Beginning the subject of the CPA and management fraud, one must first define management fraud. Of course it is many different things. Accountants have traditionally thought of fraud in terms of stealing from the corporation. Most of the literature originally arose as a result of frauds of this nature. In fact, as one looks back on the history of accountancy and the reason why auditors were hired, it was to prevent such stealing from the corporation.

However, from the point of view of basic financial statements, this type of fraud has seldom been of great importance. There are certainly a few cases in which the speculations of officers have bankrupted corporations, but the number is very slight. As one looks at the basic area of the securities laws and presentation of financial position, this has not been the big problem. Normally small amounts are involved although it is possible all auditors deep down have the desire to find a fraud of this sort. Nevertheless it isn't a major problem.

A second major category of fraud is that perpetrated on investors and of course on banks and other suppliers of credits by creating false financial statements through the creation of fictitious assets, the understatement of liabilities, and similar activities. A substantial number of this type of fraud has been seen where assets were written up when there were very few evidences of value. These types of fraud still cross my desk as we look at some small mining companies, real estate ventures, and so forth, where promoters wish to give the impression of strength when in fact there is none. There are situations such as the Equity Funding case which, of course, is very topical today, and McKesson Robbins. These are classic examples of the case where fraud has taken place by management doctoring the books. It may or may not be to cover up theft. In fact, in most cases theft doesn’t seem to be the objective. The objective appears to be default, to paint a picture of prosperity that is simply false.

In some ways, even greater problems arise where a question of fraud arises not be creating fictitious assets, but rather by using accounting principles one way or another. Or where the creation of transactions is used to paint a false picture which is not just a blatant writing down of an asset that isn’t there, but performing a feat of accounting ledger which makes something look different than it really is in economic terms. One method by which this fraud takes place is through creating transactions which appear to be bonafide, but in fact are with related parties and represent some variant of the classical “million dollar dog traded for two half-million dollar cats” type of activity.

There are also frauds of this type which result from the use of accounting principles inapplicable to the circumstances. Percentage of completion accounting is used in a number of circumstances to create a picture that is just as economically unreal. There are various other applications of cost deferral approaches used in this regard. Other examples of deferral approaches are booking tax loss carry forwards under some circumstances and dividends in kind. Other types are where accounting principles inapplicable in the circumstance are used to paint a picture that is incorrect.

In addition, and this is a more difficult area, there are cases where discretionary estimates have been made in a fashion designed to mislead. There are situations where bad debt reserves, obsolescence provisions, estimates of economic life of assets have been tampered with in the interest of presenting a picture that is fundamentally inaccurate in terms of business realities.

In some cases management takes discretionary actions which are designed to mislead. Again there is a question whether this doesn’t create in effect a fraudulent financial statement. The classic railroad example of cutting maintenance costs substantially below normal levels is one instance of this.

Then of course, there are some cases which probably should not be called fraud. Questionable frauds are where one makes accounting changes to reflect a change in a circumstance that is apparent but not real.

Painting a false picture is a third major category of fraud. Not be creating fictitious assets but by using accounting techniques to do so.

A fourth area of defrauding investors is the failure to disclose significant transactions that would be of importance to investors in understanding how a corporation operates. In some cases, this failure to disclose is total and in other cases there is partial disclosure of realities. Recently there have been such failures to discloses in the so-called illegal payment cases which the SEC has been pursuing in the wake of Watergate. It appears it is apparent that where there are significant transactions of this sort, disclosure must be made if the items are material. The test of materiality cannot be based only on size. The nature of the items must be considered. For example, if senior management of a corporation is involved with funds disbursed outside the corporate accountability system, that fact alone may be sufficient to require disclosures since it reflects on the basic way in which the corporation is being run. If such types of payments are essential to operations, and would materially adversely affect operations, financial statement disclosures would be necessary because of the risk involved that a historical financial statement would mislead in terms of what might reasonably be expected in the future. That is a fundamental criteria of fairness.

Similarly, if disclosure would have a material adverse effect on the realization of assets, the risks involved would have to be set forth. It is not simple to determine which of these types of transactions need to be disclosed. There are several tests that have to be applied and I wouldn't suggest that it is always easy to tell what is the right answer. But certainly one must look to see whether there are payments outside the corporate accountability system where the basic disbursement is not properly accounted for. This is a significant clue to the problem. The legality of the payments must be considered--amounts involved--the amounts at risk--the effect on operations. All of these must be considered in determining whether or not the payments involved are material and hence must be disclosed. It is apparent that at least the SEC does not believe it is sufficient to properly classify such statements in the income statement and provide an appropriate tax accrual. Bribes to legislators who happen to be lawyers are not legal services. Bribes to garbage men are not waste disposal services. The fact that something is properly classified as cost of sales as opposed to general and administrative expense, does not solve the problem.

What is the CPA's responsibility. One must look at two elements. First, the responsibility for detecting fraud and second, what his responsibilities are in circumstances where fraud comes to his attention. Looking at the responsibilities for detecting fraud, some of the types indicated aren't clearly the auditor's responsibility. When one looks at the questions of what accounting principles are applicable in the circumstances, it is apparent to all that this is directly the responsibility of the auditor. Where an accounting principle such as percentage of completion is musused to create a totally false picture, there isn't any question that the auditor is responsible. In fact, in at least one or two cases, there have been criminal prosecutions in this area.

Regarding the area of discretionary provisions and actions designed to mislead, again, the auditor is responsible. The auditor has to look at what is being done. He has to recognize discretionary charges for what they are. He has got to be certain that first the charges are reasonable and, second, they are fully disclosed. In other cases, however, when we get past this type of fraud, the obligation to detect is not so clear. An auditor's basic responsibility is to conduct an audit in conformity with Generally Accepted Auditing Standards. Such an audit is based on the premise of good faith. It is not an adversary activity in the normal instance, although it can become one under unusual circumstances. Many people take considerable comfort in the fact that their only responsibility is to perform an audit in conformity with Generally Accepted Auditing Standards. But one has to recognize that when looking at what generally are accepted auditing standards, there's a lot of rubber there for interpretation. Standards require adequate training, adequate supervision and due care. There has not been a case before the SEC where we haven't felt that due care could be called into question. Sufficient competent evidential material are fairly general standards. If they are fulfilled, they will give protection. One has to recognize that varying interpretations of what is due care may exist. Certainly as one looks at an auditor's responsibility, it is clear that an auditor is expected to be alert and to have professional skepticism. This doesn't mean not believing in the client. This doesn't mean treating him as a liar. It does mean that as circumstances develop which would create questions, that the auditor ask questions. He determines the circumstances and maintains a professional skepticism. The auditor must respond to circumstances. Too many cases have occurred where the questions that should have been asked were not voiced until other evidence gathered by the auditor was assessed.

Certain auditing procedures have traditionally been fraud oriented. Perhaps more should be designed to focus on the problem. At the present time there is considerable attention being given to the subject of the search for related party transactions. The Auditing Standards Executive Committee have recently released an exposure draft on this subject and will probably release a final standard, a Statement on Auditing Standards soon. Auditors must increasingly ask for representation by management in regard to illegal activities and funds outside the corporate accountability system. It may be these representations should be asked not only of management, but of the audit committee, board of directors, and so forth.

A representation does not protect where it is clear that the auditor should have seen potential fraud and then simply relied upon a management statement. On the other hand, a representation has a powerful communicative force to the management and to the people who sign it. So, the auditor has to give some thought in regard to representation as to whether or not such items should not be specifically asked about. It is apparent, (the Stone report on the Equity Funding case also touches upon this) that there is a need to look with more care at the importance of examining relating entities where there are significant questions raised in an examination. It is difficult to look at one small piece of an economic reality. There have been a few cases in which auditors were deceived by having several auditors look at different pieces. In this case no one put the whole together.

Obviously, the objective of an audit is not primarily to detect fraud. It is also fair to say that well designed fraud may be concealed even if material. But, auditors must be alert to vulnerable areas and to fraud possibilities. Looking at cases of fraud which have crossed my desk over the past three years, there are very few where the design was good enough so that there were no red flags flying.

What is the CPA's responsibility when he becomes aware of fraud? Again, it varies with the type of fraud. When one is talking about a small theft from a company by a junior clerk, once the matter has been brought to management's attention, there is not much more that need be done. On the other hand if the theft from the company represents something which reflects upon the chief executive officer or senior officers of the corporation, there are questions as to whether or not disclosure must be made. They may not have to be made in the financial statements, but even that is a question. Proxy rules call for disclosure of certain transactions. There is at least one case indicated that the SEC believed it was management's responsibility to make disclosure of a blatant case of expense account padding where the same costs were charged to two different parties. The SEC brought a case, not naming auditors but in indicating that the company had an obligation to make the disclosure.

Where the fraud is of the sort that results in false financial statements, it is apparent that the first step is to require proper financial statements. Of course, if this comes to the auditor's attention before any statements which he has audited emerge, his responsibility is clear. He must make sure before the statements emerge that they are proper. If knowledge of fraud arises after past financial statements have been issued, the obligation is of course to revise any past statements known to be false and do so as promptly as possible.

When discussing the failure to disclose significant transactions, there are additional difficulties which have to be faced. Where such transactions are discovered, the first responsibility of the auditor is to be sure that every member of the board of directors is notified. Second, the auditor has to be satisfied that the board has taken appropriate action. If the board does not take action to stop this type of transaction, the auditor has an obligation to resign and to require a report on Form 10AQ (AK if a public company is involved). The form AK requires a disclosure of all disagreements when an auditor change takes place. And it would strike me that this certainly would meet the test of being a disagreement that would have to be mentioned in the auditor's report.

If the board does stop the transactions, then the auditor must assess the materiality of the tranactions according to the afore mentioned criteria. He should determine whether or not there is a need for disclosure in the financial statements of the company in order to insure they are not misleading. This is not an easy problem, but one must consider materiality in terms of the nature of the activity. In recent months there have been a number of gray-area type cases. When is a commission an illegal payment? What about commission agents who receive cash or funds an may disburse them in a fashion that the corporation is not aware of. What sorts of disclosures have to be made? These are tough situations.

The fraud area in general is a complex one for auditors. Since fraud is not always apparent before the fact, and transactions are difficult to analyze, it should be apparent that auditors must pay more attention to the possibility of all types of fraud existing. A revolution is the responsibility for detecting fraud is not required. Indeed it would not be cost effective. Auditors must be aware that public confidence cannot take too many more financial statement frauds. In most of SEC cases, professional care and skepticism by the auditor would have done the job. There must be more care for the future if credibility in the auditor's role is to be sustained.