Forensic Accounting & Fraud

Face risk management or court fraud

By TIM J. LEECH

The list of companies and individuals that have suffered multi-million, even multi-billion dollar fraud losses linked to the current economic crisis continues to grow.

Whether the losses stem from Ponzi schemes like the multi-billion dollar Madoff funds frauds, representations made by fund managers, collateralized debt packagers and banks to customers and regulators, or a myriad of other linked events, fraud is regularly the common ingredient. Inquiries in progress around the globe are increasingly pointing to deficient risk management in organizations, specifically fraud risk management, as one of the root causes of the current economic crisis.

A key question that will be asked in boardrooms, congressional hearings, and courtrooms during due diligence litigation will be: Should the risk of fraud-related loss have been anticipated at the entity and regulatory levels and steps taken to prevent it? For organizations that had an internal audit function that claims to follow the Institute of Internal Auditors (IIA) professional practice standards, the answer is a resounding yes.

In 2001, the IIA issued new professional practice standards governing the conduct of members. Section 2110.A of the standards stated: "The internal audit activity should monitor and evaluate the effectiveness of the organization's risk management systems."

In January of 2009 the IIA elevated the wording from "should monitor and evaluate" to "must evaluate" in the newly issued standard 2120.

Unfortunately, a large number of organizations with internal audit departments have elected not to comply with the professional conduct standard that requires they assess the effectiveness of entity level risk management systems.

Building on the general IIA requirement to assess and report on the effectiveness of risk management systems, the American Institute of Certified Public Accountants (AICPA), the IIA, and the Association of Certified Fraud Examiners (ACFE) issued a more focused and detailed guidance paper in July of 2008 titled Managing the Business Risk of Fraud: A Practical Guide.

This guidance was also endorsed by the Canadian Institute of Chartered Accountants (CICA) and the Institute of Management Accountants (IMA) in the U.S. The exposure drafts of this guidance were originally issued broadly for comment in 2007. Principle 2 of this new fraud guide, a section which is very much aligned with Section 2110.A1 of the 2000 IIA standards, states: "Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate."

In spite of the IIA professional practice standards, the more specific and broadly endorsed fraud guidance issued by the AICPA, IIA and ACFE, and the massive multi-billion dollar fraud-related losses incurred around the world at various times in history, only a small fraction of organizations have completed full enterprise-wide fraud risk assessments to date and reported the results to senior executives and their boards.

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A question that all boards of directors of organizations that haven't completed a fraud risk assessment should be aggressively asking is: why not? Why haven't many organizations done an entity-level fraud risk assessment? There are a number of justifications that will likely be offered by the vast majority of organizations in the public and private sectors that still haven't initiated annual entity level fraud risk assessments: Nobody asked us to – Although the IIA, AICIPA, ACFE, CICA and IMA have all broadly endorsed the importance of conducting entity level fraud risk assessments a large percentage of boards of directors and senior executives still haven't asked chief internal auditors or CFOs to produce them.

It's not my job – In organizations that either lack an internal audit function or the internal audit function is unable or unwilling to complete an entity level fraud risk acceptance, it is often unclear who should take a leadership role to initiate one. Only a fraction of fraud related risks are under the CFO's domain. If the organization has not appointed a chief risk officer there is often a responsibility void.

Internal auditors or CFOs and chief risk officers don't know how – As with many emerging expectations there is only a small number of audit and risk professionals who know how to tackle the task of completing an entity-level fraud risk assessment. Sarbanes-Oxley and National Instrument 52-109 are still largely process/control focused.

Few companies have even attempted to profile residual fraud risk as a component of their financial reporting control assessment work, let alone undertake entity level assessments to identify the full range of fraud risks.

Some senior executives don't want fraud risk acceptance decisions profiled – A key benefit of completing an entity-level risk assessment is that risk acceptance decisions being made consciously or unconsciously are revealed and reported to boards. In some cases the compensation systems have encouraged executives to make some risky bets in bids to hit earnings targets and obtain lucrative bonuses and stock options. Senior executives sometimes don't want transparent disclosure of these bets and the negative consequences that might occur.

Better not to know – A leading management consultant and author, Peter Senge, and other experts have put forward hypotheses that there is a strong human tendency to avoid seeing what Senge refers to as our "current reality." It has been widely known for decades that the approach to rating credit risk is a system fraught with conflicts of interest but nobody, including national and provincial security regulators, has shown a willingness to tackle the problem. It has also been known for decades that the U.S. financial regulatory system was hugely fragmented and ineffective.

Corporations accept widely varying levels of fraud-related residual risk in scores of dimensions. Few have wanted to expend much in the way of resources to proactively measure and report those risk acceptance decisions.

The economic crisis has once again highlighted the importance of early identification and mitigation of fraud related risks. The major professional auditing and accounting associations in North America have reinforced the need for fraud risk assessment and provided practical guidance.

All that remains is a key question all senior executives and board members should be asking. What fraud related risks are we accepting? Can your organization answer or are you accepting a new risk, that of not meeting the latest due diligence standard?

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Today's deficit, tomorrow's tax: CFIB

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measures take effect earlier. "I don't really understand the delay" when there was an opportunity to act sooner, he says.

Nevertheless, Brooks is pleased with the corporate tax initiatives, particularly as they will affect small business. "I think focusing on enabling business and small business in Ontario is going to benefit everybody. Those are the job generators," he stresses.

Mackenzie, however, thinks the corporate tax rate cuts, which the government says will provide $4.5 billion in tax relief over three years were "completely unnecessary," coming on top of the new HST and previous measures to eliminate capital taxes. He would rather have seen additional funds directed toward beefing up the provincial social assistance program to cushion the blow of strict federal employment insurance rules for Ontarians who have already lost, or will lose their jobs in this recession.

"They could have taken advantage of this opportunity to really fundamentally change the way social assistance works, and didn't," says Mackenzie. Now as a result of the corporate tax cuts, the fiscal room to manoeuvre is gone, he says. Furthermore, "there doesn't seem to be any political will to do anything about it, which I find really upsetting."

The Ontario government also announced a personal income tax rate cut from 6.05 per cent to 5.05 per cent for individuals in the lowest tax bracket, which currently involves an income threshold of $36,848. This measure, which will

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take effect January 1, 2010, represents a 14 per cent cut, which is a "big deal" for low income earners, says Hillier.

But Hillier, among others, worries about the price Ontario might have to pay down the road for its long-term deficit spending.

Ultimately it comes down to the same investment risk/reward scenario found in the private sector, he says. If the provincial stimulus leads to additional investment and jobs in Ontario, along with rising incomes and a higher standard of living, "then the expenditure today won't be an issue."

But a lot of the outcome rides on the accuracy of certain growth assumptions, and then waiting to see how the economy actually unfolds over the next few years, Hillier cautions.

Brooks is also wary of the looming deficits, which total $56.8 billion until balanced budgets are forecast to return in fiscal 2015-16. He doesn't think the provincial government should wait that long, but rather "look for opportunities to get back to a balanced budget, and ultimately a debt reduction strategy, sooner."

The CFIB membership, consisting of 105,000 small and medium sized businesses across Canada, is still "quite hawkish when it comes to sliding down that slippery slope of deficit financing," says Andrew.

Although they understand that balanced budgets are not always possible when revenues are slipping, "they did not subscribe to the spend-like-crazy for stimulus school of thought that was reflected in the Ontario government's budget," she says. "Today's deficit spending (represents) tomorrow's taxes and they're concerned about that" because taxes are already their "number one problem," says Andrew.