

Of Mutual Interest

SAS 99 – Friend or foe?

How NOT to get sued under the new fraud auditing standard

By Gary D. Zeune, CPA

The answer to the question, “SAS 99 – Friend or foe?” is “BOTH.” If you follow the guidelines set forth in this Statement of Auditing Standards, SAS 99 can be your “friend.” But there’s a fundamental problem with the structure of the accounting profession that comes into play as you attempt to adhere to the standards set forth in SAS 99: Who pays for the work? The client. You cannot be independent of and objective about someone who pays you to do the work.

You don’t think you’re biased in making judgments? Consider the following:

Question: *Are you a better-than-average driver?*

Answer: Something like 90 percent of us think we are.

Question: *Are your kids smarter than average?*

Answer: Of course!

The long-term solution is to find a funding approach (other than clients) to pay for audits. This is a challenging task that’s best left for another article.

Going back to the initial premise, SAS 99 is both friend and foe. It is our friend because it provides auditors with more guidance on how to detect material fraud.

But it’s also a foe because it provides that same guidance to plaintiffs’ attorneys. SAS 99 is effective for audits of financial statements for periods beginning on or after Dec. 15, 2002. So it applies for audits conducted for the 2003 calendar year.

If a firm misses a fraud and is sued, the plaintiff’s attorney will simply hand the firm’s representative a copy of SAS 99, go down the list of procedures (required or suggested), and ask, “Did you do [fill in a step from SAS 99]?”

Every time you say “no,” the attorney will then ask, “Why is it that you think you’re smarter than the 24 people who sit on the Auditing Standards Board? Because you didn’t do this step, you missed the fraud. As a result of the fraud, your client was able to cause my client, 13th National Bank, to renew your client’s loan under false pretenses.”

What is the end result?

SAS 99 ultimately will fail in its intended purpose for a number of reasons.

1. The first problem is with the title of this standard: *Consideration of Fraud in a Financial Statement Audit*. Because SAS 99 is intended to change the way audits are performed and how auditors behave, the title should be *The Auditor’s Responsibility to Detect Fraud*.

2. If you recall, the profession went through the same posturing when it adopted SAS 82, the predecessor to SAS 99. The purpose of SAS 82, we were told, was to hold the profession to higher standards of fraud detection. If SAS 82 had worked, the scandals at Enron, WorldCom, Adelphia, Tyco, etc., wouldn’t have happened; Arthur Andersen would still be around; and we wouldn’t need SAS 99.

What I’m waiting for is a smart plaintiff’s attorney to sue the profession, via the AICPA, for promulgating a defective standard. It’s going to happen. Count on it. Why? Because SAS 82 – and now SAS 99 – still allows and doesn’t prohibit auditor practices that make it easy for clients to commit fraud.

For example, it’s only *suggested* that auditors *consider* surprise procedures. It should

be *required* that auditors vary procedures to keep the client off-balance. Furthermore, auditors often tell clients which inventory locations they are going to “observe.” How much easier can you make it for a client to commit inventory fraud than to provide specific information as to which locations you’re going to count?!

3. SAS 99 sends mixed signals as to what is required, versus what is recommended. SAS 99, like all others, uses *should* for procedures that *must* be performed.

4. Many firms will cull their riskiest clients, trusting the remaining clients because of an honest track record. Over a period of time, these firms may let their guard down. Then **BOOM** ... undetected fraud.

“But I trusted my client,” the firm says. “Trust” is *not* an internal control.

In general, our profession is a *self-regulatory organization*. We make up our own rules and procedures. But we don’t set all the standards. Judges and juries can override our rules and standards because GAAP and GAAS do NOT have the weight of LAW.

Example: Do you know why we began observing the inventory of audit clients? You can thank McKesson & Robbins. The audit firm missed the fact that five Canadian warehouses that were supposed to be stocked were empty. The managing partner stated that the Big 8 firm would not impugn the integrity of the client’s CEO by questioning

SAS 99 has been hailed as the accounting profession’s solution to the scandals of the last couple of years. But will it create more problems than it solves?

See SAS 99 other side

As seen in Of Mutual Interest, Winter 2003.

SAS 99 *continued from other side*

his inventory assertion. As a result, we now observe the inventory.

The solution

The solution is for us to hold ourselves to the same standard other parties hold us. In other words, close the *expectation gap*, the primary cause of malpractice liability. Simply put, the expectation gap occurs when auditors believe that SAS 99 is the *maximum* level of work required. Thus, we often perform work below the level required.

But those who sit in judgment (judges, juries, SEC, etc.) have said, over and over again, that our own standards meet the *minimum* level of acceptable performance. When you perform below the jury's acceptable minimum and miss a fraud, it's difficult to talk your way out of responsibility.

SAS 99 won't close the expectation gap. If anything, it will make the problem worse because we now have the added challenge of educating our clients as to why they should pay more for their audit when the unqualified opinion they received in 2003 says the same thing it did in 2002.

How quickly do you need to implement SAS 99?

IMMEDIATELY. Get fully up to speed because each year's audit stands on its own. If you miss a fraud at a long-term client, you don't get to argue, "But ABC was a client for 17 years. There was a fraud only the last year." You don't win 16 to 1. You just might lose 0 to 1.

Aligning SAS 99 and the opinion

Paragraph 1 of SAS 99 states 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." Thus, SAS 99 clearly tells us that auditors have a positive, affirmative duty to detect fraud. You no longer can say fraud detection isn't your job. But note, just as with SAS 82 – and appropriately – the standard is still not absolute; it's "*reasonable assurance*."

SAS 99 attempts to align the audit and the standard clean opinion, "financial statements fairly present." An unqualified

opinion is a positive, affirmative statement that the financials are okay, *not* that there was nothing adverse discovered. So the opinion that the "financial statements fairly present" has always been in direct conflict with the profession's assertion that it has no responsibility to detect fraud. To some extent, SAS 99 will correct this conflict.

The result of SAS 99

Here are a few thoughts on the future of auditing under SAS 99. (Items 1-4 were adapted from *SAS 99 and Your Duty to Detect Fraud: How Quickly Do You Need to Respond?*, AccountingMalpractice.com)

1. All frauds are material because they signal that management lacks integrity. Further, materiality isn't just an amount. A small amount also can be material because of the reason it's there. Under the SEC's Staff Accounting Bulletin 99, a small amount is material if it accomplishes something significant, such as getting the bank loan renewed or maintaining your stock price.

2. Malpractice cases are litigated with 20/20 hindsight, with all the facts out for the world to see. If you don't pursue the red flags of fraud – even those not listed in SAS 99 – you likely will be held liable for resulting losses.

3. SAS 99 requires that you significantly change your relationship with clients. You no longer can assume that your clients are honest just because they have been in the past. Further, if your marketing materials promote your firm as a "specialist" or "expert," you are creating a higher client expectation in the performance of your audits. And if you win business or keep clients by promoting your firm as client "financial partners," think how a jury will interpret that.

4. The cost of audits is on the rise. Clients may attempt to save money by either terminating their current accountants or asking for a compilation or review rather than an audit. Bankers may not notice the difference between the compilation letter and the audit opinion previously submitted by the company. You should consider adding, in large, bold print, the wording, "NOT AN AUDIT OPINION" at the top of compilation and review opinions.

Another potential risk is that a former client may take a previous audit opinion and change it to make it appear to be a current opinion from your firm. Speak with your counsel about advising the bank that you no longer audit the former client.

5. SAS 99 is an admission that risk-based auditing doesn't work. This is because no matter how good the controls are, management can always override them. (Take a moment to consider WorldCom, where the CFO Scott Sullivan allegedly made simple journal entries as a way to commit an \$11 billion fraud.)

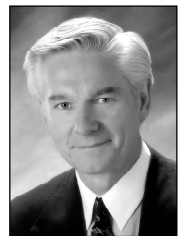
6. Don't wait until you have identified a risk of material fraud to perform appropriate procedures. That's backwards. Perform the procedures to identify the risk. For example, if you're conducting the audit for a bank loan covenant, teach every staff member *why* the audit is being done so they'll know what to look for.

The best defense is a good offense

Remember, like your teenager getting a driver's license, getting an audit is a privilege, not a right. The best way to protect yourself and your firm is to select very carefully those with whom you do business.

Don't accept clients just because they are willing to pay for the work. For example, in the infamous ZZZZ Best Carpet Cleaning fraud, management picked its auditors because it believed that this firm would be the easiest to fool. If you don't know anything about the potential client's business, take a pass. In this new environment, the fees simply are not worth the risk.

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