of preserving this position of independence indicates certain standards of conduct.
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