University of Mississippi

eGrove

Proceedings of the University of Kansas Symposium on Auditing Problems

Deloitte Collection

1-1-1976

Management behavior -- An auditing horizon

W. Donald Georgen

Follow this and additional works at: https://egrove.olemiss.edu/dl_proceedings

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Auditing Symposium III: Proceedings of the 1976 Touche Ross/University of Kansas Symposium on Auditing Problems, pp. 016-024;

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Proceedings of the University of Kansas Symposium on Auditing Problems by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

2

Management Behavior—An Auditing Horizon

W. Donald Georgen
Touche Ross & Co.

The independent accountant has—and always had—a responsibility to look for management fraud and illegal acts. Less clear is the auditor's responsibility to discover these activities if they have occurred. The professional literature is ambiguous, and the recent Supreme Court ruling in the Hochfelder case did little to resolve the uncertainty. Speaking practically, however, the profession must face up to the expectations of the public. The question is not whether we have any responsibility in these areas—the real questions today are, how far does that responsibility go, and how should the independent accountant go about executing that charge.

While not new, this responsibility is being given considerable attention by practitioners, academicians, and regulatory agencies, as well as the courts, because of the sensational disclosures recently regarding implied improprieties (most of which have not been proved conclusively), management fraud, and illegal payments. The public is concerned and dismayed, not only that such events could have happened, but also that they were not detected and reported on a timely basis. Ultimately, that concern focuses on the independent accountant. In the public view, the independent accountant has the best opportunity (and therefore the responsibility) to determine that proper controls are operative to prevent such events, or where those controls fail, to timely detect and report the events. The public must acknowledge that independent accountants will never be able to guarantee that all instances of management fraud and other illegal acts have been detected—but on the other hand, it is my opinion that our detection "hit rate" must be substantially improved.

Attributes of Management Fraud and Other Illegal Acts

Before we attempt any analysis of the auditor's responsibility, we have to examine the attributes of management fraud (and analogously, illegal acts). Also, we must look at the traditional audit approach to see how it might be changed.

Fraud, very simply, is a deceptive practice—one where the perpetrator hopes to avoid detection. (Armed robbery is not a fraud, because the overt act is obvious.) Frauds in the business environment fall into two broad categories—those occurring at the employee level and those occurring at the management level.

Employee frauds generally have two basic characteristics:

—The object of the fraud is to convert cash or merchandise to the individual's benefit.
—The activities of the employees are or should be covered by an effective system of internal control. Although an effective system will not prevent all acts of employee fraud, it should provide for early detection and preclude frequent repetition.

The characteristics of management fraud are significantly different:

—Generally, fraud at the management level does not involve direct theft of cash or merchandise; instead, it often involves "performance" fraud—the deceptive practices result in high reported earnings or they forestall the recognition of a decline.
—Indirect benefits accrue to management from the fraud—salary, bonus, profit sharing, and/or value of stock options may be improved or preserved, and the likelihood of continued employment is increased.
—The fraud is likely to operate outside of established business systems and related internal controls—in other words, the bosses are not subject to the system.
—The nature of the deceptive act is not always apparent, for it may be difficult to determine whether deception or error in judgment is involved.

I would particularly like to emphasize the last two points. Management most often has the ability to operate outside the system, simply because it is generally the top point of control in the system. And the independent accountant is often unable to distinguish deception from an "honest mistake"—at least until subsequent discernments provide a clue to management's motives. These two points underscore our dilemma. The traditional auditing approach is not really effective against management fraud. Also, the traditional audit approach, which is independent and neutral, does not focus on the judgments necessary to evaluate the qualitative aspects of management activity.

The Audit Approach

Given the characteristics of management fraud, let us take a critical look at the usual audit approach. Traditionally, generally accepted auditing standards have allowed the independent accountant to assume that management's behavior will conform to a predictable, set pattern. In other words, although he should be alert to fraud opportunities, the auditor's primary objective is the gathering of sufficient evidential material to form a series of judgments leading to the expression of a professional opinion on the financial statements—*not* the detection of fraud. The auditor's conventions tell him to gather "enough" of the "right kind" of audit evidence. Although there are conventions which give guidance to the determination of "enough" and "right kind," the auditor's judgment in the particular situation is the principal determinant of audit scope.

Does this suggest that the auditor's scope or approach has to be changed to improve the fraud detection rate? The answer is probably yes. Does it suggest that all audits should be performed in the fraud mode—where you turn over every stone and peel every grape? The answer is categorically NO! The cost to society would be prohibitive, given the relative number of actual frauds perpe-

trated. And more importantly, given a dishonest management, the independent accountant would never be able to do enough work to satisfy himself—or anyone else—that *all* acts of fraud were detected. We simply cannot assume the total responsibility for fraud detection, if we are to be honest with ourselves and society. However, in the same breath I have to admit that we have to be concerned with the consequences of the relatively few frauds. And even though we can't catch them all, I am convinced that we can catch substantially more than we have in the past.

Coping with Fraud

In my judgment, it's a matter of working "smarter" rather than "harder." We say that the auditor's responsibility in the attest environment is to make an "informed judgment"—and I think the way to improve detection of fraud lies in that phrase. Further, I don't believe exponentially exploding the number of transactions tested and accountabilities verified necessarily results in a more "informed judgment." Although the scope of the evidence gathering is always important, the quality of the information gathered, how it is obtained, how it is correlated, and the overall evaluation process are equally important in arriving at an "informed judgment."

Our firm has spent considerable time and effort in developing an approach which we believe will make us more effective in the detection of management fraud. The procedures are not new, but the emphasis is. The program has basically three features; and they are all related:

—an effective client investigation program *before* we commence a new engagement and a similar periodic update on continuing engagements;

—an in-depth understanding of the client's business—the economic conditions, the inherent control problems, the peculiarities of the industry; and

—concentration on material transactions—to determine their true nature and their arm's-lengthness, and to determine the proper accounting and the required disclosures.

Client Investigation

The client investigation feature of this approach puts emphasis on determining the reputation of the company and, in particular, its management. The questions asked and the information gathered are intended to answer the question—is this a company and are these people with whom we want to professionally associate? Is there any reason we should not associate?

Some will argue that this "exclusiveness" is socially irresponsible. Some will argue that all public companies are entitled to the services of an independent accountant. However, society has decreed that an independent accountant's investigative tools are to be limited—there is no subpoena power and no right to take testimony under oath. Instead, society has inculcated that there be a professional relationship between independent accountant and client. Within that structure, I believe the independent accountant is entitled to accept professional associations with care—indeed, I believe care is essential.

Understanding the Client's Business

Understanding the business is part of the client investigation routine which carries over into the establishment of scope or depth of the audit. Here we concentrate on:

—who is management, or who can make the business decision (Appendix A);
—in what roles does the management group operate (Appendix B);
—what economic factors are present in this industry—in this company—which would be conducive to encouraging or enhancing the fraud opportunity (Appendix C);
—what is the business structure, and would it facilitate or prevent the management fraud act (Appendix D).

When we have gathered, correlated and evaluated this information we then identify the areas of risk and set the scope of our audit procedures relative to the degree of risk. The evaluation is a professional judgment—but a professional judgment based on the relevant facts. Occasionally, based on our evaluation, we will say that the business factors individually or collectively present a risk situation which we cannot audit. In these circumstances we should—and have—withdrawn from the engagement.

Material Transactions

The third feature of our approach is a concentration on material transactions. Again, this part of our approach carries over from the client investigation and our efforts to understand the client's business. We *do not* pick a random selection of transactions and accountabilities and look for management fraud. Rather, we first identify all material transactions and accountabilities and then analyze those transactions in depth, for management involvement and its consequences. In the absence of direction from the profession, the regulatory agencies, or the courts we have established the following standards of "materiality" for this process:

—balance sheet items—measured at 5 percent of total assets
—shareholders' equity items—5 percent of total shareholders' equity
—income statement:
  —sales or purchase items—10 percent of total sales or purchases
  —operating income or expense items—5 percent of income before extraordinary or unusual items
  —nonoperating items—5 percent of pre-tax income

When we have identified a material transaction in which management or a related party is involved, we audit to evaluate the transaction and the nature of the management involvement. We study the transaction so that we can ask for and obtain the relevant documentation—we want documentation, *not* conversation. We then go one step further and request independent confirmation *of the details behind the transaction.* This is an important distinction from the traditional approach. We go beyond the normal confirmation of transaction timing, amounts involved, balances due or owing, and terms. We specifically ask for

confirmation of *all of the facts*—previous, continuing, and prospective—which are conditions of the transaction. This procedure is intended to determine if there might be additional documentation or even unwritten understandings which override the available records.

A Professional Overview

Our approach, although now in effect for 18 months, as a "state of the art" is still in the development stage. Other firms are experimenting with their programs under the general guidance of SAS 6 of the AICPA on "Related Party Transactions." The usefulness of this approach to fraud detection will evolve as we all gain more experience. I seriously doubt if any "brand new" audit procedures will come out of these efforts, but the auditor's attention will be directed more explicitly. A management fraud approach must put emphasis on informed judgment, insist on substantive rather than mechanical analysis, encourage probing of material transactions for a better understanding of the facts, and in general promote a "healthy skepticism."

In the late '60s and the early '70s a number of famous management frauds surfaced. More recently, another, more wide-spread form of illegal activity has come to the fore. The press has been full of stories of illegal political payments, slush funds and apparent bribes. Again, the public is asking, where was the independent accountant?

Illegal Payments

As I indicated earlier, it is my judgment that this illegal payment problem is analogous to the larger management fraud problem, insofar as it challenges the role of the independent accountant. This is true because illegal acts are often the product of management's direct involvement or indirect forebearance because of industry practices, economic conditions, or systems and control weaknesses.

But let's put these problems in their proper perspective. The public arousal over illegal payments and the cries for disclosure and "cease and desist" are in my judgment a product of the Watergate environment. Illegal payments are not a new phenomenon on the business scene, as evidenced by present disclosures. Many of the news stories report questionable payments, covering an extended prior period. Why was there not earlier concern over these practices—by the public, the regulatory agencies and independent accountants? While many will profess ignorance—and I suspect most people were not aware of the widespread nature of the practice and the huge sums involved—I believe that, as a result of the concept that these payments are "accepted business practice," the problem was generally ignored.

Without going into the developing morality or flailing ourselves for past omissions, I am willing to say that I believe it is our responsibility, as independent accountants, to be satisfied that our clients' audited financial statements taken as a whole contain adequate disclosure, and provisions for the financial effects (where applicable) of illegal payments. In the absence of direction or standards from the profession and the regulatory agencies, however, the specific ground rules for accomplishing this responsibility are very unclear.

Rather than philosophize as to the ultimate direction the profession will

take, I would like to share with you the policies and practices that we have adopted, in our firm, to deal with the subject of illegal payments.

We have decided that we *cannot* define illegal payments per se. We say this determination is ultimately a judicial question and an opinion—as to legality or illegality—can only be given by competent legal counsel. We then treat the subject based on defined illegal payments and "possibly" illegal payments. As in our approach to management fraud, we have identified possible situations where illegal payments may be expected. The purpose of this initial analysis is to direct the audit emphasis. For example, the independent accountant should be alert for the possibility of illegal payments when the client sells in countries where those business practices are expected, or where there are substantial cash transactions, or where there are significant "soft expenses." We have also developed standards of materiality in determining the scope of our examination for such payments.

Where we have knowledge that an illegal or possibly illegal payment has occurred, we require:

—that the matter be discussed with the client's board of directors;
—that an opinion be requested from the client's legal counsel as to the legality/illegality of the payment, the requirements for disclosure under the securities acts, and the form and content of that disclosure;
—consultation with our national technical staff; and
—finally, an objective evaluation of all the information and the legal opinions to determine the propriety of financial presentation and disclosure, and the impact, if any, on our auditor's report.

Although we are once again in a "state of the art" situation without specific direction from the profession, regulatory agencies or the courts, we believe our program is focused on the essentials of the problem—detection and disclosure.

Some Concluding Observations

In talking with you about management fraud and illegal payments, I have tried to avoid any suggestion that we were talking about specific procedures or standard steps. And I particularly want to emphasize that we are talking about an integrated whole. Or said a different way, we think this approach is simply a re-emphasis of the business approach to auditing—defining the "business approach" in the broadest possible terms.

As a result of thinking through the approach to management fraud and illegal payments, we have given more thought to our overall audit objective. It is apparent that a successful audit depends on more than program details. It is apparent that a proper attitude or philosophical audit approach is necessary. For the last several years, we have summarized these "truths" in a year-end audit reminder to our professionals, and I would like to share them with you:

- Our assignment is to independently challenge and evaluate, *not* to rationalize.
- When we say we want to emphasize the "business approach" to auditing, we mean do the reported facts make business sense—*not* can we support what management has concluded.
- On each engagement, we have to ask the question—are the statements

auditable? We have to make a rational judgment; the conclusion is *not* a given assumption.

- Emphasis has to be placed on a basic evaluation of evidentiary material—*not* a mechanical analysis of reported transactions and accountabilities.
- Audit evidence must be based on factual documentation, *not* conversation.
- Accounting and reporting matters are governed by generally accepted accounting principles. In many areas GAAP parameters are fairly broad. In the application of accounting principles we have the responsibility to determine the appropriateness of the principles in the circumstances.
- The responsibility to perform an effective audit of the facts is just as important as the proper resolution of accounting and reporting issues. We have to guard against a preoccupation with the solution of accounting and reporting issues to the exclusion of the audit of the underlying facts.
- We need the appropriate level of audit management involved on all audits. A significant part of the audit process is evaluative and judgmental. The skills necessary to execute these qualitative factors are developed largely through experience. We cannot delegate experience. We cannot delegate these judgments in the critical areas of the engagement.
- The development of audit skills requires a basic methodology; a disciplined approach and experience. The methodology can be taught and experience is a product of time and variety of engagement assignments. Development of a disciplined approach is dependent on the environment in the office in which the professional works and the perceived attitudes and work habits of those for whom he works. The development of a proper disciplined approach from the bottom up can happen only if we have a properly disciplined approach at the top—in the management group.

In my opinion, the problem of illegal payments will largely disappear in a relatively short time. The public outcry, the pain and embarrassment of public disclosure and censure, tighter corporate policies and controls, closer scrutiny by boards of directors and others, and specific Federal regulations will effectively limit these practices.

Management fraud, on the other hand, is with us and is not going to go away, in the absense of any moral uplifting. The pressure for earnings growth has been a catalyst for management fraud in a stable or accelerating economy; the pressure for survival in uncertain economic times may be an even greater stimulant. We can say that other disciplines—the board of directors, the audit committee, the public and the regulatory agencies—have a responsibility to force management integrity. But we cannot deny our own responsibility. We can say that we can't catch them all—and this is true—but we have to catch more of them. Some will say that making an independent accountant look for fraud is an unreasonable burden; I would suggest to you that a properly balanced responsibility offers us an opportunity to attain top professional status.

Appendix A

Who is management?

- Officers
- Directors
- Associates
- Affiliates
- Trustees
- Partners
- Co-venturers
- Principal Stockholders
- Others

Appendix B

Management Involvement Role

- Buyer
- Seller
- Guarantor
- Lessee
- Lessor
- Forebearer
- Debtor
- Creditor
- Nominee
- Franchisee
- Franchisor
- Licensee
- Licensor

Not intended to be all-inclusive

Appendix C

Some Conducive Economic Factors

- Insufficient working capital or credit
- Urgent desire for good earnings to support stock price
- Developing industry—massive demand for new capital
- Dependence on a very few products, customers or transactions
- Debt restrictions binding
- A declining industry with many business failures
- Company with excess capacity
- Many lawsuits, especially from shareholders
- Rapid expansion or numerous acquisitions, especially in diversification
- Collection difficulties from key customers, for instance, REITs
- Inventories requiring non-auditor expertise
- Long-term manufacturing cycle
- Unrealistic sales projections
- Obsolescence danger—high technology industry

Appendix D

Examples of Conducive Business Structure

- Dispersal of locations, documents, evidence
- Diversified company and accounting systems

- Management dominated by one or few
- Divided audit responsibility
- Inadequate internal audit function
- Extreme mobility in key financial positions
- Mobility or lack of outside legal counsel
- Constant crisis mode in accounting function
- Numerous substantive adjusting entries in audit closing