The War Against Fraud & Abuse: Are We Winning?

Dave Cotton, CPA, CFE, CGFM
Cotton & Company LLP
Alexandria, Virginia
www.cottoncpa.com
Remember: Four words have preceded EVERY fraud that has ever been committed …

It can’t happen here!

Remember: Eight words have followed EVERY fraud that has ever been discovered …

We didn’t think it could happen to us!!
Winning the War Against Fraud & Abuse

- Should auditors be expected to find fraud?
- If not auditors, then who?
- How about management?
- How about “those charged with governance”?
- Maybe the government should do it?
- How about more standards?
- The Answer

Should auditors be expected to find fraud?
The four possible audit outcomes with respect to fraud …

1. There was no material fraud

2. There was material fraud, and the auditors discover the fraud

3. There was material fraud, and the fraud is discovered through some other means after the audit is completed

4. There was material fraud, and the fraud is never discovered

Financial statement fraud is characterized by …

- Chicanery
- Collusion
- Concealment
- Cover-up
- Deceit
- Deception
- Deliberate distortions
- Dishonesty
- Evasion
- False entries
- False exculpatories
- False pretenses
- Falsification
- Guile
- Lies
- Misdirection
- Misrepresentation
- Trickery
Finding fraud is not an even contest

- Auditors have limited powers, tight schedules, constrained budgets, high visibility, and much to try to examine

- Auditors begin their work unaware that a crime has been committed

- Perpetrators know that a crime has been committed and how it was committed

- Perpetrators will take as much time and exert as much effort as necessary to avoid detection

Finding fraud is not an even contest

- Perpetrators know exactly what needs to be concealed

- Perpetrators know exactly who is trying to find their fraud and how they plan to go about doing it

- Perpetrators will work round-the-clock to avoid detection

- In most cases, the perpetrator’s desire to avoid detection far exceeds the auditor’s desire to find fraud
Here’s what the current standard (SAS 99) requires

“the auditor has a 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 is a broad legal concept and auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor’s interest specifically relates to acts that result in a material misstatement of the financial statements. The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional.
Here’s what the current standard (SAS 99) requires

- Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.

- Management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization. Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation.

Here’s what the current standard (SAS 99) requires

- Fraud also may be concealed through collusion among management, employees, or third parties. Collusion may cause the auditor who has properly performed the audit to conclude that evidence provided is persuasive when it is, in fact, false.

- Fraud usually is concealed and management’s intent is difficult to determine ...

- Absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud.
Here’s what the yellow book requires

Whether an act is, in fact, fraud is a determination to be made through the judicial or other adjudicative system and is beyond auditors’ professional responsibility. [Paragraph 7.30]

So, does it matter to auditors if a misstatement was caused by fraud rather than error?
Yes, according to the PCAOB

Although any financial statement audit entails some risk that the auditor will not detect a material misstatement even when the audit has been conducted in accordance with the standards of the PCAOB [i.e. SAS 99], the risk of nondetection is likely to be higher for misstatements caused by fraud than for misstatements caused by error, since fraud usually involves deliberate concealment and may involve collusion with third parties. The auditor should, therefore, assess risks and apply procedures directed specifically to the detection of a material, fraudulent misstatement of the financial statements. [PCAOB Release 2007-001.]

Here’s what the current standard (SAS 99) requires

If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

a. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor’s report thereon.
b. Consider the implications for other aspects of the audit.
c. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.
d. If appropriate, suggest that the client consult with legal counsel.
Case Study: Performance Audit of Port of Seattle Construction management

- POS Construction Management Records are Incomplete and Disorganized.
- POS Fails to Enforce Basic Contract Requirements, Resulting in Delays, Extra Costs, and an Inability to Defend Against Claims.
- POS Construction Management is Vulnerable to Fraud, Waste, and Abuse.
Port of Seattle Response

- “As to the issue of fraud, it is important to note that no instance of fraud was found ...”
- “… the Port has zero tolerance for fraud should it ever be found.”
- “This performance audit found no fraud.”
- “The Port notes that the Performance Auditor did not find actual cases of fraud during his investigation.”
- “… the Port believes that it is not vulnerable to fraud to the degree suggested by the Performance Auditor ...”

Official Reaction to the Audit

Seattle Post-Intelligencer

January 7, 2008

Feds open criminal inquiry into port

The Seattle Times

State and Local January 7, 2008 - Waste
Report: $97.2 million down the drain
Justice Department to investigate Port

The Seattle Times

January 8, 2008

Possible fraud at Port focus of criminal probe
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.

Port of Seattle Performance Audit

Even when evidence of fraud is overwhelming, those responsible will deny the facts, attack the auditor, and demand that auditors provide “proof” of fraud.
Maybe auditors find more fraud than we realize …

- The only difference between an error and fraud is *intent*
- Intent is *very* difficult to prove
- Auditors find lots of “errors”
- Maybe some of them are really fraud

Case Study: *Daewoo v United States of America*
Daewoo v United States

- Daewoo Engineering and Construction Co., Ltd., was awarded an $88 million contract to build a 2-lane highway around Babeldaop Island, Republic of Palau.
- Daewoo encountered weather-related delays.
- The road was supposed to have been completed in 2001.
- The road was finally completed in the fall of 2007.
- Daewoo submitted a $64 million claim to the Army Corps of engineers.
Daewoo v United States

- DOJ hired Cotton & Company to help defend against the claim
- We spent 3 weeks in Palau auditing the claim
- Daewoo’s claim contained equipment costs (about 85% of the claim), labor costs, and other costs, including the “kitchen sink”

A true “kitchen sink” claim
A true “kitchen sink” claim

<table>
<thead>
<tr>
<th>Description of Item</th>
<th>Total Cost</th>
<th>Monthly Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chopsticks (set of 2)</td>
<td>$1.25</td>
<td>$0.02</td>
</tr>
<tr>
<td>Dish Towel (70)</td>
<td>7.33</td>
<td>0.12</td>
</tr>
<tr>
<td>Can Opener (2)</td>
<td>3.79</td>
<td>0.06</td>
</tr>
<tr>
<td>Knife for Meat</td>
<td>84.00</td>
<td>1.40</td>
</tr>
<tr>
<td>Rain Coat (50)</td>
<td>341.44</td>
<td>5.69</td>
</tr>
<tr>
<td>Telephone (3)</td>
<td>86.45</td>
<td>1.44</td>
</tr>
<tr>
<td>Wooden Rice Scoop (2)</td>
<td>1.21</td>
<td>0.02</td>
</tr>
<tr>
<td>Large Pan (2)</td>
<td>28.53</td>
<td>0.18</td>
</tr>
<tr>
<td>Coat Hanger</td>
<td>123.26</td>
<td>2.04</td>
</tr>
</tbody>
</table>

Convoluted claim presentation

- 300+ pages
- Costs for Daewoo as well as Daewoo’s 6 subcontractors
- Different formats and bases
- Daewoo hired a claims expert to review its claim and that expert presented an entirely different claim
Convoluted claim presentation—equipment costs

Standby Cost of Direct Equipments (DAEWOO)

<table>
<thead>
<tr>
<th>ID Number</th>
<th>Description</th>
<th>Make/Model</th>
<th>Date of Arrival</th>
<th>Monthly Standby Rate</th>
<th>Age Adjusted Factor</th>
<th>Adjusted Standby Rate</th>
<th>Monthly Standby Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>TDC400</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
<tr>
<td>2</td>
<td>TDC400</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
<tr>
<td>3</td>
<td>TDC400</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
<tr>
<td>4</td>
<td>TDC400</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
</tbody>
</table>

PT. PUTRA SEMESTA BARUGA

A. STATUS OF EQUIPMENT OVERHEAD EQUIPMENT

<table>
<thead>
<tr>
<th>ID Number</th>
<th>Description</th>
<th>Make/Model</th>
<th>Date of Arrival</th>
<th>Monthly Standby Rate</th>
<th>Age Adjusted Factor</th>
<th>Adjusted Standby Rate</th>
<th>Monthly Standby Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>TRUCK</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
<tr>
<td>2</td>
<td>TRUCK</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
<tr>
<td>3</td>
<td>TRUCK</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
<tr>
<td>4</td>
<td>TRUCK</td>
<td>DAEWOO</td>
<td>20040319</td>
<td>1.07</td>
<td>0.67</td>
<td>0.7</td>
<td>98.60</td>
</tr>
</tbody>
</table>

Auditing the Claim

- We asked for the Excel spreadsheets that generated the many pages of equipment cost schedules
- We "unhid" the hidden columns
- We rearranged the columns so that they were consistent for all spreadsheets
- We merged the spreadsheets into a single spreadsheet
- We performed a "data sort" on the "Chassis No." column
Auditing the Claim

- We sought Daewoo’s explanation for the duplicated equipment.

- To “prove” that they had certain items of equipment, Daewoo’s equipment manager revealed a previously undisclosed spreadsheet.
Auditing the Claim

- We used this newly discovered spreadsheet to identify scrapped equipment in the claim
- Duplicated and scrapped equipment in the claim totalled at least $2,020,252.
Daewoo’s Explanations

- Duplicated and scrapped equipment were insignificant errors in their claim

A Compelling Trial Exhibit
Daewoo v United States

We noted that all Daewoo’s “errors” in the claim increased the amount of the claim; no errors had the effect of reducing the claim. This would be a remarkable coincidence in a random review of claim elements, or any means of “sampling” by auditors. See, e.g., DX 1015 (Cotton Report); DX 1015 (Cotton Supplemental Report); Tr. 17303 (McGeehin). The possibility that the inflationary effects of Exponent’s and Daewoo’s errors resulted from innocent mistakes is remote.

--The Honorable Robert Hodges
Daewoo v United States

- **ALL** of Daewoo’s $64 million claim was denied
- The Court entered judgment in the Government’s favor under fraud counterclaims pertaining to:
  - The fraud provisions of the Contract Disputes Act
  - The False Claims Act
  - The Special Plea in Fraud (Fraud Forfeiture)
  - Fraud in the Inducement (bait & switch)
- Daewoo has been ordered to pay the Government $50,639,855.88
- An additional $10-20 million in penalties (as well as debarment) is still pending
- Daewoo’s appeal was ruled on in February 2009

United States Court of Appeals for the Federal Circuit

2007-8129

DAEWOO ENGINEERING AND CONSTRUCTION CO., LTD.,

Plaintiff-Appellant,

V.

UNITED STATES,

Defendant-Appellee.

Appeal from the United States Court of Federal Claims in 02-CV-1914, Senior Judge Robert H. Hodges, Jr.

DECIDED: February 20, 2009

The court awarded the government $10,000 for Daewoo’s False Claims Act violation and $50,639,855.88 for Daewoo’s Contract Disputes Act violation. Id. at 597. It also held that Daewoo’s claims were forfeited under 28 U.S.C. § 2514. Id. We affirm.
SCOTUS Appeal Outcome

(Order List: 558 U.S.)

Monday, November 2, 2009

Certiorari Denied

08-10337  Bisby, Jerry L. v. Crites, Asst. Warden, et al.
08-10666  Yost, John v. West Virginia
08-10723  N. I. V. Orange County Social Services
08-10827  Musick, Gary V. United States
08-10845  Ogunde, Oludare v. Virginia
08-11065  Gutierrez, Alfred A. v. California
09-3      Daewoo Engineering & Constr. v. United States

The Compact Road, Fall 2009

dcotton@cottoncpa.com
The Compact Road, Fall 2009

The Compact Road, Fall 2009
Daewoo v United States

Lessons Learned …

The audit identified many, many “errors” in the claim. It took a 13-week trial to enable a federal judge to conclude that many of those “errors” were actually fraud.

Even then, Daewoo continued (and continues) to deny that it had committed any fraud.

Are auditors getting the job done?
Accounting experts say Andersen should have noticed that WorldCom hid $3.8 billion of expenses

He Said It

"We just got a message from Saddam Hussein. The good news is that he's willing to have his nuclear, biological and chemical weapons counted. The bad news is he wants Arthur Andersen to do it."

— President Bush, joking at last weekend's Gridiron Dinner
Are auditors getting the job done?

How about management?

- After all, we all know that it is management’s responsibility to design, implement, and maintain a system of strong internal control to prevent fraud, waste, and abuse
- Yes, let’s all agree that management should be responsible …
Quiz #1: What do all of these entities have in common?

There are two types of fraud …

- Misappropriation of assets (aka employee fraud)

- Fraudulent financial reporting (aka management fraud)
BUT, most of the recent high-profile fraud cases have been management fraud cases …

Is management preventing fraud?
How about “those charged with governance”?

- This is what we’re trying under Sarbanes-Oxley for publicly-traded companies
- Old question when fraud happened: Where were the auditors?
- New question when fraud happens: Where was the audit committee?
- Essentially a recognition that management cannot be trusted in all situations
Case Study: Orel Suer

Would you give your hard-earned money to this man?
Ex-Chief Of Local United Way Sentenced

Former Chief of Area United Way Sentenced to 27 Months for Fraud

Oral Suer pleaded guilty to defrauding the United Way of almost $500,000 over a 6-7 year period

He was caught in 2002

UWNCA 2001 revenue: $90,000,000
**Ex-Chief Of Local United Way Sentenced**

- Former Chief of Area United Way Sentenced to 27 Months for Fraud
- Oral Suer pleaded guilty to defrauding the United Way of almost $500,000 over a 6-7 year period
- He was caught in 2002
- UWNCA 2001 revenue: $90,000,000
- UWNCA 2002 revenue: $19,000,000

**The Suer investigation revealed another scheme: Round-Tripping Receipts**

- DC Area Donors
  - $\$\$
- United Way of the National Capital Area:
  - Takes 10%
  - Takes another 10%
  - 72.9% goes to UWNCA charities
- Neighboring United Way: takes 10% of the 90%
- 81%
- 72.9%
- Charities get 72.9%
Ex-Chief Of Local United Way Sentenced

- Lessons
  - Auditors and not-for-profits need to re-evaluate their focuses on quantitative materiality
  - Abuse is often the iceberg-tip that can reveal bigger problems ($60,000 to sound-proof Orel’s office might have been a good red flag)
  - Governance matters

New Guidance for Audit Committees

FREE at: www.aicpa.org

dcotton@cottoncpa.com
Management Override: The Achilles Heel of Internal Control

TARGET AUDIENCE:
Those Charged with Governance

How about “those charged with governance”?

- Too soon to tell at the SEC level …
- There are about 17,000 publicly-traded companies
- There are about 450,000 private companies, not-for-profits, and state/local governmental entities …. Most do not have audit committees, some do not have boards
- How good is the typical non-SEC board?
Can we rely on “those charged with governance” to stop fraud and abuse?

Maybe the government should do it?

- Sure, let’s let the government do it
- The government’s doing a real good job at other things …
- Like crime-prevention, education, emergency management, balancing budgets …
- Look at the great job the SEC has done to prevent fraudulent financial reporting since 1934 …
Picture = 1,000 Words (and $65 billion)

Can we trust the government to stop fraud?
How about more standards?

- Sure, this *HAS* to be the answer
- We need more auditing standards and more accounting principles
Restatements by Stock Exchange 1990-2000

Source: Financial Executives Research Foundation Inc.

Trends in Restated Annual Audited Financial Statements

See: www.huronconsultinggroup.com
Figure 2: Total Number of Restatement Announcements Identified, January 1997–September 2005


SASs and Financial Statements Restated

Source: GAO analysis of relevant press releases and SEC filings.
Will adding more standards put an end to fraud?

One more thought on all those auditing standards …

- We have had 116 SASs since the ASB was formed in 1973
- How many dealt specifically with fraud and illegal acts?
- Just 5: SAS 16, 53, 54, 82, and 99 (just 2 still in effect)
- So, we’ve had **111** SASs focused on finding mistakes?

One more thought on all those auditing standards …

- In the Bob Kratchet, green eyeshade accounting era, maybe 111 SASs focused on finding errors was a good idea …
- But, in the age of automated accounting and electronic data processing????
- Maybe we **COULD** use a few more SASs focused on finding fraud
- Just a thought …
The Answer: Comprehensive anti-fraud programs and controls

- Deterring, preventing, and detecting fraud needs to be a comprehensive and concerted effort by all involved
The IIA Anti-Fraud Task Force

- Chaired by Dave Richards, IIA CEO, and Ron Durkin, KPMG Forensic Partner
- Developed a comprehensive guide for organizations committed to implementation of the strongest anti-fraud measures possible
- Exposed for review and comment
- Vetted by endorser and supporter groups
- Issued in 2008

Preventing Fraud, Waste, and Abuse

- Comprehensive fraud risk management
- *What the COSO Framework has been to internal control, this new guide will be to fraud prevention*
Preventing Fraud, Waste, and Abuse

- Written by the Anti-Fraud Task Force, sponsored by:
  - Institute of Internal Auditors (IIA)
  - Association of Certified Fraud Examiners (ACFE)
  - American Institute of CPAs (AICPA).
- Task Force members included accountability professionals from a wide array of large, small, public, private, governmental and academic organizations and institutions.
Preventing Fraud, Waste, and Abuse

- Managing the Business Risk of Fraud: a practical guide
  - Introduction
  - Fraud Risk Governance and the Fraud Risk Management Program
  - Fraud Risk Assessment
  - Fraud Prevention
  - Fraud Detection
  - Fraud Investigation and Response

Preventing Fraud, Waste, and Abuse

- Managing the Business Risk of Fraud: a practical guide
  - Appendices:
    - Reference Material
    - Fraud Governance Policy
    - Risk Assessment Framework Sample
    - Fraud Prevention Scorecard
    - Fraud Detection Scorecard
    - COSO Fraud Risk Management Activities

dcotton@cottoncpa.com
Preventing Fraud, Waste, and Abuse

APPENDIX D: FRAUD PREVENTION SCORECARD

To assess the strength of the organization’s fraud prevention system, carefully assess each area below and score the area, factor, or consideration as either:

- Red indicating that the area, factor, or consideration needs substantial strengthening and improvement to bring fraud risk down to an acceptable level.
- Yellow indicating that the area, factor, or consideration needs some strengthening and improvement to bring fraud risk down to an acceptable level.
- Green indicating that the area, factor, or consideration is strong and fraud risk has been reduced — at least — to a minimally acceptable level.

Each area, factor, or consideration scored either red or yellow should have a note associated with it that describes the action plan for bringing it to green on the next scorecard.

<table>
<thead>
<tr>
<th>Fraud Prevention Area, Factor, or Consideration</th>
<th>Score</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Our organizational culture — tone at the top — is as strong as it can possibly be and established a zero-tolerance environment with respect to fraud.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Our organization’s top management consistently displays the appropriate attitude regarding fraud prevention and encourages free and open communication regarding ethical behavior.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Our Code of Organizational Conduct has specific provisions that address and prohibit inappropriate relationships whereby members of our board or members of management could use their positions for personal gain or other inappropriate purposes.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
End Thoughts

- Fraud is VERY difficult to prevent
- Even harder to detect
- No single player in our free market system should be held singularly responsible
- We ALL need to be involved in the fight

End Thoughts

We have the strongest capital market in the world and the most vigorous and generous donor community in the world. These are the engines of productivity, prosperity and progress.

Imagine how much stronger they can be if we stamp out fraudulent financial reporting and draw more capital from totally confident investors and donors across the country and around the globe.
It CAN be done.

The War Against Fraud & Abuse: Are We Winning?

Dave Cotton, CPA, CFE, CGFM
Cotton & Company LLP
Alexandria, Virginia
www.cottoncpa.com

dcotton@cottoncpa.com