NEW APPROACHES TO FRAUD DETERRENCE

—Joseph T Wells

Questioning is one of a Chartered Accountant's most valuable talents. The auditing profession's current approach to fraud detection – as well-intended as it is – wont' have the impact the public expects until auditors and their firms are willing to invest in improved fraud deterrence and detection skills and resources.

We are still doing much of what we've always done. This article should provoke thought and debate among the professionals on how we might consider different approaches in the way audits are conducted in order to give the public what it really wants: business enterprises with integrity.

Deprogramming Ourselves

In considering new solutions, it becomes necessary for us to critically examine our current thinking. One question that is frequently asked is, "How do we prevent fraud?" The answer: "Internal control". But is it, really?

Under that theory, organisations with adequate controls won't experience fraud. But they do– time and time again. Part of the reason is that no controls exist that provide absolute assurance against fraud. Those who are sufficiently motivated to override or circumvent them usually can find a way. Don't get me wrong: Controls are a vital part of fraud deterrence. However, they need to be considered in a larger context.

Fraud is not an accounting problem; it is social phenomenon. If you strip economic crime of its multitudinous variations, there are three ways a victim can be unlawfully separated from money: by force, stealth or trickery. While the first two are on the wane, the third is not. And the reasons have little to do with accounting controls.

The Confusing Issue of Criminal Justice

But before you jump to the conclusion that increasing penalties for crime is the answer, consider another counterintuitive fact: The United States has some of the harshest criminal penalties in the modern world— coupled with the highest crime rates. Criminologists almost universally understand why: Punishment-based deterrence simply doesn't work very well. Nearly 75% of incarcerated inmates are rearrested within three years of their being released, usually for more serious offences.

If you are thoroughly confused, you should be. That's because classic criminological theory says there are three related factors involved in deterrence: the certainty, swiftness and severity of punishment. Of those factors, the first is by far the most important – if punishment is certain and swift, it doesn't need to be severe. As a matter of fact, the longer the prison sentence, the more likely it is the miscreant will offend again.

Regrettably, under the present system of justice, there is nothing certain about being punished. Under

The author is professor at the University of Texas, Austin. He can be reached at joe@cpenet.com.

Sarbanes-Oxley, the criminal penalties for mail fraud were quadrupled, from five to twenty years per offence in the United States. But there has been no corresponding quadrupling of funds for prosecutors, investigators and prisons.

If the penalties go up and the money devoted to enforcement stays the same, then the certainty of punishment actually goes down. Our prisons are bursting at the seams, so generally the prosecutors and judges across the globe make very unattractive choices of who is prosecuted and who isn't. When it comes to making those decisions, they almost invariably choose to jail those who commit violent crimes – not the people who rip us off.

So when a potential fraud offender thinks he or she can commit a crime and get away with it, that assessment usually is correct. What is society to do, then about the current wave of fraud that seems to have engulfed us?

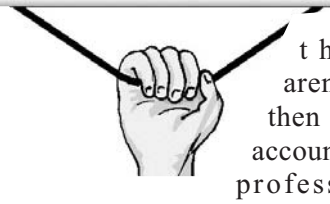
First, we need to understand that our problems cannot be solved by government intervention. Prosecution of offenders, although necessary in a civilized society is akin – as we might say in Texas – to closing the barn door after the horses are gone.

Second, we must acknowledge the private sector has a responsibility to cure its own ills. Third, we must commit the resources necessary to find solutions that work.

Understanding Fraud Prevention

If you accept the postulate that fraud prevention and internal control are not exactly the same– and they aren't— then the accounting profession needs to learn more about preventing fraud. Unfortunately, this issue has not been studied in any great detail, especially when it comes to occupations fraud. We know some of the answers, but not nearly enough.

If you accept the postulate that fraud prevention and internal control are not exactly same -- and they aren't— then the accounting profession needs to learn more about preventing fraud. Auditing profession could be better served by adopting a more holistic approach to the deterrence of fraud.



A different Tactic

One of the most difficult issues facing the profession is that there are no auditing procedures that can provide absolute assurance in detecting all fraudulent financial reporting. As a result auditors have historically attempted to avoid, albeit unsuccessfully, the responsibility for fraud detection. In the current environment, the public holds expectations of auditors with respect to fraud that simply cannot be fulfilled. The auditing profession could be better served by adopting a more holistic approach to the deterrence of fraud. This concept, called the Model Organisation Fraud Deterrence Programme (the model), employs a "best practices" approach to fraud prevention. Using this model, researchers would identify the factors present in organisations— both accounting and otherwise— that affect occupations fraud *(see 'Factors Affecting Occupations fraud: A Partial List')*. They then would develop a model deterrence programme based on those factors. Thereafter, instead of opining that the entity is essentially free of material fraud, the auditor would disclose the client's degree of compliance to the model.

Although this is a shift in the way audits are conducted, it has three distinct advantages. First, it would move the emphasis away from an unwinnable strategy of detecting fraud to an achievable one— preventing it. Second, it would encourage entities to adopt prevention strategies. Third, it could solve the liability dilemma that plagues the auditing profession.

But we don't have to wait until we have all the answers in order to do something different. Two ideas are worth debating now: the use of antifraud specialists on public audits, and financial transparency for executives.

Antifraud Specialists on Public Audits

Accepting that fraud deterrence and accounting are related but distinctly different disciplines, the auditing profession could utilise the unique skills of antifraud specialists on public audits. Virtually all of the major accounting firms currently employ such specialists. However, they are now being used reactively instead of proactively.

Rather than using their talents

exclusively to investigate allegations of fraud once they have been reported, antifraud specialists also should be involved during the audit itself to help identify key risk areas, which then can be furnished to the auditors for further consideration. Moreover, the mere presence of antifraud specialists during audits could have a significant impact on increasing the perception that illegal activities will be detected. This is similar to the strategy of reducing crime by putting more cops on the beat. Although punishment after the fact doesn't work very well, criminologists have thoroughly documented that more vigilance to stop crime before it happens is the most effective deterrent.

A number of years ago, I videotaped an interview with legendary fraudster Barry Minkow while he was serving an eight-year sentence in a federal prison in Colorado. (Minkow, a high school dropout with no accounting skills, fooled his independent auditors in a $100 million financial statement fraud scheme). When I asked him how auditors could cope with his ilk, Minkow said: "I'll tell you what I would do: I'd send in trained fraud examiners before the auditors arrive. And I'd tell the client, 'You know, I really want your business, but I want to make sure you're not committing fraud, too. So I'm sending the examiners in first. They're going to be looking at everything and asking the tough questions. 'Would that stop a lot of fraud, or what? It certainly would have stopped me".

Financial Transparency Where it Counts

From the study of a long list of financial statement frauds, beginning with the classic Equity Funding fraud in the 1970s and continuing through today's multibillion dollar accounting scandals, a distinct pattern has emerged: Corporate managements—executives, insiders and board members—have lined their pockets at the expense of the shareholders. Their methods vary and are often cloaked behind complex transactions not readily apparent to the entity's auditors.

But the profits from these illegal schemes nearly always find their way into the personal finances and spending habits of those involved. In some situations the same firm that conducted the audit, albeit by different personnel, prepared the individual tax returns of insiders. That was the case in the $300 million ESM Government Securities fraud of the 1980s in the US. Although the financial fraud was concealed on the company's books, the insiders had declared huge illegal profits on their own persona tax returns. Had the auditors examined the tax returns of the principals (which they did not) the scheme would have been obvious.

This illustrates a fundamental tenet of fraud examination: Follow the money. There are but two ways that this can be accomplished. Illicit transaction can be traced from an insider to the organisation or vice versa. The former approach is invariably easier than finding funds from the company to the insider, which often are disguised in a variety of ways.

Corporate insiders have a fiduciary duty to act in the best interests of the shareholders. A part of this duty should include their financial transparency. Auditors could be given access to any financial information that bears on this issue. That would include, but not be limited to. Personal tax returns and detailed banking records. By having such access, two important objectives could be accomplished. First, it would make it more difficult for insiders to conceal ill-gotten gain. Second, financial transparency could be a significant and powerful deterrent.

The ideas contained here are not the complete solution. Even if all of them would be adopted in some form, we still would have to recognise that there is no mechanism that could prevent all financial statement fraud. Still, traditional accounting approaches have failed so far to solve these difficult problems. But if we do what we have always done, we'll get what we have always gotten.

Factors Affecting Occupational Fraud: A Partial List

- Financial condition of the organization.
- Pressure to show profits in the marketplace.
- Internal accounting controls.
- The state of the economy.
- Integrity level of corporate leaders and employees.
- Commitment to the organisation's value system.
- Personal traits and characteristics of executives and employees.
- Reward systems for ethical behaviour.
- Organisation culture and dynamics.
- Peer pressure.
- The perception of detection.
- The swiftness, certainty and severity of punishment.