



Seventeen Accounting Procedures That Put Credit Managers at Risk

By Gary D. Zeune, CPA

It took the terrorist attacks on September 11, 2001 to prove our national security measures were inadequate. It took the bankruptcy of Enron, the largest in U.S. history, to prove that the fundamental auditing processes aren't up to the task of protecting users of financial statements. Enron isn't the only failure, just the latest and largest. Remember Sunbeam, Waste Management, Global Crossing, Xerox (which recently paid a record \$10 million fine) and Leslie Fay (the CFO has been sentenced to prison for 9 years), just to name a few?

Enron represents a "shock" to the system. How could a company worth \$80 BILLION go bankrupt in less than a year? Enron collapsed because it lost credibility. Investors, regulators, creditors and auditors simply stopped believing what it said. Has it ever occurred to you that your personal and company credibility is the only thing that gives your work value? Most commentators think the complex transactions—the off-balance sheet deals—Enron engaged in, brought it down. Wrong. Many companies, such as investment and commercial banks, are built on complexity. BUT, the companies' financial statements are transparent, and the market takes the financing techniques into account and values the company accordingly.

So, the first lesson is to NOT do as Enron did. Do what's right—no matter how much it hurts. Of course, that's easier said than done, but I digress. Back to how audited financial statements put you at risk.

Think credibility isn't important, that the underlying fundamentals of the accounting profession aren't under the microscope? Consider just a few of the recent headlines:

- "Can't Executives Be as Honorable as Our Soldiers?" *WSJ*, March 12, 2002
- "The New Business Casual: Prison Stripes," *WSJ*, March 13, 2002
- "Is Accounting Dead?... These days,

accounting smells... Perfectly legal accounting tricks can hide big problems." *Forbes*, March 4, 2002

- "Investors' New Worry: Auditor Risk—Who's auditing the books?" *Business Week*, January 25, 2002
- "Stocks Take a Beating As Accounting Worries Spread Beyond Enron," *Wall Street Journal*, January 30, 2002
- "After Enron, New Doubts About Auditors," *The New York Times*, December 5, 2001
- "Tweaking Results Is Hardly a Sometime Thing—Many Firms, Under Diverse Pressures, May Play With Numbers," *WSJ*, February 6, 2002
- "Stocks Plummet Amid Accounting Fears," *The Wall Street Journal*, January 29, 2002
- "SEC Warning: Playing By Rules May Not Ward Off Fraud Issues," *WSJ*, February 12, 2002
- "Under the Microscope—After Enron, investors are looking more skeptically at companies whose bookkeeping seems confusing," *Time*, February 4, 2002
- "Can you trust anybody anymore?" *Business Week*, November 28, 2001

You can be the most technically competent credit manager around, but your abilities don't mean much if you rely on a work product that has inherent flaws. It's like finding out 2+2=4. Thus, you must do everything in your power to protect your company and yourself. Let's explore a number of standard audit practices that put your company, and you personally, at risk.

Because of a string of high-profile failures undetected by auditors, demonstrating that the profession is incapable of regulating itself and sanctioning its own, the SEC has instituted an independent board to oversee the profession. How did the most admired profession 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: Accountants simply don't understand that just because the audit has to be done, that anyone thinks it's valuable. In my classes for CPAs, I ask several questions:

Q: When was the last time a client was excited that you were coming out to begin the audit? A: Laughter.

Q: How many clients do you have that would have the audit done if it weren't required? A: Out of 100 CPAs, maybe one or two raise their hands (usually because it's an absentee owner who wants a double check on the financial program).

Q: Has any client EVER gotten excited you were almost done with the depreciation schedule? A: Never happens.

Q: What does that tell you about the value your customers put on their audited financial statements? A: It's to be performed at the cheapest possible price, which in turn puts you at risk if you rely on the customer's financial statements in making credit decisions.

As a result of the "Wal-Martization" of audits, everyday audit procedures have become habits, just like driving to work the same way every day, and thus, accountants fail to ask if their procedures protect you or even whether they should be doing them.

Most accountants will say audits aren't designed to detect fraud. WRONG. And that's the heart of the problem. And that's what puts you at risk in making credit decisions. Accountants love to quote a statistic that the audit failure rate is less than 1 percent. That's like saying that only 1/4 percent of drivers speed because that's the percentage that get tickets (don't chuckle—it's not nice). The problem is that 1 percent is the DETECTED failure rate, not the rate of occurrence.

Even if the failure rate is only 1 percent, consider this: There are 35,000 airplane flights every day in the U.S. Can you imagine the outrage if 350 crashed? Would that be acceptable?

These Audit Procedures Can Get You "ENRON'd"

I don't intend to imply that these practices were present in the ENRON audit, but they are very common and can lead to your being "ENRON'd" by financial statements with a "clean opinion" when there are material errors:

1. **Audit the business:** Statement on Auditing Standards Number 82 (SAS 82) "Consideration of Fraud in a Financial Statement Audit" is a positive affirmative DUTY of auditors to detect fraud. Figure 1 depicts the fact that most of SAS 82 audit procedures are OUTSIDE the books. It was effective December 15, 1997. Yet many accountants still use the same audit program as they did before SAS 82. Paragraph 1) says, "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." This is a POSITIVE, AFFIRMATIVE duty to detect material fraud. It's not an absolute duty. The auditor must perform at a reasonable assurance level.

Figure 1.



Just one example of an audit procedure "outside the books" that is critical. Under SAS 82, auditors are to determine if the client's job screening procedures are adequate. Do you know whether or not your customers' auditors check the hiring system for employees who have access to liquid assets or in a control position? Why are background checks important? Because the easiest way to prevent someone from stealing the company blind is not to hire the

employee in the first place. In addition to criminal checks, check driving records and credit history. Employees behind on their bills are more likely to steal, as are people who get many traffic tickets—they are risk takers.

In a recent survey, 40 percent of 18 to 35 year olds said they lived above and beyond their means. What makes you think you aren't hiring any of these employees? So find out if your customers

do background checks, and if not, make it a condition of credit if you have any doubt about getting paid. After all, if someone steals the customer's cash, it might not be able to pay you. Many small businesses can't pay vendors because the "trusted" controller ran off with the money.

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

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First: Why would audit staff say they did work when they didn't? Answer: Pressure to meet the time budget and to get a promotion and pay raise by coming in under budget and keeping the client happy.

Second: How do audit staff know what to falsely sign off and not be detected? Answer: Look at last year's workpapers. (The definition of a really good set of audit workpapers is a set that this year looks just like last year.)

Third: Why doesn't workpaper review by supervisors/managers/partners detect false sign-off? Answer: Because accountants trust their staffs; if staff sign off that the work is done, reviewing partners assumed they did it.

3. **Peer review:** Peer review is the accounting profession's primary quality control mechanism. Yet, it doesn't detect false signoffs. 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 CFO or controller is a former auditor from the firm. Why? Because the staff person doesn't want to look stupid to her supervisor. I'm not talking about where an invoice is. I mean, for example, how to select receivable accounts for confirmation or which items to count for the inventory. Accounting firms need an absolute rule: No one is allowed to ask client personnel how to perform an audit. Violation should be grounds for dismissal.
5. **Listen:** When a customer's employee is embezzling/stealing/etc., someone in the company nearly always knows it. The accounting firm should train staff to listen to the grapevine. If top management is cooking the books, some lower level employees nearly always know and 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 customer because they pay your bills? Big mistake. Same thing applies to auditors. Of course, the client is going to pay the bill if it needs a clean audit opinion to consummate a

significant pending transaction like a bank loan renewal or other financing or acquisition or completing a deal with you.

7. **Consistency:** Doing the same thing is an auditor's worst habit. If the audit is performed so consistently that the client knows what accountants are going to do, auditor is NOT independent. Auditors should 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:** Auditors should not tell the customer what they are doing. For example, a "surprise" cash count isn't a surprise if the auditors have done it for 25 years.

But the most common mistake is the auditor telling your customer where they're going to observe inventory. What if you have a lien on the inventory? How much easier can an auditor make it to defraud you, than to tell the client where they're going to check the inventory?

So if you lose money where an account is secured by inventory, there are only two reasons an auditor would tell the client which locations they're going to "observe." One is the auditor conspired with the client to cook the books. The only other option is the "stupid" defense. Don't think it can happen? Ever heard of PharMor? The auditors missed a \$500 million inventory fraud over 4 years because they told the client which four stores out of 325 stores they were going to observe. The firm settled out of court.

9. **Prepared:** Accountants will tell you they are independent. Yet, they also let the customer perform much of the audit work for them. Auditors are very good at verifying what's on the schedule. But they'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.
10. **Demand an answer:** Suppose an audit staff person comes across something unusual or that just doesn't smell right. She 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 staff person do? Gives the controller the answer she wants to hear.

Why? Because in our culture, we can't stand silence. And the staffer can show the controller how smart she is by figuring out what happened. So, the auditor should have a policy that staff are not allowed to give the client the answer.

11. **Understand the client's business:** Want to find out if the customer's auditor puts you at risk because they don't understand the customer's business? Ask the auditor to tell you the top 3 reasons your customer's customers buy from its client instead of a competitor.

1. _____
2. _____
3. _____

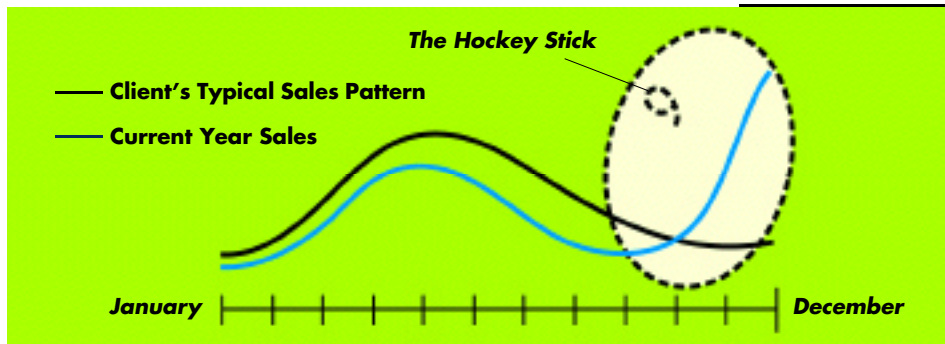
If the accountant can't name the 3 reasons, he doesn't understand the customer's business, and you're at risk.

For example, in the ZZZZ Best fraud, the auditors accepted the client's representation that a \$7.2 million 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 that 300,000sf 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.) In other words, there is no such thing as a risk free audit. So, each year, the American Institute of CPAs (AICPA) publishes audit risk alerts for many industries. Ask whether the accountants have read and incorporated the risks before they design the audit program and begin the fieldwork.
13. **Compensation:** There are two compensation issues that are critical. First, look for unreasonable compensation. ZZZZ Best's CEO Minkow paid employees more than they could ever earn anywhere else and never let them forget it. California Micro Devices' CEO demoted CFO Steven Henke to Treasurer, but gave him a pay raise when auditors found significant accounting problems—both glaring red flags.

Second, determine if the compensation drives the right behavior. Broker Merrill Lynch recently paid a \$100 million fine when its analysts gave glowing

Figure 2.



recommendations on companies that shortly thereafter crashed and burned. The flaw was that the analyst's pay was linked to the amount of investment banking business the firm garnered. The pay should have been linked to correctly predicting the stocks' performance.

Make sure you understand the behavior of the compensation system drives. If a significant portion (30 percent+) of an employee's 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 the pay is that much.

14. **Attention:** Someone who can't stand NOT being the center of attention (Barry Minkow, CEO, ZZZZ Best Carpet Cleaning, started the company so he could get a date in high school). This is way beyond liking to be the center of attention. We all like to be the center of attention. That's why you take time to answer a question when you're working on a project that has to get done. Answering the question makes you feel "smart." Pay attention to people whom HAVE TO BE the center of attention.

15. **The Hockey Stick...** Make sure the customer's auditors look for 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 like "Even a blind man can see it makes no sense." Do you know each of your customers' sales patterns, so you know when it doesn't look right?

16. **Qualify clients:** Have you ever asked yourself why clients want an accounting firm to do the audit, when the firm doesn't have a client in that industry. Has it ever occurred to you that the customer hires that firm because it will be the easiest one to fool? Find out if the accounting firm has an expertise in your customer's industry. And check if the firm got the audit because

it was the low bidder. Because the firm will want to minimize the hours spent so it won't lose its shirt, the audit puts you at risk.

17. **Ethics:** Hold up your hand if you think accountants are ethical. Do you have any customers where the owners treat the companies like their own personal piggy bank? YOU DO? No kidding. Now there's a surprise. When the accountants let the owner take a corporate deduction for personal expenses, it puts you at risk because there's less money to pay your invoices.

Accountants will argue the deductions are small and insignificant. Just because

the deductions are insignificant, they are still illegal. And if the customer is willing to cheat on her company's tax return, what makes you think the client won't cook the books if they are in big time trouble, can't pay you, but still need your product or service?

Protect Yourself

For most of us, the stuff we've discussed will never be a problem because the customer will buy our product or service and pay the bill. But you know it takes a LOT of sales from many customers to replace the lost profits from even a small number of customers that don't pay you. Financial statements report history. Don't over-rely on audited financial statements. Incorporate these issues into your standard vendor contracts to protect yourself.

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