Mid-America Intergovernmental Audit Forum

141910

The Auditor And The Law

Transcript of Meeting
December 11-12, 1989
Kansas City, Missouri

SP 055

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The Mid-America Intergovernmental Audit Forum extends sincere appreciation to: Eva Johnson and Lynn Lammers, GAO-St. Louis for typing; Marge Vallazza, GAO-Kansas City, for editing; and GAO Publications in Washington for cover graphics, printing, and distribution.

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THE AUDITOR AND THE LAW

CHAIRMAN JONES: As a bit of a lead-in on this meeting, the Executive Committee had quite a discussion about the program and what the topic should be. Some of us had seen a presentation at the National Audit Forum Meeting about the savings and loan crisis and some other things. We felt that there has been so much on the savings & loans disaster in the newspapers and the role of the auditors with respect to that.

More recently, I think there are some good questions about the insurance industry, which from a federal viewpoint may not be a federal problem because it is mostly regulated by the states. But certainly from the state viewpoint, pensions are being questioned in terms of the vulnerability that might exist. All sorts of questions abound about some other programs in terms of fraud, waste, and abuse in general that, we felt as an Executive Committee, we felt would be a good topic for discussion at the Forum meeting. Then tomorrow we will get more into some of the actual financial institution situations with Fred Wolf and Larry Alwin, both of whom have had some significant involvement with the savings and loan and insurance investigations.

Without further ado, I will turn it over to your moderator for the first portion this afternoon. We will go through "The Auditor in Court" tape. There is a participant manual. Herb is going to explain to you how the thing works and there will be certain points where we will stop the tape. After we go through the tape and the exercise there, we will take a break before Chuck Pierce and Karen Laves make their presentation on what they have experienced in court.

THE AUDITOR IN COURT

MR. MORTLAND: In front of you, you have a document, "The Auditor in Court." Before we show the tape, I would like you to spend approximately 10 minutes looking at it. I know a lot of you out there have already seen the movie and a lot of you have probably been in court; but, spend about 10 minutes, to glance through it quickly. I suggest that you jot notes at certain areas in the document because you will need notes for the participation section of the program. Audience, how many people have ever been in court? Please show your hands.

For the ones who have not been in court, you will benefit from this tape and you will not like what you see. It is a very difficult, ticklish situation and it can happen to everybody. When I viewed the tape, I immediately thought of the state auditors, mainly, because of what has happened in Missouri

recently, but I also had lunch with Warren Jenkins and he said the situation would be applicable to Iowa. I thought, "Well, no local CPA ever gets sued; just the big boys, and they hire big attorneys and everything." But, stop and think about sitting on a stand and having somebody grill you.

The St. Louis Post Dispatch on Sunday has General Dynamics suing the federal government for $23 million, so one day the feds might be in a courtroom, sitting there, saying, "Did you do a proper audit or did you not?" I know everyone thinks that they are immune to suits, but they will not be in the future. They might be in a courtroom just like the CPAs are. So without further ado, we are going to show the tape. There are four segments in this tape and we will break each time and have a little discussion on what you watched.

The underlying theme will show us a cross-examination of an auditor who failed to meet good accounting standards. Generally accepted accounting standards were not met. We want to improve your understanding of the nature and relevance of generally accepted accounting standards which, I think, everybody knows. After you look at this tape, I think you are probably going to go back home and say, "I have got to clean up my own shop." At least, that was the impression I received after I saw the tape, and I know I run the best office in St. Louis!

(Videotape shown.)

MR. MORTLAND: All right. Let's talk briefly about what you just saw on the tape. Let's talk about how many errors everybody saw in the first segment of the tape. How many problems?

MR. CARRINGTON: I think the first one was inadequate planning.

MR. MORTLAND: Planning, inadequate planning.

AUDIENCE: No supervision.

MR. MORTLAND: No supervision.

Does everybody agree with us so far? If anybody disagrees, just say it right away.

MS. KELLY: Qualified staff.

MR. MORTLAND: Qualified staff. Why? What was wrong?

Let's talk about qualified staff. Just because that guy did not have a degree in Accounting and just because he failed the CPA Exam twice? That means he is not qualified?

MS. KELLY: He did not have knowledge of the industry.

MR. MORTLAND: "He did not have knowledge of the industry." Joe, does that mean he is not qualified?

AUDIENCE: That is right.

MR. MORTLAND: You mean, if I passed an exam and you give me a piece of parchment, I am qualified?

AUDIENCE: No.

MR. MORTLAND: Do I have to be a CPA, David? I thought the feds do not hire accountants all the time, that they hire other than accountants. Does that mean, if you do not have a financial background, you are not qualified? Come on.

AUDIENCE: No, it does not.

MR. MORTLAND: Well, what is wrong with this guy? He was qualified. He had been around a couple of years. He had done a couple of audits. He knew what he was doing. Do you not think, Ken? I mean, we are picking on a guy that was not even there, right?

MR. KUSTER: Right.

AUDIENCE: He may be the best they had.

MR. MORTLAND: Could have been the best they had, yes. But he could have been real good, too. Just because he did not pass the exam, you are saying he is not qualified. That is unjust. Is everybody in your office, in your shops, qualified CPAs? What if they have to have a little training, 2 years of training? What if he was a computer person? I do not know what he was, but we are going to put down that the people are not qualified on the audit.

Does everybody agree?

AUDIENCE: No.

MR. MORTLAND: No? We have some people who do not agree. All right.

AUDIENCE: Do you not have to have some minimum standards? Like for our folks, they have to have a degree with 24 hours of Accounting at least. There is a minimum line there somewhere. We do not know what the minimum requirements were. Maybe he met the minimum requirements.

MR. MORTLAND: Very good point! Does everybody agree with that point? Did everybody hear him? He might have met enough requirements. Okay? He might be very qualified. Just because he did not pass the exam? I know a lot of people who can not pass the CPA Exam. It does not mean that they are not qualified in my eyes.

AUDIENCE: It was not just the exam.

MR. MORTLAND: All right.

AUDIENCE: He did not have a degree.

MR. MORTLAND: Now, wait. He had a degree. It said he had a degree.

AUDIENCE: Is was not in Accounting.

MR. MORTLAND: Well, clarify that.

AUDIENCE: He had no Accounting degree. He had not passed the exam. He did not have a significant level of experience in that area and had little supervision.

MR. MORTLAND: All right, A good point. Does everybody agree with Mark? What about you, Bill?

AUDIENCE: I think it is a valid point that he lacked supervision.

MR. MORTLAND: There is another catch. I like that. What Bill just said is that he might have been qualified and he might not have been qualified, but he had no supervision either, right?

AUDIENCE: As a team, I do not know that they were qualified.

MR. MORTLAND: There was no team qualification. There is a good point.

AUDIENCE: That is a point I was going to make. The standard says "collectively possess" the qualifications. I am not too sure in this case, that they collectively possessed the qualifications.

MR. MORTLAND: But the point is, just because he does not have a degree and/or he has not passed the exam, if you look at the team collectively, there may not have been a qualifications problem. Except in this case, it appears that you still do.

AUDIENCE: Well, they had no supervision. Did they?

MR. MORTLAND: What else? That is only three little points.

AUDIENCE: No documentation.

MR. MORTLAND: Very good point. It was at the end. Were you all asleep at the end? It says they are talking about nobody's initials.

AUDIENCE: Would that documentation apply to all those areas? The qualifications might have been met, but it was not documented. It was not evidenced in the workpapers.

MR. MORTLAND: I do not know the qualifications would have the documentation. What am I going to do? Sit down and write up a lot of stuff on an individual?

I mean, I agree with what you are saying 100 percent on parts I and II. It is valid that there was no planning. It was not documented. If there was, it was "We talked together." There was no supervision.

AUDIENCE: What about internal systems quality control?

Would the qualifications of the staff, collectively not, be documented there?

MR. MORTLAND: Do you mean to say this would be in our office? How do we know?

AUDIENCE: Well, I--

MR. MORTLAND: Sit down with everybody performing the audit and spend 50 hours a week planning and documenting? Get real. Get out in the real world. We do not have time for all that, if there are only four people. We can not sit down and talk.

AUDIENCE: But I think it is more on the documentation than on qualifications because he could not prove that he was involved in supervising without notes and initials.

MR. MORTLAND: You mean that partner could not?

AUDIENCE: Yes.

AUDIENCE: That is superficial.

MR. MORTLAND: He just signed off, right? He signed his name, the partner?

AUDIENCE: I imagine that initials are something that he would have to do.

MR. MORTLAND: But he did not initial anything. Remember?

AUDIENCE: That is what I am saying.

MR. MORTLAND: The supervisor did not either.

AUDIENCE: Oh, the supervisor.

MR. MORTLAND: All of them did not initial.

AUDIENCE: I was going to say with regard to qualifications, many times you have staff who are reassigned to an audit, but here they have an entire brand new staff on an audit. Somewhere along the line, you will have just one or two people who have been on an audit.

MR. MORTLAND: Now, Harold, how did you like that partner? He had lunch and that was it, huh?

AUDIENCE: That was all right.

(Laughter)

MR. MORTLAND: Nobody picked up on that. The partner was never on the job site. All he ever did was go have lunch one

time or twice. That was a smart partner. He was not even involved, was he? There was the problem.

At the top, coming down, let us start with the planning at the top. He did not help. All he did was to get the job, collect the fee, and have a couple of cocktails, right? What else was noted?

AUDIENCE: It seemed like the partner had some information that he was not passing on down in terms of some major things going on in the company. Well, in fact, he was the only one who had a lot of company knowledge that related to the entire audit, but he was not passing it down to the others.

MR. MORTLAND: Did everybody hear that?

Now, that is a very good point. The partner found out some information and never passed it down to the supervisor or to the underlings.

Did you all notice one thing? Nobody knew anything about the plan, from the senior, all the way, even unto the partner. He probably did not know much, okay? He was just sitting there collecting the fee. All the people who did the job did not even know what the history was about, did they?

What does that have to teach you? How do you go out and do an audit without knowing what you are auditing? How many at the federal level, the state level, and even at my level, go out and bid an audit and you do not even know what you are auditing? We had that this morning in the Single Audit meeting. We sat there and talked about subrecipients, okay, and did not even know what they were going to audit.

How can I send a young guy out and not plan and explain to what guy what the client is? It is done every day of the week at the local level. I imagine it is done at your level, too. Right?

AUDIENCE: Certainly.

MR. MORTLAND: It does because you do not have the chargeability to get the job done and the underling gets out there and he does not know what he is auditing unless somebody tells him what he is auditing. It is the same in the federal situation. I doubt if it is at the state level, okay? I know they are almost perfect, right, Warren?

MR JENKINS: You bet.

MR. MORTLAND: They always know what they are auditing, right? Yes, David?

CHAIRMAN JONES: If you look at the discussion they got into on the 40,000 pounds and 6,000 pounds, in the context of the total loss being one of those, then you have got a question of materiality. You must consider materiality.

MR. MORTLAND: Did everybody hear that? Materiality. They caught 46,000 pounds versus 1 million pounds. But we did not know about that million pounds until later. Remember? We did our job. We did not find out about that until after the fact. Did somebody miss something? I keep looking for the ones the feds should jump on right away. You know, the million came to light later?

But why did it not come to light during the audit? We did a perfect audit. It should have come to light.

AUDIENCE: Not according to the workpapers, it did not come to light.

MR. MORTLAND: Oh, I did a perfect audit. The lawyer was just kidding you. I did a perfect audit. I know I did not initial it, but I know I did a good audit. What happened? What is everybody missing?

Internal control! Did they not bring that to light? What happened? We have internal control! What are we supposed to do as auditors? Evaluate the system. Right? Test it out, right? Do you think they could have found a million dollars then? Maybe and maybe not. But I would have covered my part in the act by, at least, doing something.

AUDIENCE: The underling had it written up.

MR. MORTLAND: Yeah, but you know that was at interim. How would you all like to be sitting on the stand? I could ask far more questions that they guy asked.

AUDIENCE: Are you saying the lawyer did not know what he was doing, too? (Laughter.)

MR. MORTLAND: The lawyers have more fun watching faces, but I am saying he could have been a lot nastier, if he so desired.

I mean, this thing reeks. I guess we have planning, supervising, "iffy" on the qualifications. Am I right? Let us have a show of hands. Who is against the qualifications and who says it is "iffy"?

We will not say it is good or bad. Personnel qualifications. They did bring that to light. Ditto. This guy

only had two years experience. No, he flunked the test 2 years, was it? And he was not a degreed accountant, but he was degreed. He had been working for a while. Did that make him inferior?

All right. Let's have a, "Yes, he is inferior." Everybody's hands.

AUDIENCE: Are you talking about one individual or the whole team?

MR. MORTLAND: No, just him, the one they picked. I am not talking about the whole team. We always have rookies on our team.

(Show of hands.)

MR. MORTLAND: Not many hands, right?

AUDIENCE: Well, define inferior. You mean unqualified?

MR. MORTLAND: I just want to point one thing out, okay? I yell. I scream, and I holler. He was inferior. Do not change your idea. He was. I just tried to convince you that he was not and I did a good job of it.

AUDIENCE: No, you did not define inferior.

MR. MORTLAND: He was inferior to go out and do a certified audit. He did not know the client, as Margaret said. He may have known debits and credits, but he had no idea what he was going and he was the senior on the job, running the job. He was definitely inferior.

But if I convinced you, what is the judge going to do? He will convince you another way, okay?

He was inferior. You have to plan a job. You are always going to have rookies on the job. That is why you need a senior. That is why you plan at the top. Start with the planning. Get the personnel involved whose going to help out, not just the first dead body or free body you have, or cold body, just to fill the job. Get a qualified body. Plan the engagement. And what you plan, please document. The big boys can afford the luxury of documenting, okay? We just sit there and hope to God we do not get caught, right? I mean, you have only four people, what am I supposed to do?

Supervision. No supervision, occurred.

Qualifications and documentation. There was not a lot of documentation and there is not a person in the audience right now who can sit there and put a hand up and say, in good faith, that

his own shop, and his own work, that they have properly documented it at all times.

If you so desire, put your hand up and I will give you the apple. Come on. Is there anybody here who thinks that every workpaper was initialled, that every workpaper was reviewed? I mean every single one. I can come down to your shop and look at them and every one will be perfectly in order? Conclusions on every workpaper?

We have a hand coming up. Come on out. Stand up and tell me you do the greatest job in the world.

AUDIENCE: They are not mine, but when I worked for the state of Arizona, we did have at least one review of some kind of multiple reviews of workpapers. So I feel that they had adequate documentation. I, myself, due to lack of sufficient staff, feel that I had a problem in that area, but I was--

MR. MORTLAND: (interrupting): Harold has lack of sufficient money coming in and he has to get it out. I know where he is coming from. We are not on the government's salary. We have to get the job done, so we can collect our fee, but that does not mean that we do not document. But I do not think you can sit there and say of the state of Arizona that every workpaper is

properly initialed and can stand alone. If you can, you are a better person that I will ever be in my life.

AUDIENCE: Herb, I think we can say that they are a lot more consistent than this guy was.

MR. MORTLAND: Oh, I am more consistent.

MS. KELLY: I understand the point. It is like "Never say never." That is what you are trying to get to. Once in a while, there might be something that is not documented, but we try very hard to do that.

MR. MORTLAND: I try a lot of things very hard. We are going to go back to the tape. We try hard, but are we trying hard enough? I agree, Don. We all do try hard. I do. After I watched this tape, I was a nervous wreck. I try very hard, okay?

AUDIENCE: Wait until you have your day in court, Herb.

MR. MORTLAND: I have already had my day in court. Do not worry. I mean, this guy is getting killed. All right. You get another 15 minutes of the tape.

(Videotape shown.)

MR. MORTLAND: Dave brought some comments to my attention that I think that I shall let him share with you, but before I do that, Phil asked me if I jumped the gun by bringing up internal control after we watched the first 15 minutes. I said, "I did not jump the gun." I had a reason why I said that because, if you recall, at the very beginning of the tape, they found problems at interim audit and they did not do anything at that point. That was the first tell-tale sign. At interim, they found problems in internal control. So then, when they went out to do finals, they did not plan accordingly.

We are going to be talking about the internal control, but David had a couple of observations that he would like to share with you.

CHAIRMAN JONES: My only point, Herb, is that we got into somewhat of workpaper review, supervision, and so forth. We have found what we do for our own internal look-see, it is not so much a question with respect to whether the workpapers were reviewed. They generally are reviewed, but it sure as heck is a question in terms of timeliness of the review, which can get you in as much trouble as not reviewing them at all, if you do not review them.

I know that timeliness is a judgment call and so forth, but I think that is an important point, too. If we review workpapers after the audit is done or the report is issued, we may have

missed something very significant. Had they been reviewed while the work was going on, we might have modified our plan. We might have modified the testing that we did or whatever it may be, because it did raise questions about the work. But I say it is more a question, perhaps, of timeliness of reviewing workpapers and the supervision question that, necessarily, whether is, was, or was not done or was or was not documented.

MR. MORTLAND: Well, it needs to be documented. To take David's comment and go a step further--

How many times have people actually issued a report because they had to have a product on the street and they have not finished a review of the workpapers. Maybe you do not do that. Maybe the feds, the states, and the locals do not do that and it is just the CPAs out there who might do it.

Tom, has it ever happened?

MR. MAHER: Not that I have known about it, in any area that I have responded to for them.

MR. MORTLAND: You make sure it is complete before it goes out?

MR. MAHER: In fact, the matter of timeliness and workpaper review, I would think should be in the line of questioning. Now, maybe it is not. I really hope that workpapers are not being reviewed after the reports are released.

MR. MORTLAND: What if the reports are not released, but they are in typing and you are out in the field? Does that add any thought when you review those workpapers? It is ready to go to press. The client is screaming for it. And you could uncover something in your workpaper review that you might--but the client wants the report.

MR. MAHER: I would hope the report's workpapers would be reviewed before that state.

MR. MORTLAND: I agree with you in theory, but I mean it does happen. That is what I am saying.

I think David pointed out something. Timeliness is a question, really. What happens when you go out and do a lot of work at interim and you bring it in and finish it and file a progress bill in our industry or you come in and then sit until you go back out and you do not use them to plan the final audit. There is the timeliness. We have all the work done and we did not do anything with it, so we go back out. I agree with everything you are saying, okay? I was in that work for a little

while, and I know for a fact that not everyone had their initials on the workpapers. I guarantee that by the time the peer review comes in, those workpapers are perfect. They usually were.

AUDIENCE: I think another thing here, too, is timeliness. I think some people can look at time. You do not get timely review of those workpapers, particularly, with respect to the junior staff of the developmental staff. Not only might you have some questions about what you should have done and you did not do, you have also lost an OJT opportunity for those folks in terms of developing those folks. You really have. You put time in them and you lost an OJT opportunity.

AUDIENCE: That is probably the most significant point about timely workpaper review.

MR. MORTLAND: That is true. Very good point. All right. We have got a few minutes to talk about internal control.

AUDIENCE: I like to know if they roll forward their internal control--

MR. MORTLAND: What do you mean?

AUDIENCE: You take a prior year's internal control and you roll it forward to the next year.

MR. MORTLAND: Then you put your initials on it and you are done.

AUDIENCE: If you think that is right, why would you sit there and rewrite the entire internal control? You would spend your whole audit fee in writing internal control questionnaires.

MR. MORTLAND: Probably twice a fee. That is true, but do you not test it that second year?

AUDIENCE: Of course, you tested it, but that does not mean you did not roll it forward.

MR. MORTLAND: Did they test it in the movie?

AUDIENCE: Obviously, they did not.

MR. MORTLAND: They did not test it?

AUDIENCE: Oh, they tested it.

MR. MORTLAND: Beautiful flowchart, right?

A lot of "window dressing" was done, was it not?

AUDIENCE: The problem with that one is the partner there on the stand was ill-prepared to give testimony. He was probably ill-prepared to do the audit in the first place.

But to look at the issue at hand, which was one of obsolescence of inventory, in any audit, you can define how you are going to deal with each of the audit objectives in various areas. Apparently, they never defined how they were going to deal with obsolescence in that audit and he now can not tell how they dealt with obsolescence because they did not.

The specific point of the programming error would have been a very tough one to have found and it should not have been done like that but it was.

On the other hand, you probably would not test for obsolescence in that particular manner.

MR. MORTLAND: Not in that test, I do not think.

AUDIENCE: That would have not been your ruling test to find out obsolescence. And if you had other tests for obsolescence and turnover and roll forward you would find it.

MR. MORTLAND: Mr. Fisher throw out your ideas on what you just thought.

MR. FISHER: They were auditing around conditions which are the most common. Very few audits are perfectly planned and detailed on paper. Do you test all controls? You decide which report to rely on and which you do not. In this case, they did not know what they were going to rely on or not.

The errors that they found, they could have found by pulling a sample of the input documents and looking, "Oh, there is no receipt date on here." They would have found they had a problem without noting that the computer program was not right.

MR. MORTLAND: Maybe and maybe not.

MR. FISHER: Who knows if they would have or not. We do not know if they did this or not. We do not know.

MR. MORTLAND: That is true.

MR. FISHER: They could have pulled the sample of all the inventory and, in fact, found out that some of it was obsolete, if they had known to, if they had done it.

MR. MORTLAND: Let us step back. Okay. Let us take it out of the business sector and let us talk about government. When you all go out and audit, do these municipalities, these taxing

authorities have internal control? You want them to have beautiful internal control. You want us to go out and flowchart them and only three people do all the work. Do you ever stop to think about what you ask the auditor to go out and do? There are three people out there running that municipality. And keeping the records. There are three people who have bought a canned computer package that they do not understand.

We come in on the outside and we are going to audit it and say that they have internal control, and I am going to end up with 10 flowcharts on all those controls? That is what we, as outside auditors, are supposed to do. I would like somebody from the federal government to tell me not to waste my time flowcharting this stuff when there are three people out there doing it. Can I still go back to the old idea that they do not have any internal control and plan my audit that way and not waste a lot of money and time flowcharting something because there is no internal control. How many agree with me? What am I supposed to do?

AUDIENCE: I disagree because your own AICPA instructions say you can not do that. You have to make a decision about the reliability of internal controls and you can not cop out by saying that they do not have them and that is the end of it.

MR. MORTLAND: That is true. That is what the law is right now. I grant you that. Come out to the real world where they are trying to do the audits. They have three people there running the municipality and there is no internal control and I can not rely on it.

AUDIENCE: I am telling you that there is the AICPA guide.

MR. MORTLAND: I know there is the AICPA guide. So what are we going to do? We are going to draw up a good response to AICPA and we are going to conclude that there are no internal controls, just like we did before, and we are going to audit the daylights out of them. We do not have a choice because where is the internal control? Does anybody know what internal control is? Who would like to take a stab at it?

AUDIENCE: It is a management control system.

MR. MORTLAND: Management control is one.

AUDIENCE: The system of checks and balances.

Phil? Take a shot at it.

MR. WHITAKER: I like the checks and balances.

MR. MORTLAND: Checks balances.

What, Dave?

CHAIRMAN JONES: Self-audit of the system.

MR. MORTLAND: Who else? Come on. Somebody tell me what internal control is.

Not you, Lynn, because you are quoting the AICPA and I understand what you are telling me.

Well, what is internal control?

AUDIENCE: Separation of duties.

MR. MORTLAND: That is even worse.

A lot of these places, have one employee and you are going to expect us to do internal control flowcharts. All we are going to do is jack up fees. It is crazy. Do not waste your time. They have got 1 employee, 2 employees, 3 employees. Even if you have 10, you might not have adequate internal control. The number does not really dictate it.

Go ahead, John.

AUDIENCE: Any system you can rely on internal control to the extent that they have some. The smaller the organization, the less they are going to have. Every organization has some control.

MR. MORTLAND: Did everyone hear that? Size does not mean anything. Even a small organization will have some type of internal control. That is a true statement, is it not? Even if it has just those three people, is there not a counsel or a court of law or somebody who is the oversight? Are they the ones approving it? "Yes, these are the things that we can document."

But once it still comes back down, I will lay a hundred to one, there is not adequate internal control, even though somebody else is signing off on it. What we need to do in the government area is audit the heck out of it. Okay?

The biggest thing that is on the tape is that everybody has these new computer programs and nobody knows how to audit them and nobody knows the controls.

AUDIENCE: But I think we still need to do that documentation, specifically under SAS 55, as part of the assessment of risk.

MR. MORTLAND: I agree. We have to do it, but I am just trying to tell everybody here that, where I am, a lot of controls are out there. We do have to assess them though.

John said it right. There is some control somewhere and even a little business, depending upon--it might be a $50 million business, but maybe they only have two people in the accounting department. All right? And they do everything, but even in that world, there is some type of control. We should document them or we should document what transpires and then start planning out audit from there. That is what you saw. They had a beautiful flowchart and that was about all they had up there. Nobody tested that flowchart, did they? Nobody tested it. And it is very difficult to test it, if it is in a computer, right? We all agree to that.

I think John said sample and test it. Then you come in with stat sampling which is another whole area.

I know that the state auditor's organizations love stat sampling and so do the feds. I do not really know if all the CPAs love it as much because it leaves us wide for gray areas. You know, we send out our stat samples. We arrive at our universe. Then we say, "Okay, we will send out 60 of them, because statistically it is sound." The biggest problem I see is, after we sent out the 60, we do not get the replies back.

Then that blows all samplings apart and we, as auditors, let it go. We still come up with our findings. How can you have a finding. What you take a sample of, say, 60, you had better get them all back in and you had better follow up on every one of them. You just saw that in the tape. They did not follow up on it, did they?

MR. MORTLAND: Well, if you take stat sampling and you do not follow up on it, I would tell you today it is a major thing.

MR. TONGIER: Does there not seem to be a lot of flags that went up and not any follow through?

MR. MORTLAND: That is true. A lot of flags went up and we did not follow up what we saw. There were a lot of things that we should have followed up on. Why did we not do it? Does anybody know?

AUDIENCE: We have a lot of trust in the management side.

MR. MORTLAND: There you go, an inexperienced staff. We did not only take the president of the company out. We probably took the finance director out to lunch a couple of times, too. But I mean, did they not depend upon the finance director?

Was not half the problem that the words you see up here is evidence. There was plenty of evidence. Was it ever documented? A lot of it was hearsay, was it not? "I talked to the finance director. He told me everything was okay."

AUDIENCE: I think the comment as to the audit client that he would depend a lot on management integrity. The problem in this case was the fact that the audit team was not aware that their integrity might have been compromised because of the sale, and they did not know about the sale, so they were not entering into it with the proper skepticism.

MR. MORTLAND: Very good point. It goes back to planning, does it not? It all goes back to the first thing we looked at.

AUDIENCE: The partner was the one that knew about it. He was the one who talked to the client. He was not telling the rest of the staff all of the information that he knew.

MR. MORTLAND: How could he be telling them anything? He was not on the site. The partner was never in the field, was he?

AUDIENCE: He was the one who talked with the finance director at lunch.

MR. MORTLAND: Yeah, but he did not go out and communicate with the staff. He had lunch. That was it. And the supervision, where was he? Does anybody know where the supervisor was? Think. Come on. Who remembers? Where was the supervisor?

AUDIENCE: On the phone.

MR. MORTLAND: He was on the phone, supervising from the phone.

So here is this poor incompetent senior, totally incompetent senior, out in the field talking and the finance director was probably talking to him, too, not only the partner, because I would like to think that he did talk to the finance director. But he did not know that the company was going to be for sale.

Can you imagine? Does anybody remember when they were young enough and they walked in on their first audit and they talked to the boss of the auditee. You were sort of intimidated, were you not?

So now, I am an incompetent senior and I am talking to the finance director. I am probably totally intimidated and to whatever he said, I said, "Fine."

AUDIENCE: One of the most common problems you find are these conversations. Everybody has them. I think the AICPA has recognized that by changing and saying, "You are supposed to meet management now with the proper skepticism." Traditionally, everybody thought, "They are good guys. They would not lie to us." Of course they will. You can listen and talk to them, but then you have to test to see if what they tell you is correct. Is it consistent with your findings?

In this case, what management was telling us is not consistent with what they were finding. They were not even thinking about that.

MR. MORTLAND: All right. Any other comments?

MR. MAHER: Herb, it even appears here that there is no documentation on the gist of these conversations that were occurring.

MR. MORTLAND: There was none. There was no evidence, I do not think, in writing anywhere. A memo to the file? "I talked, I talked," is all we read. Basically, I do not know if he really talked to him. There is no evidence.

MR. WHITAKER: Even if the company was not for sale, is it not an audit designed for a lot of people to use? Would the CPA

go talk to the finance director and, based on that conversation and his assurance, not follow up to see that what he said was going to be done was being done?

MR. MORTLAND: No, we are required to follow up, but we have to talk to somebody intelligent. I am an incompetent senior out there and I need to talk to somebody who I think is not going to lie to me. I mean, you always go to the top, really, when you are out there. You go to the top and you test it out.

I think a lot of times, and the point you just mentioned brings to light my personal feelings. A lot of times, we, as auditors, deal with the top management and they are not the ones doing the work. They are not the ones who are making the posting errors. They are not the ones out there doing the actual day-to-day work. They are the ones who know what the system is supposed to be. They manage the people. I think, then, what we need to do is go, maybe, back out and not only do the test work that we are required to do, but communicate with the people who are doing the work. A lot of times--I know this has been said to me many, many times--we, as auditors, hold ourselves out as God and that we are far superior to the people who are doing the manual or computerized work and that is one of our biggest mistakes.

If the auditor wanted to find out about the obsolescence, he should not have talked to the finance director. I mean, besides

seeing flags pointed everywhere, okay, he could have gone back out to the plant. Nobody says you can not go back and talk to shipping or production people. But you have to understand that the guy did not know what he was auditing anyway. That is part of it. Okay?

I had a good one and no one has brought it up yet... you know, the allowance for bad debts. We sent out these letters and they did not come back, but that is normal, is it not? I do not know if you audit in the government sector or at the state level, but I know in the CPA level, we depend very, very heavily on confirmation letters. A lot of times I would like to think that the government does not have to because they are always doing the audit 2 years behind, and you could audit via subsequent events and subsequent receipt of funds or subsequent disbursements of funds, but we do not have that luxury sometimes and we depend upon outside banks, et cetera, to do it.

What did we just talk about the last time? Stat sampling. That is one of the biggest fallacies we have going a lot of times. If we, as auditors, would go out and use stat sampling and send out all these nice little letters and net get them back, but that is normal. Who cares? Stop and think about it. What does that do to your stat samples? Does it make them valid? Just because nobody sends it back, then it is normal? It does not make it very valid, does it?

What else happened? No evidence. Evidence was not in writing. We did not follow up on any of the evidence. We had the red flags, did we not? We had mispostings. How many times did we find little stuff misposted and we say, "Oh, it is immaterial. Let us go on." I have said that many, many times. I will be the first one to own up to it. "It is immaterial." If you are misposting in the fixed assets area, I think it is material. You started thinking of the internal control, but they did not put it altogether again, did they?

Why did they not put it together? No supervision? No planning. That could be it. I think most of it was no supervision. They had the flags up, but there was no supervision.

(Videotape shown.)

MR. MORTLAND: Got 25,000 did they not? 25,000 pounds, and the auditor is in court. They did their "best." Remember that word. When you go home tonight and you think you are doing the best laying on your pillow, say, "I did my best." Then when you go to the courtroom, you can always sit back and say, "I did my best."

I think the summary of that little tape you just saw shows it all. We have already heard from one partner who really did not do anything. He did not do any planning. He did not do any supervision. He did not do anything on the audit. He did not even have answers for most of the questions being raised. So the guy in charge, the head honcho, got caught. He definitely was not prepared to take the stand, was he? He should have hired a better attorney to represent him.

We have learned alot. You have seen something that one day can help you and I guarantee it can happen to you. The federal employees are no longer exempt from lawsuits, believe me. You are going to be sued, General Dynamics is doing it. It was in the paper. I did not read the whole article, but they want $29 million in legal fees paid back to them and I guarantee, if I was the federal government, I would probably pay it and try to rid of the lawsuit before it is over with because, from what I read, I doubt if you are going to win.

One day everybody has an opportunity to be in court, not only for a speeding ticket but for poor audit work. Lynn pointed out an awful lot. The federal people now fall right under the AICPA, do the not, Lynn?

I mean, "if they are going to sue us, we are going to sue you." That is where it is. I am sorry to be at that point, but

that is where we are in the profession today. You have to do quality work. One day you can be sitting in a courtroom. When you are there and you end your summary and say, "I did my best and I do not think I did anything wrong," what do you think the jury is going to say, after you saw that tape? Who is going to win? I guarantee you, "best" is not going to cut it. We are no different from the medical profession who do their best daily and they get sued all the time for malpractice and I guarantee they do their best, but they are still subject to us suing them. Well, it is our turn to be sued now and we will be in the courtroom. It is not limited to just the Big 8 CPA firms that we hear about, or the other CPA firms. In addition, you will see people suing the federal, the state, and the local.

Right now in St. Louis--you can correct me, if I am wrong--we have a lot of people suing municipalities in St. Louis, mostly over zoning issues. I mean, nobody has hesitated to sue municipalities. They are not sacred any more. I do not think anybody is suing the state of Missouri, but they will be. Thank you.

MAKING THE CASE

CHAIRMAN JONES: We have Karen Laves and Chuck Pierce of the Missouri State Auditor's Office to discuss some of the things that they have done recently in support of staff testifying in court.

Karen is the Director of Local Government Audits for the Missouri State Auditor's Office. She has a Bachelor of Science in Business Administration from the University of Missouri - Columbia. She is a member of the Missouri Society of CPAs and the American Institute of CPAs. Karen's audit responsibilities include auditing the 94 third class counties in the state of Missouri. It is better than the 254 in Texas!

Chuck Pierce has a Bachelor of Science in Accounting from Lincoln University. He has been with the Auditor's Office since 1981 and is an Audit Manager. He is also a member of the Missouri Society and the Institute of Internal Auditors.

Chuck's responsibilities include auditing political subdivisions, whose citizens have petitioned the Office of the State Auditor for an audit.

MS. LAVES: We appreciate you asking us to come and talk to you this afternoon. When Susanne called and said she was looking

for someone to talk about fraud and experience in the courtroom, we were interested in sharing our experiences and in putting those things that we have learned recently in writing and in some kind of outline form. We really had not taken that time. Chuck and I put together a small presentation and we talked to the Missouri prosecuting attorneys earlier this year. It was a little different focus from what we are going to talk about today to you all.

We have both been directly involved in a fraud situation that resulted in us going to trial, so we have both been in a courtroom and on the witness stand to help the prosecution prove a case. We have learned a lot.

That one courtroom experience is a wide gap from none. I assume all the rest of them, if they come, will also be additional learning experiences, but I can not imagine that we could learn that much each time as we did the first time.

I was involved in a trial in Newton County, involving about a quarter of a million dollar loss in the Collector's Office. Criminal charges were filed against two of the deputies for felony stealing in that situation. Chuck has been involved in the audit of the City of St. Louis, a petition audit. The trial that he will be talking about is the ouster suit that was

filed by the St. Louis City's Prosecuting Attorney against the License Collector there, Billie Boykins.

On the basis of the experiences that we have had and of some training that we have been through, we have three things that we would like to share with you this afternoon.

(1) A need to establish a fraud policy in your office. We would like to go through some points, some areas that need to be considered when you develop that policy.

(2) Some specific do's and do not's (based again on our experience), when you actually go to testify in a trial.

(3) Some steps that we feel that an office can take to encourage the detection of fraud, changes to audit manuals, specific steps that we would like to go through, some of which we have changed as a result of specific frauds we have found, some that came to our attention through some training that we have had.

Hopefully, all of this will help to ensure that, if you go to trial, as we saw in the film earlier this afternoon, you will be prepared and you will be in a good position to testify.

It was indicated that we were helping the prosecution. That does not mean that we got up and just told our side of the story and sat down. We were not only challenged on what we testified but on the preparation of our working papers and what we did and did not do, what we should and should not have done, what we did and did not ask the people, and on and on.

So all of the things that you heard about, those first couple of hours, become very important any time you go on the stand for any reason.

We have a handout that lists the different frauds that our Office has been involved in the last couple of calendar years. It is based on these different fraud experiences that our Office has gone through, that most of our comments today are going to be based. A lot of different situations are there, a lot of different types of frauds--theft of court monies, of the Collector's Office, of the Sheriff's Office, some state agencies, resulting in a variety of different outcomes, some guilty pleas, some restitutions, termination of employment. Three of them, I think, that actually ended up going to trial.

MR. PIERCE: We passed out a listing of some of the frauds that we have encountered. (Exhibit 2) If you have any questions about those at any time or would like copies of those reports,

just make a note of the number and see one of us afterwards and we will be happy to send you a copy of that report. We are going to very briefly go through some of the "Yellow Book" requirements, particularly the changes in the 1988 versus the 1981. I do not anticipate a regurgitation. I am sure, you are all very familiar with these standards, but we would like to point out a couple of things. Then we want to talk a little about the development of fraud policy and share some of our courtroom procedures, some of the ideas that we have as far as improving your organization's ability to detect fraud, and then, hopefully, talk a little about the actual case experiences that we have had, particularly the Newton County case because I think that is particularly interesting, and the Billie Boykins ouster in the City of St. Louis.

We will first go through some of the Yellow Book requirements of how the 1988 revision differs from the 1981 and some general discussion of how that differs in it impact on auditors. (Exhibit 3)

In the 1981 Yellow Book, auditors were required to be alert to situations, or transactions, that could be indicative of fraud, abuse, and legal acts and, then if you noted that, to extend audit steps and procedures to identify the effect on the entity's financial statements.

As requirements for fraud auditing would go, I think that is pretty easy. I mean, I do not think anybody in this room as an auditor that would have trouble living up to that standard. You are supposed to understand that fraud can exist. I think anybody in the auditing profession would accept that. You are supposed to be alert to situations that could indicate that. If you see something that looks like fraud, then you expand your audit procedures. That is, I feel, a relatively easy standard to live up to.

Indicative of the 1988 Yellow Book, as in SASs 53 and 54, a change is there. Now, auditors are required to design audit steps and procedures to provide reasonable assurance in detecting errors and irregularities and illegal acts that could have a direct and material effect on the financial statements. What does that mean? That the same auditor has the same responsibility for detecting an illegal act as you do any other type of misstatement in the financial statement.

Forget collusion. Forget all that you have learned about internal controls and how it is management's responsibility to design controls in such a way that this will be detected. The Yellow Book says we have to design our procedures so that we will detect that. It also says that we should be aware of the possibilities of illegal acts that could have an indirect and material effect on the financial statements. Now, I have not

given this a lot of thought, but I am not sure what that would include. It seems to me that it brings in a gamut of things that the client or audit team might be involved in.

In the corporate sector, insider trading -- is that something that you are to design an audit test for of another company? Probably not. Is it something that could have a material effect on the financial statement when that kind of info becomes public? Stock evaluations, the quantity, it could have an effect on the company, but yet it is not one that you would necessarily be able to design an audit test to detect.

A couple of other tips from the 1988 Yellow Book: Use due care in extending audit steps so that you do not interfere with any investigations or legal proceedings. (1) You may be required to promptly report indications of certain illegal acts. That particularly impacts those of us in the State Auditor's Office. In other words, if we indicate or see an indication of illegal acts, we frequently do not have the next level of management to report to. Maybe the standards require that you make known the appropriate levels of management. We may not have anybody left in the organization. It may be the head of the organization that we suspect the fraud lies with. In that case, we would be required to make a report to law enforcement or the appropriate authorities. (2) You are now responsible for being aware of the characteristics and types of illegal expenditures

and acts associated with the errors. Auditors should be able to identify the indications that these acts may have occurred. In other words, you need to know and recognize the symptoms of fraud.

I think we talked a little about some of the differences between the two. One of the overriding similarities, I guess, under both standards, if the auditor follows the standard, you are not guaranteed to find all fraud. I think we would all agree with that. Even though you follow the standards and used due professional care in conducting your audit, you are not going to detect all fraud. All right? It also says that a subsequent discovery of illegal acts does not mean that the auditor's performance is inadequate. I think everybody in this room would agree with that. If you follow the standards and still do not find fraud, that does not necessarily mean you have failed in your responsibility as an auditor. But if you end up on the stand, as this guy does, that may not count. If you end up assisting a prosecutor after your audit has not uncovered fraud, once again, that may not count. As a kind of poll, how many people here feel that it is the auditor's responsibility to detect fraud? Okay, nobody does. How many believe it is the auditor's responsibility to detect material fraud? (Show of hands.)

Possibly. Possibly, if it is on the books and records and if it is big enough.

How many people think that John Q. Public has any idea of the difference between those two statements? They do not. If you do an audit and you did not find fraud, then it is okay. It is not there. "There is nobody stealing money because the State Auditor's Office was just here and they did not find it." Forget the fact that there are 35 pages of internal control findings that say that we could not even render an opinion on the statement. Forget the fact that there is one person who sits there overseeing the entire operation by himself all day long. "The auditor was here and they did not find fraud."

At the point that you end up in court, that is what you deal with, for whatever side. If there are 12 lay people in there, that is who you have to convince and they do not understand law book standards. They do not understand generally accepted auditing standards (GAAS) and they do not care. The auditor's job is to go out here and tick-and-tack and check the books and, if somebody is stealing money, they are supposed to catch it, period. So what can you do for your organization that helps you deal with this type of situation?

Later on, we will talk a little about increasing your staff's awareness, but one thing that is worth considering is the

development of a fraud policy. What that entails is sitting down within your organization and asking yourself some questions about what to do and how to handle fraud.

Now, I am going to throw out some general ideas and some discussion. I would hope, if anyone has any ideas, or comments, at any point along here, feel free to jump in. They are just questions that we feel any organization should consider before they actually begin in fraud work. First, we will talk about what to do when fraud is first detected or suspected and give the frontline auditor an idea of where we go from here and maybe relieve the burden of following up on those exceptions and give them an out. If they are not getting the answers that they want as they go through here, the development of a fraud policy helps give them guidance. (Exhibit 4)

One of the things that you should address in a fraud policy is who should be notified. If you see a situation and it is not "passing the smell test" and the auditor is still not satisfied with the explanation and they think there is something going on, what is their next step? Who are they supposed to talk to? Are they supposed to talk to the in-charge auditor? Is the manager supposed to be consulted? The director? At what level? Where do they go next?

Part of the fraud policy is who should control the work. We will deal with this a little more as we go along, but one thing to consider is some organizations use what is called a fraud team approach. In other words, they have special sections of their audit staff that handle all fraud cases. At the point a fraud is detected or suspected, the work is turned over and directed by that unit. Other organizations handle it by increasing all their audit staff's ability and familiarity with fraud auditing techniques and they just leave it in-house. The director and the manager involved with the job handle the job and the staff that detected the fraud develops the fraud.

Both of them have pluses and minuses, on and it is something you need to work out based upon your individual organization. An argument for the fraud team and the fraud director is that it develops specialization and continuity. In other words, you treat all your frauds the same without the managers having to have direct involvement. They also develop specialization. Some people are more adept than others at this kind of work. Some people take to it and some people really avoid it. They will try to audit away a fraud for a long time and come up with reasonable explanations which may not be there.

Another thing to consider is: What work are you actually going to do as part of the fraud work? What kind of approach? How far are you willing to go? What type of procedures will you

use? You can consider a little about the actual audit work that you are going to do. For those of you who have been involved in a lot of fraud work, where you really anticipate going to court, I think you would agree that the level of documentation, the amount of detail, the type of work that you do, is quite different from what you might do on a normal audit. So that is something to consider. What kind of documentation standards apply to that type of work versus your regular audit work.

Another area to consider is: Who is going to interview suspects? We are not talking about an exit conference; we are talking about a suspected perpetuator of a fraud. You do not necessarily want to send junior auditors on the job in there to discuss this with them and try to clear exceptions. A couple of reasons, first of all, the junior auditors are probably going to be likely to believe about anything that they are told. Their skepticism is lower. Secondly, if they are the ones who do the interview, they are probably the ones who are going to have to testify, which brings us to the next area.

You need to address in your fraud policy who in your organization is going to testify. Management or above? The auditor who was responsible for doing the work? Directors? Partners? Have some idea of who and how you are going to testify.

AUDIENCE: It is not necessarily your choice, is it? Can they not subpoena pretty much anyone they want?

MR. PIERCE: Yes, they can, and that is a good point. One thing that you can consider doing is establishing this policy and try to sell them on it early. In addition, if the policy is that the manager, and above, testifies, then make sure the manager is involved when that job starts and at all stages of the fraud and in trying to sell that idea to the prosecutor. But you are right, if they decide to subpoena someone, they well may.

MS. LAVES: It has not always worked for us, but I know for instance in Newton County, had we not said something, the individual testifying would have been our assistant auditor on the job. I think just based on some of our prior experience, saying to that prosecutor, "We have a policy that audit manager, and above, testify. I was the audit manager on that job at the time. I am in a position to testify for you. I am familiar with those working papers. There are reasons that I can testify and you are not going to have problems when you put me on the stand in terms of being unfamiliar with the job," like the individual we saw earlier this afternoon was. You have got to be able to sell some of those ideas, but you are exactly right and it has not worked in every situation we have had.

MR. PIERCE: Right. In fact, in two cases in St. Louis, it did not work and they wanted other auditors to testify as to certain parts of the case. So, at that point, you are really in a pretty ticklish situation. Whether they subpoena him or not, you certainly do not want, particularly, if you are the State Auditor's Office, to be on record as being unresponsive to their wishes or uncooperative in the prosecution or in the investigation. We had some great people and they did some fine work. They really did an outstanding job up there. It is just not something that you would wish. If you have ever been there, I am sure you will agree it is not something you would wish on anybody else and you would certainly not wish it on a relatively inexperienced audit staff.

MS. LAVES: How many of you have been on the witness stand in a fraud case?

(Show of hands.)

MS. LAVES: Of those who have your hands raised, if you had your choice, would you have allowed a staff auditor to testify? I only had to go through a preliminary hearing before I knew my answer was no. I would not want to put anybody else through that. I felt in a much better position to answer those questions than to ask somebody else on my staff.

MR. PIERCE: So you do not always get your wishes, but you can sure get your vote in. Another thing, as part of what to do when you detect it or suspect it, it helps to know, as an organization, what your commitment is to developing this fraud. Does it stop with your requirements under the standards to determine the materiality and to report it? Are you committed to helping the prosecutor make that case? How far do you want to go with the work? It helps to know that upfront because a lot of time it is hard to back off after you get in there, particularly after you get involved with a prosecutor. Finally, an issue of record control. Who? Your organization, the auditee's organization, someone else? Who should control the records or is that an issue?

AUDIENCE: I am not doubting what you say, but do you not have to have a lot of these things worked out in your case up front with you or the Attorney General? Because, it is not the Attorney General or the D.A. or whoever it may be, are they not going to be the ones who are going to make the decisions as to how far they want you to go, who they want involved, and so forth?

MS. LAVES: Our experience has been that, when we wait until we are talking with that prosecuting attorney in the state of Missouri, it is a little too late. We need to have some ideas of our own. At least, in this state, at this point in time, a lot

of those individuals have not prosecuted these kinds of crimes and we have more experience in a lot of these cases than they have. For those individuals who have some experience, they are still interested in what we would choose to do or what our vote is. So it is not that we do not change our minds going in or we do not discuss it at the point when we get to the prosecutor. And I think Chuck is going to allude to this a little later, but at what point are you going to get involved with that prosecutor? Generally, you have made a commitment and already gone a certain distance before you are going to involve that prosecuting attorney in order to prove that fraud.

MR. PIERCE: If your commitment to developing the fraud is to do everything that is necessary to go to court, then you may actually end up almost like an investigator for the prosecutor. In other words, if that is the role you want to play, then you are right. In that posture, you are probably going to make a lot of those decisions. As Karen said, a lot of times we find ourselves in a situation where they are actually asking us what we think, our advice, as far as, "What can you do to prove this?" "What more can we develop?" "What does this mean?" "What is all this "accountant-ese" that you guys have here? What does it really mean? Where is the crime? I do not see a crime here." You know, that is not always the case and it is not that they are not qualified individuals in those positions. It is just that a

lot of them do not have a lot of experience with these kind of frauds.

Another thing to consider would be the reporting practices. How should the fraud be reported? A host of options exist and I am sure this does not include all of them: A separate written report. In other words, if you are doing a regular audit of one of your normal auditees, and, at the point you noted fraud, does that become a separate report or not? Do you just include it as a finding, or comments, in your regular overall audit report? Be aware that if you do that, there is a good possibility that everything you leave in that one audit report, all the working papers supporting that, will be available to discovery. This means, if you have an audit of seven binders and, less than one binder has to do with the fraud, then probably every finding, and everything else, and every working paper that you did relating to that audit, will be reviewed by the prosecution and the defense. So you open yourself up to answering a whole lot more questions about working papers that might not really even have any implication with the fraud at all.

MS. LAVES: We are talking, at least, from the standpoint of state or federal auditor, I would think. That is, we are in a position to determine the report that we are going to issue and decide what we are going to do, as opposed to someone who is being hired by that entity. But it does several things for us.

I mean, issuing it separately, some of the advantages are the following: (1) It gets it out much quicker. (2) You do not have to wait to complete maybe some other unrelated areas of the audit. (3) The most important thing, when you look at Newton County, to have issued that as part of the county as a whole and run the risk of having all those working papers involved in that trial, as opposed to one binder of workpapers that related strictly to the County Collector. I think it offered an advantage for everyone. No one else, including the defense attorney, needed to muddy through all the rest of the working papers that we had.

MR. PIERCE: We are not necessarily geniuses or anything. We figured this out probably the hard way. We kind of got "burned." We ended up with an audit that had this much fraud work in it (illustrating) and that much audit workpapers (illustrating) all being in court. So you need to try to develop these policies, but it is an evolutionary process.

A couple of other options. Some organizations use a case file for law enforcement, in particular, some state agencies and other investigatory bodies. They structure the case file like what the prosecutor is expecting to see, which is not an audit report, but literally a case file with exhibits and that type of stuff laid out that way. Another thing you probably need to consider is the level of detail to include. Once again, you need

to know how much to include in your report, but part of that is going to be affected by the prosecutor. You probably need to discuss that with them, although I would guess that you could get as many differing opinions as there are prosecutors as to how they feel the level of detail hurts or helps their case. But, once again, they may rely rather heavily on your experience.

Another thing to consider is when the fraud should be reported. A couple of items there. Just as questions are a consideration, impact on any law enforcement investigations is a concern. If something else is going on or the prosecutor is trying to develop a case in another area there or some other authority, or agency, are, try to note that and make sure that your report does not have an adverse impact on that. And, too, security of the assets is an issue. Is timeliness of the report important to continuing the action and securing the assets?

Another thing to consider is when or do you notify law enforcement or the prosecuting attorney. We have already discussed a little bit about it. Sometimes it is best not to do that until your work is complete. Know what you as an auditor can do and how far you can develop the case. That is something your organization needs to decide, and is based on how they handle fraud. I think what has happened to us sometimes, by going to the prosecuting attorney early in the case, is that they

kind of look on us as investigators, referring us to the next step.

Try to determine how you will control the work. In other words, you set the audit objectives and determine the level of work.

CHAIRMAN JONES: Chuck, what bothers me on this timing business is how to get around the situation. If you go on by yourself, how do you get around the situation? You may blow it because you did not "Mirandize" the people who you interviewed.

MR. PIERCE: We do not have to Mirandize anybody. We have no law enforcement power. I can not put anybody under arrest. The statutes for the state of Missouri allow the State Auditor to subpoena and take depositions, but we do not ever do that. We just are auditors doing our audit work and we might conduct interviews of someone as a result of that audit work, but we do not place anybody in custody. We do not have to Mirandize anyone.

MS. LAVES: In fact, in the Newton County case that we had, Don Waggoner, my boss, and I interviewed three of the deputies in that office. We did not Mirandize them. We did not have any law enforcement power or any arrest power. We took three statements from them that were admitted into the trial. Some evidentiary

hearings questioned that ability because we had not Mirandized them and it was upheld that those statements were properly taken, that it was a part of our working papers, a part of our audit process. It was not a law enforcement interrogation.

AUDIENCE: Regarding the comments that you made just a moment ago, the presentation there was just the reverse by the prosecuting attorney that they would want to be involved upfront with an audit. They would want to be sure that their expertise and needs were considered in the development. In addition, I do not know if this is still the case, but at one time it was not necessary that you have arrest authority or anything like that. If the subject believed or was under the impression that you did, that was enough to require him to be Mirandized.

MS.LAVES: We were questioned extensively on that, the second part of your question, as to whether that suspect or that individual believed that we had that power of arrest. We made it very clear upfront then that we did not and that, in fact, if they wished to leave, they could. Whether that was necessary or not, I do not know, but we did make that clear.

MR. PIERCE: We try to always make it clear to them when we talk to them that we are here to talk about the audit. The door is not locked. They can leave when they want to. If they do not want to talk to us, they do not have to.

AUDIENCE: I think it may have been relaxed, but at one point, in the Miranda decision, when it was first made, the arguments were made on both sides. The prosecuting attorneys and the defense attorneys argue that they carried enough weight in the statements and workpapers to deem that they have that authority and, therefore, they had to Mirandize. That is about all.

MS. LAVES: As far as when to notify the prosecutor. I do not know that we are telling you that you should wait. We are just telling you that you need to make a decision on where in that process you ought to notify them. I know at least in a couple of situations where we have waited, it has worked, I think, to our benefit. That is not to say that it will every time or that it should be your decision.

MR. PIERCE: Finally, when you do notify law enforcement, it is still our experience that you should be objective and factual but persuasive. You do not want to look like you are on somebody's side on this thing, but you also want to be convincing. You want the prosecutor to know that you know what you are talking about and that you really do think this is a problem and you have developed, or you can develop, whichever the case may be, hard facts and evidence that will prove that something is happening. If you go in there and just lay a bunch

of "accountant-ese" and some audit report on him, that may not mean a lot to him. You have got to be prepared to make the argument.

One thing that you probably should consider is how you handle communications with the media because you will probably get some inquiries. What do you tell them or do you tell them anything? Finally, your fraud policy would need to include at least some thought in your organization on who will testify. It depends to a certain extent on how you decide in your fraud policy to handle the case. In other words, if you have a fraud coordinator or a special team developer, or whatever you call that individual, that is probably the person who is going to testify. If you handle it just in the normal chain of command within your organization, then we recommend you at least give some thought to what level of staff you feel you would most like to have testify. It needs to be someone who is very familiar with all aspects of the audit because, as in the film, when you are up there, they can ask you any question about any part of the audit. So you need to be familiar with all of it. You need to have looked at all the working papers, particularly if they have been made available for review. You need to be thoroughly prepared to answer any question whatsoever about the audit.

As we said earlier, if you have a policy such as that, it is helpful to communicate that to the prosecutor early-on in the

work. They may make the decision for you by subpoena. That is true and, if they do, then you just deal with that. But, as a rule, they are usually responsive to your wishes, I think. Once again, it is a matter of being persuasive and compelling. If you can convince them that you are the best person to testify, that is who they want on the stand. Be aware also of the Business Record Exception Rule which just says, "You do not necessarily have to have done the work to testify that it was done and testify about it."

MS. LAVES: In Newton County, I think that was something that kind of evolved there. It was a concern that if the original auditor who prepared the working paper was not testifying, how could someone else do that? Would that be hearsay, or whatever their other types of exceptions are, when you are not the direct person who was responsible for that work?

As long as you were not necessarily the person who prepared it, but you had some supervisory authority and you had some responsibility for that work that you exercised, then I think much like any business it is not the individual clerk who prepared that document but the one who instructed or directed it who could testify. I think we want to make clear that the primary goal is not to go to trial and probably anybody who has been there knows that, particularly if you are in front of a jury. I do not know if you have even a 50/50 chance. It is a

very serious matter, but it is a game and the game is done in front of a jury. It depends on how you look, on how you act, and how you are able to answer those particular questions in the way that they are phrased and not just the facts any longer.

We had a couple of things that we found helpful, at least, in explaining the case, sometimes beforehand, even to a prosecuting attorney or to a defense attorney. These have been just some large exhibits (Exhibit 6), much like we saw in the film earlier, but they have been real effective. In fact, these are copies that we used just to explain some types of crimes to the prosecuting attorneys. There we were talking to an educated bunch of individuals, some of whom were familiar with the types of crimes we were talking about. We may be talking to a jury of 12 persons, a lay jury. One of the questions, I think, the prosecutor asked during the questioning in the selection of the jury was, "How many of you have reconciled a bank account?" He was not so interested in that they did, but in if they thought they should. That was a good sign. We were in need of people who were at least aware of what needed to be done. So we need to be able to explain to this group of people as simply as we could what the crime was and that we had evidence. Then we were in a position to answer all the questions the defense attorney came to us with.

So, not a particular crime here but just, in general, on a "check substitution scheme" or on a "lapping scheme," how would you go about explaining this? I do not know if you have ever sat down and thought, "How would I explain to someone who knows nothing about accounting how a check substitution scheme works?" We have been involved in a couple of check substitution scheme frauds. When you try to explain to a prosecuting attorney exactly which money is taken. They have recorded these cash receipts on the ledger and deposited them, right? So they could not have taken these. They did not take the checks that were not recorded. Try to put that into words that a 12-person jury for a fact that these checks that were not recorded, but were deposited in the bank account, are evidence of a loss.

So it is going to become very important to be able to talk very simply, not use a lot of accounting jargon, to go very slowly and explain what happened, step by step.

A couple of other posters that we used here, actually in a trial, and again just to kind of explain the accounting system. It had to do with the Collector's Office, just trying to explain the various different types of reports generated. To each one of these particular areas on this chart, we had an exhibit that was introduced and the back-tax books. Then we could use this to say, "Okay. This is how the system should have worked and what happened. "Let's walk through here and show where each"--you

have to get them to understand how it should have worked before you can tell them what actually happened and what the problem was.

Just a couple of things in regards to testimony. You can not be too prepared. I do not think, if you have not been on the stand, that you can really know how alone you are. We participated in public deliveries all over the state and you can always look at the person who is standing beside you and say, "Now, is that not right?" And then you can talk to the public. You can not talk to anybody else up there. You are on your own.

The press calls and wants to know something. You can say, "Let me check. I will get back to you." That is fine with them. All they want is the answer. You are up on the stand. You can not talk to anybody. It does not matter if the person who did the work is sitting out in the audience or your boss is outside the door, you can not go talk to anybody. So you have to be totally prepared. It is a one-shot deal. It is how you come across, not just what you know.

MS. VALDEZ: Karen, did you have prep sessions with the prosecutor before you went on the stand?

MS. LAVES: Yes, I did and I think, probably, Chuck's crew also did. I would suggest you do that. Run through the kinds of

questions the prosecuting attorney is going to ask and be prepared to answer that question on the stand when the defense attorney asks you, "Have you gone through all this testimony with the prosecuting attorney?" "Yes, I have." You bet. I was prepared. I knew what I needed to do, how I needed to talk to you, so I could explain this clearly.

MR. PIERCE: Our advice would be do not say anything during those prep sessions that you do not want to say on the stand. I think there may be a kind of a camaraderie of "We are all in this together," and you may be to a certain extent, but it may not be something that you feel as an auditor that you can totally say and be independent, objective, etcetera, on the stand. If you talk to the prosecutor about it during the prep sessions, he or she, may very well ask you that on the stand and they are expecting you to respond to it the same way up there that you did in the prep session.

MS. LAVES: But, obviously, you do not want them asking questions that you are not prepared to answer on the prosecution side.

AUDIENCE: During your prep sessions, did your prosecuting attorney suggest you count to five before you answer any of the defense attorneys?

MS. LAVES: My boss was way ahead of them. That is what he said. "Think of what you are going to say. Then open your mouth." That does a couple of things. It increases the likelihood of the answer that comes out being right and sounding good and it also gives the prosecuting attorney a chance to object when you are on cross-examination. Yes, excellent advice. They can not rush you, as long as you are taking your time, pausing between questions. You know, if they get to asking a lot of questions real fast, and I am talking of the defense attorney here. I am assuming the prosecuting attorney is going to be going slow and everything is going to be going according to plan. But you do not want to get rushed by that defense attorney. One way to do that is to take your time. Put some pauses between the answers. You need to be familiar with all the exhibits that you are going to be testifying to.

We took no notes in with us. Everything that we spoke from were the exhibits that were handed to us, so we did not run a chance of taking in something that the defense attorney had not seen or those kinds of things. I think there probably are some exceptions, but that kind of thing needs to be worked out ahead of time with your prosecuting attorney. I would encourage you not to take anything in with you. Just use the working papers and the exhibits that are going to be made available to both sides.

You need to answer all questions truthfully. That probably goes without saying. If you do not know, say so. I probably used that one line more, at least, on cross-examination than any other one and that was, "I do not know, sir." Do not guess. All they need for you to do is say, "Well, I think," and you have already planted some doubt in their mind; if they let it go on, if they do not know the answer, tell them you do not know. If you do not understand the question, tell them you do not understand the question and that you would like for them to repeat it or rephrase it.

One thing that we have found valuable was having someone in the courtroom the whole time and having that may involve an additional person beyond the person, or persons, who are subpoenaed. In our particular trial in Newton County, I was dismissed after I testified. Now, we had an additional person from our office who was going to testify, so if we needed somebody called back in, that was not going to be a problem. So I sat in the courtroom. Had that not been the case, had they wanted me to stay out of the courtroom, which (generally, if you are subpoenaed like that, if there is more than one person, or if you are the only individual) you can not hear any testimony before or after, assuming that you have not been released and might be recalled to the stand.

You may want to consider having someone from your office there to listen to the entire trial. In my view, it was not against the rules to run out in the hall and tell them what they said; but, you just could not sit in there and listen to the exact words as they were being said because it might color your testimony.

MR. PIERCE: Now, in our case, in St. Louis, in two trials up there, the prosecution was able to move for the judge that, due to the voluminous nature of the workpapers and the technical matter involved, etcetera, and the big sob story, he was able to excuse some of the witnesses. An in-charge auditor, who was later asked to testify, actually sat at the table with the prosecutor and assisted him, on the condition that they also assist the defense. In other words, if somebody needed to find something in our working papers, then that individual was responsible for helping them find it and that allowed him to stay in during the whole trial.

As far as cross-examination, I guess a limited preparation can occur there. You be as prepared as you can be. Do not argue with the defense attorney. You can not win. You probably would damage your credibility and, again, it is part of the show. There may be some situations where--it depends upon the kind of testimony or your individual personality (you can get into it with the defense attorney and end up coming out ahead in front of

the jury. In my particular situation, I resolved to remain calm and collected and not argue with this man at all. He was a very large man and had a large booming voice. I guess he was also going to play this game.

Before, when he had been in preliminary and when Don had been on the stand, the man was right up on his face. It is not like any of the films where you are standing up and looking down at this man. You are looking up at this man when you are on the stand. This defense attorney got up out of his chair, backed up about 6 feet and sat down and asked, "Are you tired yet?" This was not the same man who had been doing the questioning of all the other people that had been on. So they are going to be playing the same game that you are, but you need to be able to hold your composure to the extent that they are going to become argumentative or try to become argumentative. If they can get you rattled, if they can bring in some irrelevant information and get you to try to comment on it, it is just going to work to their benefit. The more they can muddy up the situation in the minds of the jurors, the better off they are going to be.

You have just got to focus on what you want to tell them, answer their questions, and leave.

To present the bit of information that we had--it was a complicated case--in Newton County took 3-1/2 hours of my time

one afternoon and that is just on the stand. So you might as well be calm and go slow and answer the questions. At the point that they are on cross-examination, you are not in control except to the answer each time he asks a question and they are going to run the show.

One other point that you probably should look at, and it probably varies from state to state and from to state agency to federal agency, is your legal authority to audit. We had that come up a lot as far as to why we should even audit the agency or the political subdivisions we were in, our right to subpoenas to subpoena certain records, our right to take certain statements, and those kinds of things. That is probably going to evolve over a period of time, as you experience it, and as you are able to look at the case law in your particular state and see how that applies. That is something that has come up on a couple of different jobs. I have worked with different prosecuting attorneys in the state and they are unclear as to what our authority is. I think we are probably in the best position to tell them the case law and the authority and our experience in other situations and how we dealt with it.

I want to talk about a couple of ways to encourage detection of fraud (Exhibit 5). One of the main points that was brought up in the film was following up on exceptions; that is probably, based on our experience, the key. Whether you have that 1

traffic ticket out of 60 that you cannot find a receipt for, that has been recorded paid; or whether you have an nonsufficient funds check that you can not find--you can see where it was redeposited, but their deposit should have been long that day then, but it was not actually receipted, it was just being redeposited and you cannot see that situation. You can not see a deposit being long. In each of those situations, you can easily find particularly an audit assistant or a junior accountant getting an explanation from someone. Someone says, "Well, it should not have been marked paid, then. It just got filed in the wrong file." We had this exact situation occur in a court in the state of Missouri. One exception out of 60, that is all it was. They said, "Well, it must have gotten filed in the wrong spot." We had a $94,000 loss in that court over about a 3-1/2 -year period and that was all we found, 1 out of 60 items. So if you are going to test from 60 and you are going to base that on a discovery sample and you are not expecting any errors. If you have an error of that type, you have got to have people who are going to follow up.

In terms of what they are going to do to follow up is something else, but we expanded on this in terms of changes to our audit manual. We did go through and we have training that has been given to all our staff. That was a starting point. We feel like some on-the-job training and supervision and those kinds of things are probably going to be the key that will get

our people to really be alert and to understand what we are looking for.

One of the things that we added to our audit manual was not a requirement, but it is certainly a suggestion. To discuss with the audit manager, "Did you tie your receipts into your deposits, item by item?" You need to consider getting the back-up from the bank. Anybody who has even been involved in that knows the bank can provide you a photocopy of every check that accompanied that deposit slip and tell you how much cash was deposited on that day. I think the hard part in talking to these new employees is to convince them that just because that will not necessarily prove something to you--you may get it and still not know any more than you do--but the chances of fraud having occurred and you not detecting it are increased when you do not do that. It can tell you whether you have a check substitution scheme.

In one particular court that we were in, we had this situation and the names that were reported on the deposit slip were not the checks that had accompanied it. They had altered the names to agree to the cash control, so it had all the appearances of accompanying it, the cash ledger sheet and the deposit slip. It was not until we got the bank back-up that we realized that there were a lot more checks going in, unreceipted checks, than we ever could have caught in any other way. That is

the way that we ended up totaling up our loss. It was from the deposit slips.

If you have got checks that people have maybe mailed in to you on a confirmation: "I am sure I paid it," and you are not sure what bank account it went into. Maybe you know it did not go into the official bank account or the agency or company bank account, but you are not sure where it went. There are numbers on that check that will allow the bank to tell you exactly where it went. And through that method we have identified checks and money orders that have been deposited into personal bank accounts. I do not know why, if you are stealing, large sums of cash on a daily or weekly basis, you would take checks and money orders and negotiate them and deposit them into your personal bank account, but I know we have seen that. So it is worth looking at. I am not saying, "If I were stealing I would not do it this way, so I am not going to look at that avenue." That is something that we have seen.

I would encourage the people in your office or on your staff to discuss fraud, at least the ones that have occurred. You know, there are still going to be new things coming up that you can not tell them exactly what to anticipate, but the mistakes or the oversights or the things that we have not done in the past, help us in the future. It may have been something even that you were not negligent on. You did all the work you needed to.

Perhaps it was not a significant misstatement or loss. Chuck was saying earlier that the public does not always perceive that difference. At the moment, you can begin to talk $10,000, $20,000, and you are talking about going into one person's pocket, particularly in our situation where you have elected officials or their staff. It is very significant. To the extent that we can design tests to detect that, when we have flags that go up, we do not want to overlook them.

Creating an environment that is conducive to detecting and reporting that fraud, I guess making sure that you are supporting the staff that asked those questions. You do not want people who are out there giving the illusion of suspecting everybody, but you would like them to have that amount of skepticism, that they will listen to somebody and then they will go back and they will make their decision, that they are not just going to "buy-off" on any explanation that comes along.

Making sure that they are being creative, they will come up with some new ways of looking at things or testing items or maybe they just want to check out a couple of avenues. Those need to be encouraged. Not letting that time budget dictate how much work is done on those follow-up areas.

Again, following up on all the steps. I think that is probably the area where we have seen that would have detected

some frauds sooner had that been done completely or, at least, as he kept saying this afternoon in the film, in retrospect that looks like something we could have done. What we want to do is to be able to do it on the project.

We would be glad to answer questions. If you want to know a little bit about the two particular cases that we have been talking about, we would be glad to give you a little rundown on what happened there.

AUDIENCE: I noticed in this listing that an awful lot of these related to court receipt. Did that generate any system-wide analysis to find out it there are weaknesses just in the whole system of controls that the courts are using?

MS. LAVES: It is not a defined uniform system. And one reason, I think, that you see a lot of the fraud, particularly in the municipal courts, is that it is something relatively recent to our audit responsibilities and, in fact, to anyone's audit responsibilities.

AUDIENCE: I think though another piece of that is that typically you find that those areas of cash receipts are not subject to central controls of the organization. It is sent to the Treasury. Therefore, they have a much higher degree of risk.

MS. LAVES: Very true. I do not know if you heard his comments. A very high degree of risk exists. A lot of cash, and to complicate that and to increase the likelihood of fraud, checks, also, any checks being mailed in.

AUDIENCE: But on the same token, with today's computerized environment, there are more computerized checks that we can put in the systems to analyze those things and maybe make sure that the systems are tighter, just because they are more dispersed.

MS. LAVES: We have certainly made some of those changes as a result of things we have seen in our audits to our audit tests--testing from the source document, making recommendations to police departments, county sheriffs who are issuing tickets to--that is a source document there. If you knew for sure every ticket that was issued and could trace it to the ultimate disposition or better yet, if the city could, then those things could get detected on a timely basis. That is exactly right. And most of those cities, whether it is a computerized system or a manual system, they could be in a position to control those and to detect them.

Yes, sir?

CHAIRMAN JONES: You say in your experience. Have you given any thought to putting together a list of the types of programs

or the types of activities that you feel may be the most vulnerable to fraud and sharing that with others?

MS. LAVES: We have certainly given thought to those areas that we view as high risk, particularly in our office, and have designed and redesigned and revised and tried to train our staff in those particular areas. As we see one area, for instance in counties, we have 94 other similar offices. We tried to determine whether that is something that is going to be pretty much of a problem in all of them, for example, courts, or whether it was something that we could expand to cover more than just the types of agencies and political subdivisions we audit.

CHAIRMAN JONES: It would be beneficial if you would do that and make it available to us.

MS. LAVES: Ed?

MR. KNAUS: Would you mind telling me what you did in Newton County? That is a pretty small county to get away with $276,000.

MS. LAVES: Well, it was a Collector's Office. Keep in mind we are not talking just county monies. We are talking schools, ambulance, fire, state, all the districts they collect for. That was over about a 5-year period.

AUDIENCE: Is that why there was more than one audit there?

MS. LAVES: The reason there was more than one audit is because we broke out that audit, identified as a special review of that Collector's Office and determined that initial amount missing. The additional $10,000 is identified in the regular Newton County Report and involved some other accounts that were not included in that review.

AUDIENCE: What did they do to get the $276,000?

MS. LAVES: They took cash out of cash drawers and put it in their pocket. They borrowed money. It is the word they used and did not have the opportunity to repay it by the time we were in there.

The way we detected it is during a proof of cash. A bank reconciliation would have done it. They were about $50,000 short. That is because the collection records, the receipt records, had not been altered for that $50,000. They had been for the remaining $226,000. That is, a report was generated of everything that was collected and when they transferred that to the sheet that they reported to the county on, they lowered that collection report. So we just had receipts that were reported less than what actually came in.

I am sure you are quickly going, "Well, they were charged with this much and here is how much they collected. Did you not know how much was delinquent?" Well, the County Clerk is involved in certifying how much is delinquent in these counties. We took a look at the back-tax book which had no page totals in it, no total page on it. We had an adding machine tape that added down to a total amount. We traced and added page totals over to--I take that back. Each page did have page totals on it, but there was no total in the book. We traced all the page totals over the tape that had been cleared at the top. This amount was certified by the County Clerk, a whole different individual, from the County Collector's Office. That tape did not add up. They testified they took the tape out of the adding machine and put $175,000 in and put the tape back in the machine and totaled it. One of the reasons we did not re-add the tape was because we thought it was prepared by an individual other than those who were collecting the money. We thought we had a third independent party here who prepared that tape. We did some test work on it. I will never again take an adding machine tape that has been cleared at the top and had the total at the bottom without adding it up.

AUDIENCE: You said this was over a 5-year period?

MS. LAVES: Yes.

AUDIENCE: Was it subject to any audit during this time period?

MS. LAVES: Yes, it was, and we were subject to a lot of questions regarding that when I was on the stand. I think when you have collusion, it makes it very difficult to detect those kind of things, when you rely on a third party, an independent party, having certified that was the amount of taxes that were delinquent at that point in time. In fact, that individual signed that sheet and that sheet was prepared by the Collector's Office. That is why it was not detected in earlier audits.

Ed?

MR. KNAUS: The Collector has to send the report to the Department of Revenue. Was the Department of Revenue at all--I guess there was really no way for them to know that the certification was false?

MS. LAVES: I do not think there probably would have been any way for them to know. It did contain the inflated delinquent numbers on it.

MR. KNAUS: Oh. Okay, so they were shown all the way around.

MS. LAVES: Those records had been altered, as well as the monthly collection reports.

MR. KNAUS: I was wondering, would it not also come through the State Auditor's Office because of the Hancock Amendment computation--

MS. LAVES: The Collector's Annual Settlement?

MR. KNAUS: Yeah, would that not show it?

MS. LAVES: We get the Collector's Annual Settlement, copies, that we use in the course of our audit. The only way to have detected it was by looking at the actual delinquent tax book and seeing that it did not add up to the numbers that they were claiming at the control account. If you went into a company and they had thousands and thousands of accounts receivable cards and no control totals, and someone totally independent of that accounts receivable reporting and collection function had run a tape, would you test some of those cards to that tape and confirm some of those accounts and take the total it was on the tape? I would not any more, but I think that is the situation that we were in. The reliance on a third party, certifying, as a matter of state law that was the amount of delinquent taxes, and never indicating to us that he had, in fact, not added up those books

books or seen any totals or generated those totals himself or added up that adding machine tape, but just signed the statement.

AUDIENCE: Was the Clerk brought into the litigation--

MS. LAVES: He was not brought into the criminal charge. The bonding companies have still not settled and I think it probably will involve his bond.

MS. VALDEZ: The most stupid thing I have seen about the Billie Boykins case in St. Louis is the discovery of all these uncashed checks in the desk drawer. What was going on there? Were those similar kinds of checks? What kind of scheme was she potentially involved in?

MR. PIERCE: We really do not have any knowledge. We do not know anything about the checks that they found out there. I think that probably bears out the controls that we--the weaknesses that we pointed out when we did that audit. That, without a doubt, is an auditor's absolute worst nightmare. That office collected some $20 million and there were no controls. None. Not one. I mean, you can document controls that we talked about earlier, but they were not there or the ones that they said should have been there were not being followed. So where did the other $279,000 in checks come from? Probably just reflective of

all the problems we have pointed out during the course of the audit which resulted in her being ousted.

AUDIENCE: That was maybe not an indication that it was some personal fraud on her part?

MR. PIERCE: It very well could have been. In fact, what prompted us to then pull the statistical sample that was primary evidence for her ouster was our concern that the controls were so bad. There could be a lot of money missing and using that sample during a 1-year period, we estimated anywhere from $3 million to $9 million could have been collected and was not reflected in the amount of money that was deposited. Now, it either was not collected or it was collected and was not deposited or some combination thereof. But that was the only way we could get any assurance at all.

AUDIENCE: It was not a criminal case?

MR. PIERCE: That was not a criminal case. I mean, we were not proving a loss. The prosecution just proved that she has not collected a significant amount of money that she was responsible for collecting.

AUDIENCE: That office probably never had any controls at all historically. It was not she just changed it.

MR. PIERCE: We were just involved in the audit of the 1-year period and, based upon what I have heard from the history of that office, that is probably true.

AUDIENCE: There were no controls there 30 years ago.

MR. PIERCE: That is what I hear, yes.

AUDIENCE: Has that office been audited before?

MR. PIERCE: It is included in the scope of the City's audit, by an independent CPA. It was the first time in 10 years that we had audited it. We audited it under the statutes that allow us to audit on petition.

AUDIENCE: At what point do you recommend confronting the suspect with the evidence you have gathered? Do you always make copies of all the records before you do that?

MR. PIERCE: Yes. As far as to the copies, anything that we feel is pertinent to either audit evidence or case evidence. As far as when to confront them, I usually do not do it until I am through. I mean, if that is at all possible.

MS. LAVES: In some situations, I think we have--and it depends upon the case and the controls. And, you know, if you have a judge who is outside the system that you can talk to in some of these courts, you may go to him first or to a city council in terms of securing those records. You may question that individual, you know, a difference between interviewing them and interrogating them. But if you have some question over the security of the assets, then we would go to some other level and either have someone above that individual make sure that locks are changed out or that records are put in a secured area--we carry lockers and that kind of thing with us.

It depends upon the kind of fraud, some of them, maybe, involving monies that are deposited into their personal account. You have to assess what could be destroyed that you would have to have or could not be reproduced from some other place.

MR. PIERCE: We had a fraud in St. Louis in the Sheriff's Office that was broken because the auditor doing the work very alertly made a copy of a document that was subsequently altered by a person. That turned out to be pretty persuasive evidence. Later, in addition to a lot of other corroborating evidence, we had to back up the shortage, but the fact that the suspect had taken the document from her when she brought it to his attention and had later changed it.

MS. LAVES: If officials brought something to our attention, we might go down and actually secure the records. Again, in a little different situation, perhaps in the State Auditor's Office, but we picked up records and brought them back to our office in a couple of situations where it just was not going to work out to secure them out in the field.

CHAIRMAN JONES: Karen and Chuck, thank you very much. We really appreciate it.

FINANCIAL INSTITUTION FRAUD

CHAIRMAN JONES: Our session this morning is on Financial Institution Fraud. It is a follow-on from yesterday when we saw the film, "The Auditor in Court", and the presentation by Margaret Kelly's staff on some of their experiences in having to go to court.

We wanted to talk this morning about some of the things that have happened and probably currently are still going to with respect to financial institution fraud. We have two speakers who are going to present a review from the audit perspective and we have a speaker who is going to talk about the legal perspective.

The speakers are Alwin, who is the Texas State Auditor, Fred Wolf, who is now a partner with Price Waterhouse, and Mary Barrier, who is an attorney with a private firm.

Yesterday Herb was talking about the number of malpractice claims that were being filed nowadays. That film certainly brought it home. Susanne happened to show me an article from the ASSET, the Missouri Society newspaper. I think it is very easy to avoid malpractice, if you just avoid tax write-up or business advice which comprised, I think, over 110 percent of all the claims that were filed. It would be very easy to avoid it. But these are some real snakepits out there and I think the financial

institutions are one of them. They have been quite predominant in the press and that is what we want to talk about.

Our first speaker this morning is the Texas State Auditor Larry Alwin. Although he claims he is an adopted Texan, Larry is really a Kansan as I found out this morning. He was a Kansas State University graduate with a B. A. in accounting. He is a CPA. He worked for twenty years for Gulf Oil Corporation in data processing and internal control. Larry says he left Gulf when they were acquired by Chevron. He became the Texas State Auditor in 1985.

Larry is going to give us an overview from his perspective and some of the problems that are experienced in Texas.

Then he will be followed by Fred Wolf, who, I think does not need much of an introduction to us who have been around the Forum for a while. Fred has been with us on more than one occasion. He is currently a partner with Price Waterhouse. Prior to that, I think you are all aware that he was the Assistant Comptroller General for Accounting and Financial Management and prior to that he had a rather varied career with Arthur Andersen.

AN AUDIT PERSPECTIVE

MR. ALWIN: My remarks will cover an overview of the savings and loan crisis. I will talk about the environmental factors related to the savings and loan crisis and the factors that created the potential for fraud.

We encounter fallout from the savings and loan crisis in the media on a daily basis. In the last 24-hour period, there have been six news items that have appeared in major newspapers or have been on television.

Yesterday morning when I purchased The New York Times, I noted:

The first article said, "Jersey Bank Take-over Imperils Other Lending." (This is in Newark.) "'City Federal, which has $9.8 billion in assets and $7.3 billion in deposit accounts, collapsed primarily because it had many real estate loans in New Jersey, Florida, and Texas that went bad,' the regulator said."

The same newspaper reported, "Regulators tell CenTrust to dispose of luxuries." (CenTrust is a Savings and Loan that is located in Florida.) It seems that the management of CenTrust has, over time, invested in paintings and sculptures worth

millions of dollars. The regulators are suggesting that those need to be disposed of.

From television:

CNN reported on Lincoln Savings & Loan and the hundreds of millions of dollars that they had invested in high-risk junk bonds. Additionally, they discussed the investments the depositors had made in the savings and loan that the depositors thought were federally insured but were not.

I also heard this morning about the Columbia Savings & Loan in Beverly Hills, California. Their president has resigned. This savings and loan is deeply involved in the junk bond business. In fact, 30 percent of their assets on the balance sheet are composed of high-risk junk bonds.

President Bush was quoted from an interview as saying, "We're in a whale of a mess on savings and loans." I believe that is an understatement. He suggested that the $50 billion that was set aside for the savings and loans is not going to be sufficient.

The picture I am trying to paint for you is that the savings and loan crisis is not over. Last August, Congress passed a bill that set a new focus on how we control and regulate the savings

and loan business, but we are still dealing with the fallout of that business.

I mentioned something earlier that I would like to go back and talk about. This regards the article about City Federal and how it has $9.8 billion in assets and $7.3 billion in deposit accounts. The same article later states that City Federal has collapsed. Does anybody see anything wrong with that statement? (Audience response: "How did it collapse when assets exceeded liabilities?" Mr. Alwin's response: "That's a good question.")

I am continually amazed when I read in the newspaper that assets exceed liabilities but yet a savings and loan collapses. I do not want to insult anybody's intelligence, but I want to briefly talk to you about what a bank or a savings and loan balance sheet looks like. On the liability side, you have deposits. This is the money that you and I have put in the bank, the money that the government guarantees. The institution then does something with that money; they either loan out the deposits or make short-term investments. Such transactions are recorded as assets. The real question is the value of loans. At City Federal, there is a difference between assets of $9.8 billion and liabilities of $7.3 billion-- a difference of $2.5 billion. Where is that $2.5 billion? In my view, it is in the overstatement of the value of the loans. The assets used as collateral for the loans from our deposits are not really worth

the amount carried on the balance sheet. The difference of $2.5 billion is probably going to cost each of us, as tax-paying families, $50. Every tax-paying family in the United States is going to pay $50 for a $2.5 billion shortfall in the savings and loan industry.

Next, I would like to look at the historical perspective of the savings and loan crisis. I think it is important that we have an understanding of the historical perspective, and I think it helps us to understand the problems associated with the crisis. The following chart should assist us in this endeavor.

HISTORICAL PERSPECTIVE - S&L CRISIS

Pre-1978 -- S&Ls were involved for the most part in low-interest home loans with low-interest saving deposits.

Late 1970s -- Inflation and high interest rates caused depositors to leave S&Ls for higher yielding money market mutual funds and other higher yielding investments.

1980 -- Congress removed the passbook interest rate cap of 5.5% and raised FSLIC coverage from $40,000 to $100,000.

1980 -- Congress gave the Federal Home Loan Bank Board power to vary the net worth requirement for savings and loan institutions between 3% and 6%.

1982 -- The Federal Home Loan Bank Board removed the 5% limit on brokered deposits.

1980 - 1982 -- S&Ls were paying double digit rates on short-term borrowing and receiving single digit rates on old long-term home loans, the bulk of their assets.

1982 -- Congress passed the Garn-St. Germain Depository Institutions Act. The government's policy was to increase S&L growth through deregulation by providing the opportunity for higher returns than available from fixed-rate home loans.

1984 -- The collapse of Empire Savings of Mesquite.

???? -- FSLIC became technically insolvent.

1987 -- A White Collar Crime Task Force was formed.

1988 -- The Southwest Plan was implemented.

1989 -- Congress passed a plan to rescue the savings and loan industry. The Federal Deposit Insurance Corporation became the conservator for ailing thrifts in the United States.

Prior to 1978, the savings and loans were primarily involved in low-interest home loans and they were paying low interest on their deposits. Some people suggest that America would not be a land of homeowners today if there had not been this type of financial institution to bring about the accumulation of deposits and capital to loan out at low interest rates.

In the late 1970s, we entered a period of inflation and high-interest rates. Depositors started taking their money out of the savings and loans and began to seek higher yielding investments. During 1980, Congress removed the passbook interest rate cap and raised the deposit insurance coverage from $40,000 to $100,000. Next, they varied the net worth requirement for the savings and loan institutions. In 1982, the Federal Home Loan Board removed the 5-percent limit on brokered deposits. This, in my view, is probably one of the most critical actions that occurred because it gave access to unlimited capital to savings and loans "operators."

It was during this period of time, from 1980 to 1982, that the savings and loans were beginning to pay double digit interest rates. Loans made in the 1970s were earning much lower interest rates than the savings and loans were paying on deposits. This became the first crisis for the industry. The savings and loan industry was going broke.

In 1982, Congress passed the "Garn-St. Germain Depository Institution Act." The government, at that point, made a policy decision that suggested that rather than close the savings and loans, they were going to go through a process of deregulation and increase their growth by providing them the opportunity for earning higher returns than were available on fixed-rate loans.

At this particular time, they were given a good deal of flexibility in their operations. Savings and loan personnel who had primarily been involved in dealing with home loans were now dealing in commercial real estate ventures. Savings and loans were able to invest in ventures that even banks were not allowed to invest in, which meant that they were becoming developers and builders of a myriad of commercial real estate ventures.

At this particular time, they were also able to loan at 100 percent of the appraised value rather than 100 percent of the cost of the project. The problems from this action will become more obvious when we look at a particular situation regarding appraisals. In 1984, Empire Savings of Mesquite collapsed; the first savings and loan in Texas to collapse since deregulation. I will talk more about some of the transactions that occurred with that collapse. It was called the "I-35 Condo Scam."

In 1985, after the collapse of Empire Savings of Mesquite, the Federal Home Loan Bank Board began to reconsider the impact of deregulation and started to reregulate. They went from a position of deregulation to a position of regulation. The problems associated with reregulation were exacerbated in 1985 and in 1986 when the real estate prices started to fall. The supply of real estate far exceeded the demand.

During this time frame, the FSLIC became technically insolvent. This meant that even though a savings and loan was what we call "brain dead," where their assets were less than their deposits, the FSLIC could not bail them out; because they did not have the funds. The insolvent savings and loans were paying high interest rates on deposits, which was hurting the healthy savings and loans, and the FSLIC could not bail out those institutions that were insolvent. It was a vicious cycle. During 1987, it became apparent that the potential for fraud existed and a White Collar Crime Task Force was established.

In 1988, the Southwest Plan was implemented. Approximately 90 thrifts were consolidated in 16 transactions. This program has received a good deal of criticism because the investors received significant tax advantages with little new invested capital required. In 1989, Congress passed a plan to rescue the savings and loan industry, and it still remains to be seen what

it is going to cost us; it is in the neighborhood of $170 billion right now. The President says we may need more.

Another item that needs to be discussed in order to understand the historical perspective is economic information as it relates to Texas. In the mid-1970s, oil was at $6 a barrel. In the early 1980s, it had reached $40 a barrel, and there was much enthusiasm over where the price of oil was going.

In 1984, the price dropped to $25 a barrel. At that time, the investors said, "It will never go lower." Everybody was convinced it was a temporary drop and oil prices were going "back out the top." In 1986, the price dropped to $10 a barrel.

These other factors are important. Between 1983 and 1986, with the drop in the oil prices, the banks with large energy portfolios were strangled; they were losing money in energy. They needed to cover their energy losses, so they moved to real estate. In 1985 and 1986, the real estate market was overbuilt and began to see defaults. This gives us a sense as to the historical perspective of what was going on in terms of the financial institutions and what was going on in terms of the market.

I am not suggesting, however, that the economic situation caused the cratering of the financial institutions in Texas. I

am not about to suggest that. I think it contributed; but, when you look at the data on financial institutions that failed and financial institutions that did not fail, you have to ask yourself the question, "What really happened? Was it an economic situation?" I think there are enough studies available from GAO and others to suggest that this is not the case. GAO has reported that their assessments of failed thrifts and banks indicate the most predominant characteristics were (1) the absence of effective systems of internal controls and (2) the widespread noncompliance with laws and regulations. In addition, inadequate financial books or records, long lapses between examinations, inadequate examination and supervisory resources, and delays in acting on problems by the regulators.

Next, I would like to talk about the regulatory environment that was in existence. I think a look at the environment and the various transactions can give us a sense of where the potential for fraud really does exist.

First, I would like to talk briefly about the regulatory structure. In my opinion, it tilted in favor of the industry. The Federal Home Loan Bank Board consisted of 12 regional banks. The directors of regional banks were management from savings and loan institutions. The Federal Home Loan Bank Board had responsibility for the FSLIC, the insurance corporation, which was responsible for examining savings and loans and for

instigating legal action in those cases where it was necessary. Even though the states had the authority to charter savings and loans, the states had to defer to the FDIC in terms of regulatory and legal action. This relates to those states that participate in the insurance program.

The Texas Savings and Loan Department was governed by a board of outside directors, the majority of whom were to be members of the savings and loan industry. The Executive Director of the Texas Savings and Loan Department, who by law must have experience in the industry, resigned when it was reported that he previously had financial dealings with an owner of one of the savings and loans-- one that he was required to regulate. It was later reported that he had accepted favors from certain members of the industry. In summary, evidence suggests the regulatory structure was tilted in favor of the industry. There is no doubt that the industry was being self-regulated.

The second point that I would like to mention is that the industry was open to the unscrupulous. The regulatory environment created the opportunity for the entry of those from outside the financial community. These outsiders were primarily developers and builders who were not familiar with the financial industry. I believe in terms of the unscrupulous, the regulators were unobservant of the backgrounds of some people who entered the industry. In several instances, individuals in savings and

loans institutions had previously been accused in some way of being associated with fraud. In 1976, a subcommittee of the House (the Government Operations Committee) investigated a series of questionable transactions and bank acquisitions in Texas. Approximately 20 acquired banks were involved in insider loans and other questionable manipulations. Several individuals were banned from future involvement in financial institutions as a result of those activities. Some of these same people 10 years later surfaced as being associated with savings and loan operations. In another case, a top lending officer of one savings and loan had previously been indicted in a bank fraud scheme.

Next, I would like to talk about the transactions. Many transactions were executed that were subject to question and were perhaps fraudulent. I am not a lawyer, but many transactions, in my opinion, are subject to question.

Noted below is an illustration of a land flip. This is an actual reported example but I have changed the names to protect the innocent, or the guilty, whichever the case may be. The individuals are identified by "A", "B", and "C", etc., and involved seven people. In October 1983, 2,145 acres of undeveloped land was purchased. The indebtedness on the property at that time was $17 million. That same day, that property was sold for $24 million. Three days later, it was sold to a

partnership that was made up of the first two people. I do need to clarify that there were various lending institutions throughout this transaction. As you can see, there were several curious transactions concerning the investors involved and the amount of the indebtedness.

ILLUSTRATION OF A LAND FLIP

DATE	TRANSACTION	INDEBTEDNESS ON PROPERTY
Oct. 1983	Purchase by A-2, 145 acres	$17 M
Same day	Sold to B	$24 M
3 days later	Sold to C-a partnership of A&B	$24 M
Feb. 1984	Sold to D-D sold 500 acres in 4 hrs	$45 M
Oct. 1984	Sold balance to E-A trust associated with A	$37 M
Dec. 1984	Sold to F - a company of which A is president	(?)
3 days later	Sold to G - a joint venture Selling price $50 million	$64 M
Oct. 1986	Joint venture filed for bankruptcy Appraisal by the lender Nov. 1985 = $90 Million Appraised by the FHLBB Aug. 1986 = $20 Million	

Unfortunately, in a spiraling transaction such as the one illustrated, an investor or lender is left holding the bag, especially if that spiral is artificially inflated. At the time of default, the indebtedness on that property was $64 million. From October 1983 through December 1984, the property changed in value from $17 million to $64 million. In 1986, this joint venture filed for bankruptcy. The lender had appraised that property in November 1985 for $90 million. The property was appraised by the Federal Home Loan Bank Board a year later at $20 million.

Several issues we need to consider on this transaction indicate the potential for fraud. First, we have to question if it is logical that a piece of property will drop from $90 million to $20 million in a year. One of the first questions is the appraisal. What controls do we have in the appraisal process? The other question on this transaction is not quite as obvious from the example noted, but the loan is transferred between various savings and loans. As the loan is sold between institutions, someone is earning fees on that transaction, at say 6 percent, for loan or broker fees. I think they lend credibility to the potential for fraud.

I have another example that illustrates the point that the regulatory environment was conducive to entry by the gambler. At one institution, a series of transactions related to condo

development. An individual bought options on land and sold it at much higher prices to condo investors. Prior to sale to the investors a series of land flips similar to the previous example took place. In order to build, they worked out a plan where you, as an investor, put up no cash. The developer provided the land, which he acquired through a series of flips at a high value. The developer also provided the appraisal, financing plans, construction, mortgage, and sales on this condo.

The lender provided 110 percent financing, which meant that you, an investor, received a cash bonus. Now, think about this. What would you do if you were approached with this deal to invest in a condo in a rising market. You know the real estate markets are going to "go out the top," like oil prices are going to exceed $40 a barrel. You do not have to put any cash in. They are going to build it for you. They have the land available. You are also going to receive a cash bonus. In some cases, that cash bonus would have been in the neighborhood of $43,000. A number of people would look very closely at this transaction. A secretary or a carpenter, for a set of signatures, could become a condo developer and receive $43,000 in cash. What most of the people did not understand, or did not care to understand, was that bonus was part of the amount they borrowed.

You, as an investor, with your $43,000 in cash, purchased a condo. You financed all of the flips that took place, which went

through several representatives, and the price got higher each time. Then the market drops. As in other land flips, it is that poor "sucker" on the end that gets stuck with the mortgage that exceeds the value of the property. Many of those people just walked away.

Another area that seems to be predominant is the kickback. If there is a situation where people are going to jail, it is for kickbacks. You borrow a certain amount of money, more than you need, and you kickback part of it to the person working at the financial institution. These transactions are obvious; you <u>can</u> go to jail for this.

Another type of transaction that was taking place, which was especially troubling to the regulators, was the sale of loans between institutions. If you have one of these loans on your books at $90 million and the property is appraised at $20 million, you work to move the loan off your books. It is called the "daisy chain." You sell the loan to somebody else in the network. You remove it from your books while the regulators are conducting their examination. Later you may get it called back or it may go to somebody else. This whole issue of being able to track the transactions, from institution to institution, is a difficult task.

In closing, I would like to leave you with two points. The first is that the environment created by Congress and the regulators was conducive to entry by the unscrupulous. The decision to deregulate may have been right from a public policy perspective, but the mechanism to determine if the policy objectives were being achieved was not in place. The failure to properly evaluate the results of deregulation created a tremendous disruption in the financial well-being of this country. Secondly, I would remind you that the initial savings and loan crisis may have been dealt with by Congress, but it is not over. All of us will be affected by the fallout from this "fiasco" for many years to come.

MR. WOLF: I would like to thank Dave and Susanne for inviting me here.

Larry is wrong on one thing. The sucker at the end of that whole daisy chain there is not the investor. It is all of us. We are all paying for it. The investors got wiped out, yes, but we are paying for the savings and loan problem. If I occasionally get upset about it, I do because it is an absolutely terrible scandal. It is not American business' or government's or financial institutions finest hour by a long way.

I will add one other thing to that. The piece of property that went up to $64 million and is down to a value of $20 million can probably be bought for $5 million these days and that is not an exaggeration. It can be acquired through the Resolution Trust Corporation (RTC) for about that kind of money.

Just a question. How many of you have ever been to Houma, Louisiana? Nobody? Two people. Houma, Louisiana. Just remember that. We will get back to it.

You have probably all read a lot about the savings and loan industry. What I would like to do is to talk about five aspects of the savings and loan crisis; what I perceive as some of the macro issues, the micro issues in a number of firms, and then talk about where were the auditors and the examiners, cover some

lessons learned, and end up with talking about some of the new rules that are in what is called the FIREA legislation -- the savings and loan bailout bill is vastly more that just a savings and loan bailout bill it has some major changes for everybody in terms of rules and regulations.

I will start with some simple numbers about the savings and loan problem -- $300 billion is what it is going to cost us. It is $150 billion of basic cost and $150 billion because we have a federal deficit and we are going to finance it over 30 years. That is what it is going to cost. That is a $1,000 a person.

Somebody else pointed out something to me today that I thought was interesting. I said, "And we are going to be paying for it the rest of our lives." That is true, literally, in my case. I am almost 49. If you take my normal life expectancy, it is somewhere in the seventies. I am going to be paying for the savings and loan bailout for the rest of my life. Look around. Your ages are not vastly different (some of the women are a little bit younger or else they look better than we do) but we are all going to be paying for it for a long time.

How did we get there? This is an industry that has gone through massive change (and we misunderstood the impact of the changes) but there were a lot of other things that went on. You had 30 years of an industry that was what I call a relatively

sleepy, straightforward business. There is an old saying, "Three, six, three," for the savings and loan industry. "You borrow at 3 percent from the depositors. You lend it out at 6 percent and you are on a golf course by 3 p.m." That is not entirely untrue.

Then, you got to, as Larry pointed out in his chronology, the late 1970s when you have interest rates start going way up and S&Ls had borrowed short and lent long, so that you had people with assets that were earning 6 percent; but, instead of paying 3 percent, they were paying 10 percent, 12 percent, and more. You had an enormous financial mismatch and the industry literally was going bankrupt. The solution was thought to be fairly simple. "We will deregulate this industry and let them get into things that earn more than 6 percent." Okay. So what you do is you raise the earning ability by letting them get into higher risk investments and other types of transactions. There is a word in there, higher risk. We did not really think much about the higher risk. We just thought about the higher return. And that was going to get us out of that problem. But, it only got us into more trouble.

At the federal level, we deregulated. At the state and local level, we deregulated more; it was almost a competition between some of the states to see who could deregulate most. It is interesting, if you look, a band of six or seven states were

"Kings of the Deregulators" in terms of asset powers for S&Ls as well as entry into the S&L business. California, Arizona, Texas, Oklahoma, Louisiana, and Florida in particular, did significantly more in terms of deregulation.

At the same time, while the S&Ls were getting into financial problems, many people said, "But let's not reflect it in their financial statements. Let's phony up some accounting rules which permit us to defer losses and to recognize additional amounts of goodwill and to do a number of other things, so it does not look quite so bad." So we did some accounting gimmicks.

Remember Larry's slide, about oil prices going from $6 to $40 to $100 a barrel and you had in Southern California the defense industry booming big in the early 1980s and a skyrocketing inflation rate and, as a rebut you had sort of a frenzy in the marketplace. "Let's just loan money out. All these projects are going to be good because prosperity and inflation is going to rescue all of them."

With high inflation the trick was apparently less and you did have a lot of changes in lending patterns. You had S&Ls get into what is called ADC lending, Acquisition, Development, and Construction. That is not a one- to four-family house. That is for a shopping center, where the guy is buying the land. He is going to build the shopping center and hope that he can get

enough people in there. As I say, if inflation is going at 12 to 18 percent, he is reasonably safe. You had a tax law which encountered all of that in the early 1980s. Through fast depreciation and a number of other things that encouraged real estate investment, S&Ls had been told, "Go out and finance it. That is going to be the salvation of the industry." You had brokered deposits, which put more money out there for the S&Ls, so they could finance all of this additional investment, lending, ADC lending, land lending, and all that.

Then you had a change in the people who came in. You used to have people who were in the S&L business because they wanted to be on the golf course by 3 p.m.; they were there because they were lenders of money. There is an ethic and there is a business approach to lending money. Well, the entry rules to the industry changed and let people, who were borrowers, come in. Their ethics, their orientation, their business approaches, are different from lenders. They saw S&Ls as a source of money to finance their projects, even the ones that were uneconomical. The incentive for a builder, for example, to acquire an S&L was very simple. He has this project and he needs money for it and he can not get it from other S&Ls. "Well, then I will go out and buy an S&L and then I will loan myself the money." Why did those other S&Ls not loan him the money? Because it was not necessarily an economic deal or they had gone back to the land records and seen what had happened, if you take Larry's land flip

slide. They said, "We are not going to loan money on that." Well, like I said, my solution as a developer is to get an S&L, so I do not have to go through that lending process. I can just get the money.

Then you had crooks enter the business. (I do not characterize a developer coming in and looking for a friendly source of money as a crook.) But you did then have people come in and they got involved very heavily in the land flips, in the so-called daisy chains (which is passing a bad loan around or passing a bad property around or swapping bad properties.) "I will trade you my dead dog for your dead cat and we will call them both alive." That was all going on in 1982 to 1984 or 1985.

The regulators, in fact, some of them, did begin to worry, at least the federal ones, as early as 1984. There is a gentleman by the name of Ed Gray who was the head of the Home Loan Bank Board. It took Ed 6 months after he came in to realize just what was going on in the industry. He spent the remaining 3 years trying to get across the message that this was a mess. He tried to change rules to stop some of the things, to stop broker deposits, to stop some of the investment activities. He was turned down by Congress. He was turned down by the administration. He was turned down by the states. And the industry's lobbying group did an enormously effective job of preventing him from doing any of those things.

He tried to get more rules. He was turned down in the regulatory process and again the industry group stymied him. He tried to get more staff. He went to OMB and said, "We need more people to oversee this industry." OMB and the White House said, "Don't you know that this is the era of deregulation? We don't need more regulators." Nobody understood the difference between deregulation of what somebody could do and the elimination of oversight and supervision. They are two entirely different things. But Ed was turned down on that.

Finally, Ed found a way to go around OMB and, after he found out a way to do it legally and OMB realized they could not stop him, they offered him 39 more examiners. He had a staff of 800 or 900 examiners. He more than doubled it in a 1 1/2 years, but they were willing to give him 39 more people.

He was stymied in another area, enforcement. Regulators can do three things. They can issue a Cease and Desist Order, "Stop doing some specific thing." They can throw the management out or they can close the place. Well, closing the place takes a lot of money. They could not do that in 1986 and 1987 because FSLIC did not have the money to do it. On the two other things, (cease and desist orders or throw the management out), they can. They were often stymied. If you have watched the Lincoln situation and if you watched the Jim Wright episode a year ago, one of the

allegations was that, in fact, congressional people were putting enormous pressure on the regulators to not take enforcement action. They did not have to warn you not to close them, because they could not close them anyway, but they did slow down cease and desist orders and actions like throw the management out. There were some things that were done, but they were done under enormous pressure not to do them.

Congress also refused to provide any money to close institutions. There was a 1 1/2 year time frame where there was legislation proposed to provide the needed remedies. It got scaled back and scaled back and scaled back and deferred and deferred and deferred, until finally, when they were given--what was it?--$10 billion for a 3-year period. It was not even close to enough.

At the end of that, during the process of that, you also had an economic downturn and you had the oil prices go down. A lot has been said about the economic downturn in the oil patch creating the throttle. That is not true. The economic impact and the economic downturn had an impact, but it did not cause or create the problem. It only exacerbated it.

A simple way to think about that -- there are almost as many bankrupt S&Ls in Southern California as there are in Texas. The last I looked, throughout the 1980s, Southern California was not

in a downturn. Their real estate has been going upwards for the whole time.

These problems went on for more than 3 years, from 1984 until 1988. No problem. "What, me worry?" No regulatory action. All of these things occurred for 4 years until, miraculously, about the 10th of November 1988, we woke up and found we had a problem. Both political parties woke up and found we had a problem. That awakening occurred about 4 days after the election. And everybody says, "Well, this was never a topic during the campaign and it should have been. Why wasn't it?" Actually that is not true. There was a 2-day period during the 1988 election where first one, and then the other, candidate raised the savings and loan issue and dropped it after 1 or 2 days because neither of them could figure out which party gets clobbered worst if this thing all unraveled before the election and so it just died.

Anyway, you get past the election and president Bush proposes some major legislation to deal with the problem, and it was a pretty good bill. It took 6 months to pass. There were a number of interim things that were done. The bill was strengthened a lot, in the House and in the Senate, in terms of all sorts of things: regulations, restrictions, enforcement powers, and a number of other things.

To get a bill through Congress in 6 months, which fundamentally restructures our entire financial system, is rather amazing actually. A lot of people worked very hard at it. One of my candidates for being one of the people most important in getting that bill through is Henry Gonzales from San Antonio, Texas. He has been the Chairman of the Banking Committee for now slightly more than a year. He got that bill through a House that was divided, pressured, and did a super job. That is not to say others did not as well. The bill gives a significant role to FDIC to clean up this mess. Whether they can do it or not and whether the money that is provided is enough, we will see over the next 4 to 5 years. That is sort of the macro of what was going on.

Now let me change focus a little bit and talk about the micro of what was going on. A simple transition from the one to the other. All those big numbers and all those things happening translated into individual companies, institutions, that were having problems. Look at a few basic numbers.

In 1988, a whole series of transactions were entered into to deal with 220 insolvent "thrifts." Those cost us (the American public) $65 billion, give or take. Right now we have 250 thrifts that are under FDIC/RTC management, 25 of them are more than $1 billion institutions; 225 are smaller institutions. They have

$100 billion in assets and the asset-liability gap is variously estimated at $25 billion to $40 billion.

There are 250 more thrifts out there which have negative tangible net worth. When you take away goodwill, which is not really worth a whole heck of a lot to an insolvent thrift, 250 of them have no capital. Well, one of the things, as Larry pointed out, is that a preventer of problems to the taxpayer is capital. Somebody else's money is at risk. A lot of those 250 are going to end up on the government's doorstep. They have $200 billion in assets--I am not sure what the asset-liability gap is, but it is probably $15 billion or $20 billion. There are about 40 $1 billion-plus institutions in there.

One of the things that we did at GAO was to take a look at 35 of the institutions that failed in the 1987-1988 time frame. It was not a "representative" sample because it included some of the bigger failures, but it had a lot of others thrown in there. What we did was look at years of examination reports, reports after the place had been closed and interviewed a lot of people, to try and find out what happened at those institutions. There are some relatively simple conclusions in that GAO report. The most significant single sentence in that report, in my mind, is that "it is clear that there was rampant fraud, insider abuse, and a complete disregard of safety and soundness regulations in almost every one of those institutions." They had weak or

nonexistent internal controls, sometimes by design. They had unsafe and unsound lending practices and loans with no economic viability. The economic downturn frequently exacerbated the problem but did not cause it.

Where were the auditors, accountants, and the examiners when you looked at those institutions? Well, let's talk about the 35 and another study in which we selected 25 institutions and then scaled it down to 12 institutions where we looked at the auditors' workpapers and a few other things. In the 12 audits, we evaluated in detail.

We ended up criticizing 7 of them rather severely, including recommending a review by the state licensing or examining board. We did not recommend disciplinary action because we did not, at GAO, have the power.

In one of them, an institution with $1.5 billion of assets, most in its lending portfolio, something like 75 or 80 percent of the portfolio was in these kind of loans what I described as ADC lending (Acquisition, Development, Construction) where there is a higher degree of risk and a higher degree of speculativeness, by a long ways, than traditional one- to four-family mortgages. A single-family mortgage is a relatively safe investment for lending. In fact, it is probably the safest you can find; people

do not walk on mortgages, certainly not after they have been in the house a couple of years. It is almost unheard of.

The workpapers for this audit, a $1.5 billion institution, with, as I say, three quarters or more of the lending in this risky ADC lending, the workpaper files for the review of the single-family mortgage lending portfolio, practices, controls, all of that, was a stack of papers--I do not know--something like 2 1/2-feet tall. Does anybody want to guess how big the file of workpapers were for the review of 80 percent of the portfolio in the higher risk ADC lending? Six inches? You are too big! That honestly is too big. They were maybe 2-1/2 inches thick.

In another institution that we looked at 5 days after it was closed by the regulator, there was a letter report from the organization that was brought in to manage it and be the receiver. That letter report said, "This institution had a portfolio of $650 million of loans to insiders, (i.e., the thirteen owners, shareholders, and directors of this organization) all located within a five-mile geographic radius in North Dallas, all collateralized by the same properties and nothing else." I mean just collateralized by the property--no personal responsibility on any of those loans. All of them exceeded lending limits to one party. And all of them exceeded lending ability to officers and directors."

Do you know what the footnote in that financial audit said about related-party transactions? It said, "One of the directors is a partner in a law firm with which this organization does business. They had $200,000 more or less, of legal fees with that law firm." That is the end of the footnote about related-party transactions.

The third one--now we will get back to Houma, Louisiana. I had to chuckle about it a little bit. I have been to Houma. Houma was something for a little while during the oil boom in 1981 and 1982. There is a workpaper in the file that says, "I have reviewed this $20 million loan; the collateral is a piece of property located in downtown Houma, Louisiana." Usually, if you have anybody in the audience who has been to Houma, the line you get back for the audience is "There is no downtown Houma, Louisiana." It is true. The workpapers said, "Collateralized by a piece of property in Downtown Houma, Louisiana with a value of $20,000 an acre." You could buy <u>all</u> of Houma for $20,000. Perhaps, there is no way that a staff person could have known that downtown Houma, Louisiana, does not exist. But, if you are going to audit these institutions and if you are going to look at $20 million loans in the portfolios, you probably ought to know a little about what you are looking at.

Let's go back to the 35 institutions we looked at. There were, in fact, some qualified audit reports, qualified from the

standpoint that you could find some exception. Generally, it related to one of two accounting issues being argued between the profession and the Home Loan Bank Board and they were sort of esoteric issues. When you read it and then you read what happened to the institution, you conclude that there is no way that anybody reading that audit report could have had any understanding that this institution was about to cost the taxpayers, or the FSLIC at that time, anywhere from $50 million to $1 billion in losses each. There was just no way that you could tell by reading those audit reports that that was what was about to occur. You might say, "Well, our responsibility is not to determine whether this institution is going concern or what the future is for this institution." But, that is not going to help anybody very much. Those institutions were sick, dead, bankrupt, and had rampant fraud, insider abuse of related-party transactions. You do not find that in the audit reports.

Where were the regulators? Well, to me, one of the sadder parts of the whole affair is that, in fact, the regulators were there and did see a lot of the problems, but they were prevented in a lot of cases from taking action. In some cases, they tried to take action and they were stymied by the people they were taking action against, sometimes by the industry, sometimes by the supervisory groups, and sometimes by Congress. Nobody was pushing to take any action.

the supervisory groups, and sometimes by Congress. Nobody was pushing to take any action.

I will give you one example of what the regulators knew. If you examined S&Ls in those days, they were using a five-point scale. "1" is okay. "5" is definitely not okay. I do not remember the exact descriptions, but if you got a "5," that institution was in bad shape. In fact, if you got anything other than a "1" or a "2." the institution was in serious difficulty.

Of the 35 institutions that we looked at roughly over a period from 1980 through 1986-87 when they were closed, 150 examinations that were done of those institutions. One-third of those examinations classified the institutions as a "1" or a "2" and almost all of those were in 1980 or in 1981 and prior to a change in ownership. Two-thirds of the examinations qualified these institutions, rated them as a "3," "4," or a "5", some of them for periods of 4 or 5 years before they were closed. So the examiners did know. You can argue about just how accurate and how correct some of those examination reports are and a lot of things, but it is clear that the examiners did know the problem institutions and they did not need, frankly, some big early warning notice or early warning system or macro economic analysis. They were in the institution and they saw that it was a terribly sick, or worse, institution, and nobody let them do a darn thing about it.

am sure it will turn out that some of the things alleged in the Lincoln hearings are not correct and that there are some things that are worse. I am not trying to say that those hearings are exactly on target on every single thing, but I do think that they portray what was going on and the impact of it is that you have somewhere a $2 billion taxpayer loss out of that one institution.

Let me now talk for 2 minutes about lessons we can learn and then we will talk about what it means to the auditors a little more specifically because it does mean things that are very specific to auditors. We can learn some lessons from the S&L crisis. I say "can" because, like Larry, I am not sure that, as a government, we have learned all of them although I am a little more optimistic than Larry sounded. But we will see. Let's look at those lessons:

(1) There is a distinction between deregulation and de-supervision. We need to understand that.

(2) Where markets are changing and there is lots of money (particularly where it is the public's money that somebody has a fiduciary responsibility over), there are lots of opportunities for people to make off with that money.

(3) In a regulated industry, you do not interfere with enforcement.

(4) You need strong internal controls, strong audits, strong supervision.

(5) Lax accounting rules are just going to make the problem worse.

(6) You have to take prompt action when you find a problem.

(7) Budget cutbacks in the government are often felt at the operations level of government and have some very negative impacts, if you are trying to supervise.

(8) Ethics and conflict on interest rules are important.

(9) This problem does not exist only in the savings and loan industry.

I think those are the kinds of lessons we can learn out of this.

So what does it all mean to the auditors? It means lawsuits and stronger rules. Auditors are not the biggest culprits in the savings and loan industry. A lot of people made off with a lot of money or did things that damaged the taxpayer, the Savings & Loan fund, and the institution they were involved with and a lot of private citizens got hurt.

The auditors did not do that. The auditors, unfortunately, are the only people in our society who, involved in a situation like this, leave tracks. We have workpapers. The lawyers out and subpoenaed them, and you have got all the evidence in there for all you did or did not see and you are a lot easier a target than the owner of that S&L. He did not keep any records. He lied. He got fraudulent documents that he brought into the institution. It is not necessarily the owner. It may be other parties.

Proving white collar crime is really tough and a lot of pressure is on the regulators right now to prove white collar crime. One kind of white collar crime that is a lot easier to prove. That is where somebody left a trail, left workpapers. The auditors are probably going to come in for an inordinate number of lawsuits. They are not a tough target in comparison to the fraudulent manager or owner.

The other thing that is out there for auditors though is in the FIREA legislation. A lot of new enforcement powers and criminal penalties and rules and regulations have been strengthened for everything that goes on in financial institutions. Capital is the new "king" in financial institutions, in terms of what is required the bill calls for substantial, additional amounts of capital, with a vengeance.

If capital is "king" in the industry, ethics are "king" for everybody inside and outside the industry. The monetary penalties for people who perpetrate fraud on financial institutions go from $1,000 to $1 million a day. I am not exaggerating. A million dollars a day is technically what they can assess in a severe case. Criminal penalties go for 5 to 20 years. Public disclosure of administrative action is permitted. It used to be that when the examiners, or the enforcement arm of the FSLIC/FDIC took an enforcement action, it was private. Well, they now not only make it public, but they issue press releases when they take enforcement actions.

Stronger and sooner intervention in any insolvent institution -- the law gives the regulatory organization significant power to go in and take action, quicker and tougher, to do a lot of new things and do them sooner. Another thing you will not see for a while is what I would call "congressional involvement," interference or even, normal enforcement, normal oversight of this process. The congressional people are going to be very leery of getting involved. Now, you have just given a regulatory supervision work force significant new authorities and new powers. Everybody can be a little concerned that they do not go overboard and there is a risk of that. In fact, not only have you given those people new powers, but you have scared the daylights out of them and they are not about to let these problems occur again, "not on my watch." So you are going to see

a really aggressive enforcement, supervision, and examination force out there.

You have given vast new powers to conservators and receivers when they take over an insolvent institution. They can abrogate contracts. They can sue much better. They can change the preference condition, or preference position, of different creditors enormously. Receivers have substantial new powers. The statute of limitations for financial fraud or fraud against financial institutions goes from 5 to 10 years.

This is what the examiners can do that impacts the financial institutions. There is, in the law, a little sentence, which says, basically, that the banking agency's enforcement authorities against banks are also extended to all professionals or consultants providing services to banks or institutions. Every one of those things that I just went through, that they can do against an officer or a director or an employee of a financial institution, they can use to go after an auditor, a lawyer, a consultant, or anybody else who is providing services to a financial institution. So not only do you auditors leave tracks, trails, and workpapers, but your risk just went up substantially because you have a much tougher enforcement group and a lot tougher set of rules that you have to follow.

I am not going to tell you how you prevent these things other than to say that, if you do a competent, professional job and, if you report accurately, ultimately on the condition of this institution, you are probably going to be okay. If you do not, you run a significant risk.

The last thing I would say is, earlier I stated that the S&L industry is not the only place that you have seen it or are going to see it. I think the insurance industry is ripe for the same kinds of problems. When I was at GAO, we did a comparison of the savings and loan industry and the insurance industry and identified, 10 or 12 attributes of the S&L industry that were contributing factors to the problem that we face today. You can go down the insurance industry and 10 of the 12 are clearly paralleling the S&L industry.

If I were out there as a state auditor or as a federal auditor or if I were back at GAO, I would look at the insurance industry from two standpoints. I would look at (1) what kind of early warning system we have and (2) what kind of examination and supervision function we use. I would also look at new entrants to the industry. I would do it before somebody else raised it in a press article that says, "Here we have the next S&L problem." It is at the state level that the problem will come up because insurance is regulated, controlled, enforced, and overseen at the state level. In Maryland, a private fund was

ensuring the Maryland S&Ls--it was not FSLIC--and the State was not involved. When the scandal hit, the governor lost his job and the State paid. I doubt that in the insurance industry if something happens it is going to be any different.

Thank you.

LEGAL PERSPECTIVE

CHAIRMAN JONES: So that we can stay reasonably on schedule, I would like at this point in time to introduce Mary Barrier, who is going to speak to us on the legal ramifications of the legal perspective of some of the things we have been talking about for the past 2 days.

Mary is a member of the Missouri Bar Association. She received her J.D. from the University of Kansas. She is a clerk for the Honorable John W. Oliver, Senior Judge, Western District of Missouri. She was a member of the Kansas City Metropolitan American Bar Association, and the Lawyers Association of Kansas City. She specializes in business litigation. In recent years, she has specialized in officers and directors, accountant and attorney liability claims, writing out failed financial institutions. That fits very well with what we have been discussing here for the past few days.

So without further ado, Mary.

MS. BARRIER: I want to thank you for giving me the opportunity to come and talk with you a little today. When Susanne asked me to comment on auditor liability and failed financial institutions, she told me that my audience was going to be senior-level auditing professionals. I was a little

intimidated. It may be a little presumptuous of me, as an attorney, to come and talk with you about auditor liability. Certainly, public confidence in attorneys is not particularly high. In the popularity polls, we are ranked somewhere below politicians and slightly ahead of used car salesmen. However, I think it can be best illustrated by what one of my friends once told me or, at least, I would like to think he was a friend of mine. He said he could always tell when a lawyer began to lie. All he did was watch and see when his lips began to move. I certainly hope you do not feel that way today at the end of my talk.

However, I think that you, as auditors, are in a more enviable position than attorneys are. In fact, you may feel that the confidence and trust that the public imposes in you, and the expectations that they have for you are too high. Generally, I think that, legally, it is clear that auditors are not guarantors, they are not criminal attorneys, and they really should not necessarily be considered detectives; though, with the liability situation changing the way it is, I think they are more and more being required to become detectives or investigators, at least when they become aware of certain facts which litigators like to call red flags that are brought to their attention in the course of performing an audit.

In general, I would like to talk with you today about:

(1) The nature of accountant liability in the failed financial institution arena, about the evolution of liability to third parties. That would be people with whom the auditor has not made his contract or his engagement, but who may have relied on the audited statement that he has prepared.

(2) Some of the common factual circumstances that we see appearing in instances in which auditors have been sued over audits of financial institutions.

(3) Some of the special circumstances, the special kinds of defenses, the special issues (a) when a regulatory agency is appointed as the receiver of a failed institution and tries to bring the claims either on behalf of that institution as the receiver or brings those claims with its corporate hat on, (b) when it is assigned the claim by the receiver, or when those claims are transferred.

First, I think that you all realize your position, either with state auditing or from your other occupational context, that financial institutions, whether they are savings and loan associations or banks, are subject to a rather extensive regulatory scheme. When a financial institution fails, people look at the professional advice that the institution's management and board have received from its attorneys, from its auditors, and from appraisers who may have provided information to it when it was making extensions of credit, to see if there is any possibility that some of that advice caused loss to the institution. I think, with all the failures of banks and S&Ls in the last few years and with the passage of FIREA which Fred alluded to, that situation is only going to become more intensive.

I got into this area originally through work in officer and director liability cases. What you are seeing happen now is that, in addition to investigating the management of an institution by its board, the operation of an institution by its officers, people are looking more closely at the audits performed and whether or not during the course of the institution's history those auditors fairly presented the financial condition of the institution. I am sure, as you all realize, an S&L or a bank has lending limits, dependent upon its net worth, and they have loan limits to one borrower. They have direct investment limitations

under the regulations. They have all kinds of limitations which, in some sense, are dependent on their financial condition.

What kinds of standards is the auditor held to when he is performing the audit of a financial institution? What have the claimant, the plaintiff, whether that is the FSLIC formerly or the FDIC as a receiver of the institution or whether it is some third party, to show to be successful to present a claim against an auditor? They have to show what I am going to call, just for generalization, some sort of an audit failure and to determine that, generally, you need to have a professional, another auditor, review the workpapers of the audit to determine if there were deviations from GAAS, if there were deviations from a professional in a similar circumstance faced with similar facts from the duties that professional would perform in auditing the institutions.

Usually, and I think the courts are agreed, the standard of care is whatever auditing standards for review are set forward in GAAS. Sometimes, even if that is not the rule, you may be able to argue liability on the basis of whatever a professional in a similar situation would be required to do. In some instances, you can even argue an express contractual undertaking evidenced possibly by the engagement letter the auditor sends to its client. For instance, your engagement letter can limit your liability in some sense, just as qualifying your report can limit

the representations that you are making or you could extend your liability. You might be engaged to perform a service that an auditor would not necessarily be expected to perform.

In some cases, it has been alleged also that auditors are fiduciaries or that they have some sort of fiduciary relationship with their client. Normally, unless there is some particular fact-circumstances to establish a close connection with the institution, with the corporation, that is rejected. Auditors are not fiduciaries any more than they are guarantors of the financial condition of the institution. This may be particularly true in a small town where perhaps you do not have a great deal of choice for an auditing firm which has the expertise to perform the audit of an S&L or a bank.

You may have a group that audits more than one institution and the institutions may have relationships with each other or they may not only audit the institution but they may go so far as to provide some sort of bookkeeping services. You may have a small unsophisticated institution in a rural area. They may have one, especially in the early 1980s when there was deregulation, and they were allowed to get into areas where they were making out-of-territory ADC loans. You may have had an institution primarily involved in small residential mortgages prior to that time and they have a bookkeeper and he does not even know how he is supposed to post his entries, how he is supposed to record the

transactions, and the loan fee income that is coming in this type of an investment or a loan. Sometimes auditors have become involved in a more close relationship with the institution. Obviously, that affects their independence. Maybe they should not be auditing an institution if that kind of relationship develops, but certainly that is a possible scenario.

About 5 years ago, and some of you may be familiar with this case, the Supreme Court spoke on the auditor's duties, not in a liability situation, but in a situation where the IRS had issued an administrative subpoena. They were seeking to obtain the tax workpapers that the auditor had prepared and the Supreme Court talked about the auditors as "public watchdogs." People have picked up on a language in that case and tried to expand the auditor's duties beyond the client privity situation,the contractual situation.

And to use that language to imply or to contend that the auditor's responsibilities are to anyone who relies on the financial statement, that the auditor should be aware that the certified financial statements are going to be relied on by the public in their business dealings.

Except for the minority cases, and we will talk about this a little bit more when we are talking about the kinds of defenses that are asserted in auditor cases, some sort of contractual

relationship or some sort of actual knowledge on the part of the auditor that another party was going to rely on the financial statement has been required. In general, if the situation is that, if the auditor is a "watchdog," his primary duty to the bar, if you excuse me for taking it to that level, is to his client or, in the case of an S&L, possibly to the regulatory agency, because he does have some duties to notify the regulators if certain kinds of practices are suspected.

Basically, when a claim is brought against the auditor, you have to show that certain problems in the institution, the auditor failed to uncover, which he should have uncovered, or that he uncovered, but failed to disclose to the board or to management and, that resulted in a loss. I think that is really the key. Most of the cases that I am involved in deal with problems with review of the loan portfolios rather than embezzlement, for instance, as an employee. It is really the quality of the loan review, the breadth of the sampling. When should the sampling have been expanded? What was the internal control system used by the institution? Did the auditors fulfill their obligations to advise management of any problem that they detected. When you are making a claim, you argue that, if the auditors had advised management or had advised the regulators of the problems they discovered, corrective action would have been taken. All loan losses, after the date that the auditors made their report, would have been prevented. For that reason,

because of these causation problems, which can be very complex in that you are dealing with loans where there has been an economic reversal in the loan area or where there has been insider fraud and concealment of certain types of transactions from the auditors, I would disagree with Fred.

I have an extremely difficult job and sometimes I think it is easier with the officers and directors trying to show we are guilty of some sort of white collar fraud than it is with an auditor who has come inside and trying to argue, "You should have seen this. You should have looked at this. You should have advised the board about this or you should have advised the regulators. If you had given this institution a qualified opinion rather than an unqualified opinion, the regulators would have taken certain action. They would have required an extensive examination of the institution or they would have required the board to take some sort of action to correct the problem."

Most of the litigation now involving auditors and financial institutions is either brought by the regulatory agency with its receiver "hat" on or it is brought by officers and directors who have been sued by a receiver and who bring in the auditors and say, "We relied on their report of the financial condition of the institution and it is really their fault. It is not out fault." It may be a suit by a creditor who says, "We relied on the report in extending credit to this corporation. We never would have

extended it if their financial statement had been fairly presented." The regulatory agency as a receiver may also be involved in that kind of litigation, if it wants to sue a particular borrower and perhaps bring in the auditor of the borrower to allege that they were not credit worthy and then they relied on the financial statement of the borrower in assuming that they were.

Let us talk for a minute about what the legal theories are, if you do bring a claim against an auditor. First, and most prevalent--is negligence. The negligence is essentially an action for malpractice, professional malpractice, the kind of action that an attorney might be sued for.

Now, some allegations of fraud exist. A case where an auditor was accused of accepting a bribe to misrepresent the solvency of an institution. Primarily, we are going to be talking about a negligence action or a breach of contract allegation. If it is a breach of contract allegation, basically, you are down to what the contractual duties were and, essentially, those are defined by the auditing standards and by the engagement letter in circumstances where you have either limited or expanded your general role. In essence, whether it is contract or negligence, you are pretty much talking about malpractice action. The difference is the kind of defenses that the auditors are able to use against the claims. If it is a

contract action, the auditors may argue that he was hindered in performing his contract because management defrauded him. He was a victim of a fraudulent insider who concealed the records.

If it is negligence, the auditor may be able to argue comparative or contributory negligence and depends on what the state law is. Most states do not have contributory negligence any longer. In the past, in some states if an auditor could show contributory negligence on the part of the institution's management, it could be a complete defense to a claim against him. Now, under the comparative negligence laws, you have to compare, "It was more his fault than it was my fault." It is finger-pointing. If you can impute the fraud or the negligence of individuals to the management of the institution or the corporation as a whole.

When a federal agency is involved, when it has its corporate "hat" on, it can usually argue successfully that you can not impute the negligence of the management or the fraud of the management, because "I am separate in entity." "I am FDIC" or "I am FSLIC." If the receiver is involved again, generally, the knowledge of the officer, or director, is imputed to the corporation, but when a receiver is involved, it can still make the separate entity argument and it can, also, argue that, if the fraud was by the sole controlling person in the institution, the corporation should not bear the responsibility, and there is no

way that corporation can act except through its officials. It is an adverse domination theory and you argue that the corporation should not have been responsible for the controlling individual's fault.

It may depend sometimes on how pervasive the fraud is and whether you are defrauding the corporation to rip it off or whether you are practicing fraud to increase the corporate assets at the expense of outsiders. A New York Court Opinion indicated that if the fraud is to increase the assets of the corporation--in this particular instance that I am thinking of, they inflated their stock value inventory and that increased the value of the corporate stock and they used their inflated stock to go out and buy other corporations on the cheap. The Court held that the fraud was so pervasive and it was done to benefit the corporation as a whole and it was imputed to the corporation--you were not going to let the corporation which had benefited by the fraud recover again by separating it from the acts of its management. When that is not the case and when it is the corporation itself that is being deprived or that is being looted or rendered insolvent, the situation can be different.

To show you how corporate insider fraud can affect recovery, I am sure many of you are familiar with the Continental Illinois situation in Penn Square. In litigation against Ernst & Whinney, who were the auditors of Continental Illinois, there was the

claim that they failed to audit properly, they did not inspect problems with internal controls and advise the management of it, that there was a high concentration of energy loans placed at Penn Square, all controlled by one lending officer. That lending officer had a $.5 million dollar loan at a favorable rate with Penn Square and that, if the auditors had brought all this out, management would have taken some action to correct and stop the continued placement of loans in this area.

The jury just did not buy it, frankly. They found that the evidence of corruption was so widespread at Continental Illinois and that Continental Illinois has been in the position to know about the lending officer's fraudulent activity; whereas, Ernst & Whinney could only find out about his conflict of interest, if they had also been the auditors of Penn Square, which they were not, and the jury came back in favor of Ernst & Whinney.

The auditor, in a different context, even if there is not fraud, can contend that the client was negligent in setting up their own system. Again, whether or not that is successful really depends on the individual facts, or circumstances, and what the auditor has engaged to do. In one instance that I am aware of, the corporation represented that one of its members was trustworthy and that the auditor could rely on them for factual information. The negligence of the employer was upheld as a defense.

In another situation, the auditor should have realized there was a threat of employee defalcation because one employee was in charge of posting receivables, receiving the cash payment, and depositing those payments in the bank. The auditor had assumed the responsibility to verify the cash balances and they did not even look at the deposit slips, so they did not realize that this employee was aware of when the audit date was going to occur and was hiding checks from one account to another and, you know, taking home thousands and thousands of dollars. In that situation they said, "That is not the employer's negligence. The auditor should have known." He had accepted this responsibility to verify the cash balances. He did not check the deposit slips which would have revealed that the books of the corporation said one thing and the deposit said another, so liability was found.

One thing that I run into frequently is the allegation that this is not the auditor's fault. This is a regulatory failure. By virtue of the examination process, the regulators whether you are a state examiner or whether you are a federal examiner, have the opportunity to discover an institution's wrongdoing. They have the authority to issue a cease and desist order to stop it. Usually, that is not an effective argument. The majority of cases have held that a regulator had no duty to the institution. The examinations are not conducted to advise the officers and

directors of a financial institution of the problem. They are conducted to protect the public and, in the case of the FDIC or formerly the FSLIC, they are conducted to protect the insurance fund.

The regulator, therefore, does not have a duty to the auditors, the auditors have not been allowed to utilize a regulator's failure to discover or to stop certain illegal conduct as a defense. That is not to say that the regulator's reports of examination, to the extent that they carry factual information about the condition of the institution, might not be relevant in litigation. You may find yourselves testifying in court, even when you are not a party, if you happen to be involved for the state or for a federal regulator as to what your examination showed, what it revealed about the condition of the institution at the time that you made it. An auditor will try to argue, if a claim is being asserted against an independent auditor, "If the regulators did not find it, I could not be expected to find it either." The simple answer to that is that an independent certified audit is different from an examination. It has different purposes and it has different standards.

Sometimes the argument is also made that the regulator's conduct is really responsible for the loss of collections suffered after the regulator becomes a receiver of an institution. In that context, it is basically poor collection

methods. The regulator, as receiver, has the responsibility to work out the bad loans that were made and to terminate the losses suffered by the institution. The auditor will argue "It is not my fault. The loans might have been made and they might have had problems, but the real reason that there was a loss incurred was because you did not pursue the proper collection remedy." Again, in general, that is not a successful argument. There are some exceptions. Some cases have held that, if the regulatory agency does more or assumes a duty greater than its duty to regulate an institution it is actually operating an S&L. For instance, it goes in and actually controls the operations of the institution for some purpose. Perhaps the institution is insolvent, but it is not closed for many reasons--that could occur, but it is under some sort of supervision agreement or there is even a deputy supervisor appointed for the institution and it is more than just supervising the regulatory compliance. There have been a few cases that have held in that circumstance. The regulator assumes a duty over and above his normal duties and he may have some duty to mitigate.

I would just like to mention some of the theories of expansion for auditor liability beyond the client situation. I think, traditionally, auditors have defended claims by third parties on the ground that there was no privity. There is an old Opinion that was decided in 1931 by Judge Cardozo in New York which arose in a case where auditors had been sued for fraud and

for negligence by a third party. They had gone in and they had reviewed the accounts receivable, and they had posted the total sum of accounts receivable that were due and owing.

If you read the Opinion, you will think in the dead of the night that one of the employees came in and added $700,000 . In 1931, $700,000 was a lot of money, $700,000 of the accounts receivable. The auditors, through some sort of negligence or whatever, failed to go back and check the accounts receivable and it turned out that these were all fictitious accounts. They did not exist. Justice Cardozo, in writing an Opinion for the court, distinguished between claims based on fraud and claims based on negligence and said that in the negligence situation, the third party could not bring an action against the auditor, if there was fraud. If the financial statement was incorrect or if there were misrepresentations in it and, in fact, the auditor knew that it was fraudulent, then there was liability but, if there was simply negligence, then there was no liability.

That standard is still followed in many jurisdictions today, with the addition that parties who are in what they call "near privity," where an auditor has knowledge that the party will rely on the audited financial statement and, indeed, has some communication with the third party, indicating that he has actual awareness of that reliance, then there will be liability or that there can be liability, I should say. You have got a lot of

steps and a lot of "t's" to cross before you get there but, at least, you can bring a suit.

Now that standard has been expanded in a minority of jurisdictions. One is New Jersey. A reasonable foreseeability standard used there includes parties the auditor could expect to rely on in their general business relationship with the client for a business purpose. As I said, that is really a minority rule. I am going to stop there with this, because it is usually not a problem in the financial institution situation because the receiver stands on the issues of the institution. In essence, he inherits all the rights of the institution, including the privity relationship with the auditors.

I would like to talk with you briefly about a couple of examples of fact-patterns that are shown which you will find where you have audition claims. As I said before, I think that the key in this area is not some sort of embezzlement or employee defalcation. The key is loans. In the early 1980s, when a lot of these institutions were, for the first time, able to engage in widespread out-of-territory ADC and real estate investment types of lending. Sometimes because of insider fraud and sometimes because of lack of sophistication, they did not have adequate controls on this type of lending. Frequently, they did not really establish the credit-worthiness of the borrower, at least not in the manner in which they were required to do that by

regulation. The federal regulations require that they have certain documentation in a loan file and that the loans be approved by the board, generally, on the basis of that documentation. They have to have a loan application. They have to have an appraisal of the collateral on which they are making the loan. The appraisal has to be on an "as is" basis. Many of these appraisals we are finding in the loan files are on an "as developed" basis rather than on an "as is" basis. This means, if you lend somebody $3 million and the property is worth $200,000, it is going to be worth $3 million, they tell you. But, at the time, it is not worth it

Problems occur in terms of the failure to obtain audited financial statements from the borrowers. Sometimes no financial statement exists at all, not even a tax return to indicate that any credit check was made on the borrower.

There may not be any indication that the Board of Directors included this loan in their review and actually approved it. There are all kinds of loan review situations. While I would suggest that you look at this kind of documentation, it does not necessarily say that the lack of any particular piece of information affects collectibility. That is what the auditors are, looking at primarily. They look at the collectibility of the loan and will that affect the financial condition of the institution.

Commonly, the auditors will allege that if a problem exists with the loans, the problem is due to a reversal in economic situations or it is bad business judgment on the part of the officers and directors of the institution. Even if they had brought problems with lack of loan documentation to the attention of the board, it would not have done any good, that the board, either if they have a fraudulent person in charge, would lack motivation to make any correction, that the action would have come too late and, anyway, the money was already out the door. "How can you hold me liable for discovering problems with the loan when it is already made?" The argument, of course, is that you do not try to hold the auditor liable for that loan. What you are alleging generally is that there is a pattern of loans in a certain area or there is a problem in controls in the institution in a certain area and if those had been brought to the attention of the board or to the regulating institution, corrective action would have been taken and no further loans would have been made. You are really alleging perspective action that can cause another problem. Can you establish precisely what corrective action would have been taken or is it all speculation? That is very important in determining causation and establishing that the auditor's action, or inaction, was really the proximate cause of the loss.

This kind of litigation is very time-consuming and very expensive, so you want to look carefully at these claims before you bring them. I think that is why you have an expert in the area review the workpapers before you decide that it is the auditor's responsibility, if an institution has become insolvent and the losses have occurred.

We usually spend years fighting over the preliminary battle. What documents can they discover? What documents can we discover? If there are subsequent audits of an institution, then you may want to get hold of those workpapers. You have to deal with issues of accountant privilege with the client. You, usually, end up having to subpoena those papers to check the conclusions of one group of auditors against the other because of the contentions that the regulatory officials are really at fault and it is not the auditors. You get into big fights over the scope of discovery that can be pursued against a regulatory agency.

There are questions of deliberative privilege, questions of what information is factual, what information should be protected, because it involves the protection of the recommendations and opinions of staff. You want to encourage a free flow of ideas between staff and superiors. You may also have questions of discretionary function, exceptions under state immunity, acts, or state acts of abrogating immunity, I should

say, or the Federal Tort Claims Act. You can even have questions dealing with sovereign immunity and what types of actions can be examined. Most of the courts do not get into the immunity issue, if they can resolve it, and they usually can resolve it on the basis of the Tort Claims Act.

Well, I want to thank you again for giving me the opportunity to come today. I certainly enjoyed it and I hope that I will not see you in the course of my future practice.

CHAIRMAN JONES: We want to thank Mary, Fred, and Larry for being here with us today and talking about financial institutions.

I was sitting over here jotting down some things that I felt ran throughout the 2 days that we were here and how they might be applicable to those of us at the four different levels involving government auditing. I wrote down standards, quality, disclosure, and follow-up as some pretty important things. Even though we zeroed in on the financial institutions and some people would raise the question that maybe the feds or the state or the locals or even the practitioners do not have any involvement in this. I, also, jotted down some areas where I think that we need to be careful because I do think we have involvement and the S&L's, and the banks, obviously, from a regulatory viewpoint, the new agency that is being created to try to help straighten out

all this mess, RTC, and some of the issues they are going to be dealing with, particularly in terms of appraisals.

It was said that insurance was primarily a state regulatory function, but we also have insurance aspects at the federal level, FDIC. HUD probably has involvement in insurance and with billions of dollars. Pensions. Pension benefit guarantee corporations at the federal level. Investments in all sorts of pensions, stock portfolios, and so forth. One, enormous portfolio is Farmers Home Administration. Farm Credit at the state level. Insurance companies are regulated at the state level, some banks, some Savings & Loans. Again, they have employee pension funds, investments, at the local level. I think that they are probably involved with the employee pension funds, investments, the city doing business with various insurance companies, bank, S&L's, and the practitioners probably cover all of them. So in terms of standards, quality, disclosure, and follow-up, on what we, as auditors, do applies to all four levels that are represented in this room.

ATTENDEES LIST

Name	Agency
ALWIN, LARRY	TEXAS STATE AUDITOR
BARRIER, MARY	MORRIS & HECKER
BOWLING, GAYLE	DEPT. OF ED-OIG
BOYER, HAROLD	UNIVERSITY OF MISSOURI
BREITENSTEIN, CHUCK	DEPT. OF ED-OIG
BROSSEAU, WILLIAM	USDA/OIG FM & ADPAO
BROWN, LYNN	GAO
BROWN, TOM	U.S. ARMY AUDIT AGENCY
CARRINGTON, JACK	EPA OIG
COATS, ROBEERT	F.B. KUBIK & CO (KSCPA)
COOPER, LARRY	U.S. DEPT. OF AGRICULTURE
DONALDSON, BILL	ST. LOUIS COMMUNITY COLLEGES
ELKIN, ARTHUR	GSA-OIG
EMERY, CAROLYN	GSA-OIG
FISHER, JOHN	HHS/OIG
FUNKHOUSER, MARK	CITY OF KCMO/AUDITORS OFFICE
GREEN, RON	KANSAS LEGISLATIVE POST AUDIT
HAFNER, LEO	KANSAS LEGISLATIVE POST AUDIT
HARDY, TRUMAN	CPA
HILL, HAROLD	ARTHUR ANDERSEN & CO.
HOEVEN, JERRY	HUD
IMBRIANI, VINCENT	HHS/OIG/OFFICE OF AUDIT
JENKINS, WARREN	IOWA AUDITOR OF STATE

ATTENDEES LIST

Name	Agency
JENNINGS, ALICE	BROWN SMITH WALLACE, ETC
JOHNSON, RAY	NE. AUDITOR OF PUB ACCOUNTS
JOHNSON, RICHARD	IOWA AUDITOR OF STATE
JONES, DAVE	GAO
KARBATSCH, JIM	DOJ OIG AUDIT
KAREL, KEN	NE. AUDITOR OF PUB ACCOUNTS
KELLY, MARGARET	MO. STATE AUDITOR'S OFFICE
KELLY, PAUL	BROWN, SMITH & WALLACE, ETC
KIPLINGER, KASEY	IOWA AUDITOR OF STATE
KNAUS, ED	ST. LOUIS COUNTY AUDITOR
KOEHLER, PAUL	BAIRD, KURTZ & DOBSON
KUSTER, KEN	MO. ST AUDITOR'S OFFICE
LAVES, KAREN	MO. ST AUDITOR'S OFFICE
LINDERMAN, ED	USDA-OIG
LIVINGSTON, TERRY	DEPT. OF ED-OIG
LYLE, JOHANNA	KANSAS STATE UNIVERSITY
MAHER, THOMAS	MCGLADREY & PULLEN
MAXWELL, RON	CITY OF TULSA
MCKAY, JIM	HUD
MILLER, KIM	USDA OFFICE OF INSPECTOR GEN.
MIRABILE, ANTHONY	ED-OIG
MORTLAND, HERB	MSCPA
NELSON, BRENT	CITY AUDITOR, INDEP. MO

ATTENDEES LIST

Name	Agency
NIELSEN, ANDREW	IOWA AUDITOR OF STATE
NOLAN, DAVID	U.S. DEPT OF LABOR - OIG
PIERCE, CHUCK	MO.STATE AUDITOR'S OFFICE
RICHARD, PATTY	NE. AUDITOR OF PUB ACCOUNTS
SAALE, JERRY	HUD
TONGIER, RANDY	KANSAS LEGISLATIVE POST AUDIT
UEHLING, FRED	DHHS/OIG OFFICE OF AUDIT
VANDENBERG, FRANKLIN	DEPT. OF ED-OIG
WAGGONER, DON	MO. STATE AUDITOR'S OFFICE
WEIHE, RALPH	NE. DEPT. OF ROADS
WHITAKER, PHIL	HUD
WILLIAMS, MEREDITH	KANSAS LEGISLATIVE POST AUDIT
WILSON, STANLEY	GSA-OIG
WOLF, FRED	PRICE WATERHOUSE

Fig. 1.1: Exhibit 1

MID-AMERICA INTERGOVERNMENTAL AUDIT FORUM

THE AUDITOR IN COURT

I. INTRODUCTION

II. LISTING OF SAO FRAUDS

III. YELLOW BOOK REQUIREMENTS

IV. DEVELOPMENT OF FRAUD POLICY FOR YOUR ORGANIZATION

V. COURTROOM PROCEDURES

VI. IMPROVING YOUR ORGANIZATION'S ABILITY TO DETECT FRAUD

VII. ACTUAL CASE EXPERIENCES

VIII. QUESTIONS

Fig. 1.2: Exhibit 2

MISSOURI STATE AUDITOR'S OFFICE

AUDIT REPORTS DISCLOSING FRAUD

JANUARY 1, 1988 THROUGH DECEMBER 31, 1988

ENTITY	REPORT NO.	FRAUD AREA	FRAUD AMOUNT
Linn County Sheriff	86-43	Mileage Reimbursements	$ 65,000
City of Cape Girardeau Municipal Court	88-44	Bond Receipts	64,000
City of St. Louis Office of Sheriff	88-62	Delinquent Tax Sales	19,736
City of Moline Acres Municipal Court	88-99	Municipal Court	18,200
Newton County Collector	88-103	Property Tax Receipts	276,000
	88-152		10,619
Phelps County Treasurer	88-107	Receipts	3,774
Jefferson County	88-116	Court Receipts	94,000

Fig. 1.2: Exhibit 2

Associate Circuit Court Division 11			
Stoddard County Associate Circuit Court	88-120	Court Receipts	23,000
Department of Revenue Farmington Fee Office	88-140	Receipts	34,784
City of St. Louis Treasurer's Office	88-257	Receipts/NSF Checks	21,000
City of St. Louis Department of Health & Hospitals Vital Records Section	88-161	Birth and Death Certificate Copy Fee Receipts	4,748
		TOTAL	$634,861

Fig. 1.2: Exhibit 2

MISSOURI STATE AUDITOR'S OFFICE

AUDIT REPORTS DISCLOSING FRAUD

JANUARY 1, 1989 THROUGH NOVEMBER 30, 1989

ENTITY	REPORT NO.	FRAUD AREA	FRAUD AMOUNT
City of Wellston Municipal Court	89-09	Fines and Court Costs	$ 37,000
Missouri Eastern Correctional Facility	89-12	Falsified Invoices	8,046
		Supply and Equipment Purchases	9,764
City of Kinloch Municipal Court	89-13	Fines, Court Costs & Bonds	64,000
Camden County Associate Circuit Court	89-17	Court Receipts	450
Sullivan County Circuit Court	89-24	Court Receipts	1,481
City of Concordia	89-38	Court Receipts	586

Fig. 1.2: Exhibit 2

Municipal Court			
Miller County Sheriff	89-44	Receipts	2,876
City of Festus Municipal Court	89-52	Fines, Court Costs & Bonds	7,083
City of Country Club Hills	89-95	Fines, Court Costs & Bonds	7,427
		TOTAL	$138,213

Fig. 1.3: Exhibit 3

MID-AMERICA INTERGOVERNMENTAL AUDIT FORUM

THE AUDITOR IN COURT

III. YELLOW BOOK REQUIREMENT

A. How the 1988 revision differs from the 1981 requirements

B. How that difference impacts auditors

Fig. 1.3: Exhibit 3

1981 YELLOW BOOK

Fraud, Abuse, and Illegal Acts

Auditors shall be alert to situations or transaction that could be indicative of fraud, abuse, and illegal expenditures and acts and if such evidence exists, extend audit steps and procedures to identify the effect on the entity's financial statements.

1988 YELLOW BOOK

Errors, Irregularities and Illegal Acts

The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, Irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of financial related audits.

The auditor should also be aware of the possibility of illegal acts that could have an indirect and material effect on the financial statements or results of financial related audits.

IV. DEVELOPMENT OF FRAUD PROCEDURES

A. What to do when fraud is detected/suspected

1. Who should be notified?

2. Who should control the work?

3. What is your commitment to developing the fraud?

4. Control of records

B. Reporting Practices

1. How should fraud be reported?

a) Separate written report

b) Included in audit report

c) Case file to law enforcement

d) Level of detail to include

2. When should fraud be reported?

a) Impact on law enforcement investigation

b) Security of assets

C. Notification of law enforcement/prosecuting attorney

1. Don't contact until work is complete
2. Try to control the scope of your review
3. Be objective and factual, but be persuasive

D. Communication with the media

E. Who will testify in court

1. Depends on how you handle case
2. Someone very familiar with all aspects of the audit
3. Level of experience is very important
4. Needs to be communicated to prosecutor early
5. Business record exception rule

Fig. 1.4: Exhibit 4

MID-AMERICA INTERGOVERNMENTAL AUDIT FORUM
THE AUDITOR IN COURT

V. COURTROOM PROCEDURES

A. Primary goal is not to go to trial
But, if you do ....

B. Proceedings include theatrics and games

C. Use props to explain your case

1. Flowcharts and graphs

2. Handouts and Poster Boards

3. Examples

D. Dress conservatively. Look like an accountant.

E. Testimony

1. Be well prepared -- You are on your own on the stand

2. Discuss questions with the Prosecuting Attorney

3. Limit/Avoid the use of notes

4. Professional demeanor

5. Be independent and objective

6. Tell the truth

7. Ask for questions to be repeated

8. Don't rush

9. Avoid using professional lingo or jargon

10. Have someone in the courtroom listening

11. Know your firms/agency's legal authority

Fig. 1.4: Exhibit 4

MID-AMERICA INTERGOVERNMENTAL AUDIT FORUM
THE AUDITOR IN COURT

F. Cross-Examination

1. Be prepared for anything

2. Do not become argumentative

3. Don't let them intimidate you

4. Stay calm

5. Look at the defense attorney or the jury

6. Don't offer information; just answer the question asked

VI. IMPROVING YOUR ORGANIZATION'S ABILITY TO DETECT FRAUD

A. Increase your staff's awareness of fraud

1. Conduct fraud auditing training

2. Make changes to your audit manual and programs

3. Discuss fraud cases (after the report has been issued)

B. Create the right environment

1. Be supportive of staff suspicions

2. Provide on-the-job encouragement

3. Don't allow the time budget to rule

4. Be skeptical

C. FOLLOW-UP ON ALL EXCEPTIONS

Fig. 1.6: Exhibit 6

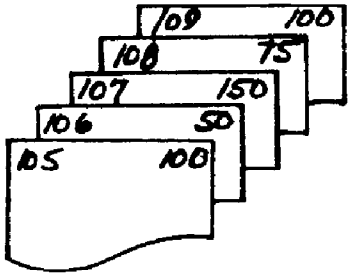
LAPPING SCHEME

	Amount
	150
	75
	100
	50
	75
	$450

$50)

DE

TUESDAY

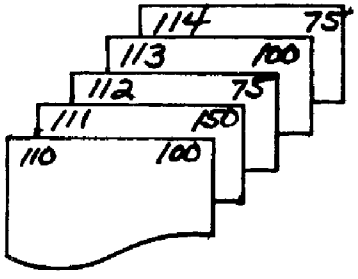


Receipt No.	Name	Amount
105		100
106		50
107		150
108		75
109		100
	TOTAL	$475

(misappropriated $50)

Deposit
Receipt #'s
100-104
$450

WEDNESDAY



Receipt No.	Name	Amount
110		100
111		150
112		75
113		100
114		75
	TOTAL	$500

(misappropriated $50)

Deposit
Receipt #'s
105-109
$475

Fig. 1.6: Exhibit 6

Fig. 1.7: Exhibit 7

CHECK SUBSTITUTION SCHEME

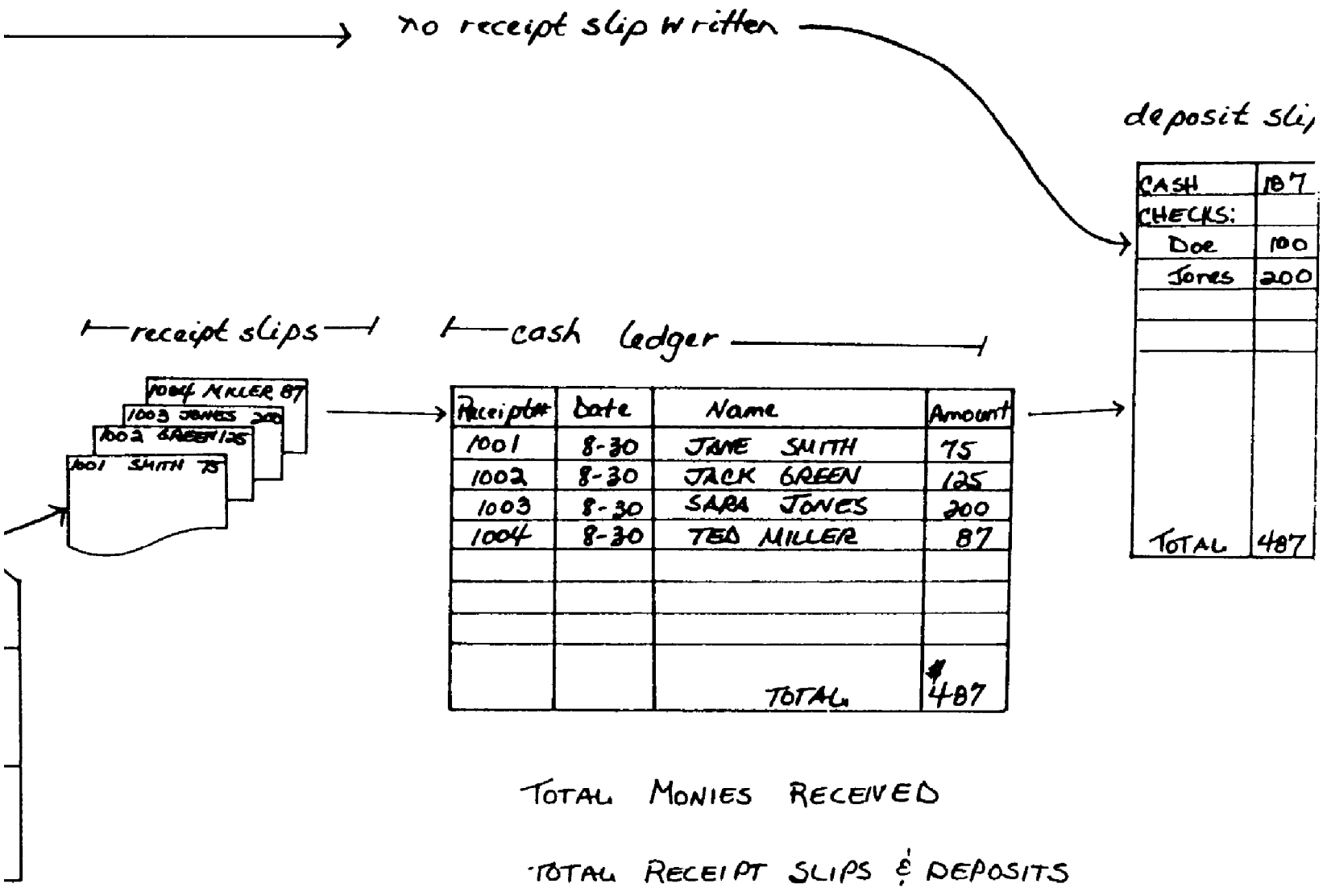


Fig. 1.7: Exhibit 7

$587

$487

$100

Fig. 1.8: Exhibit 8

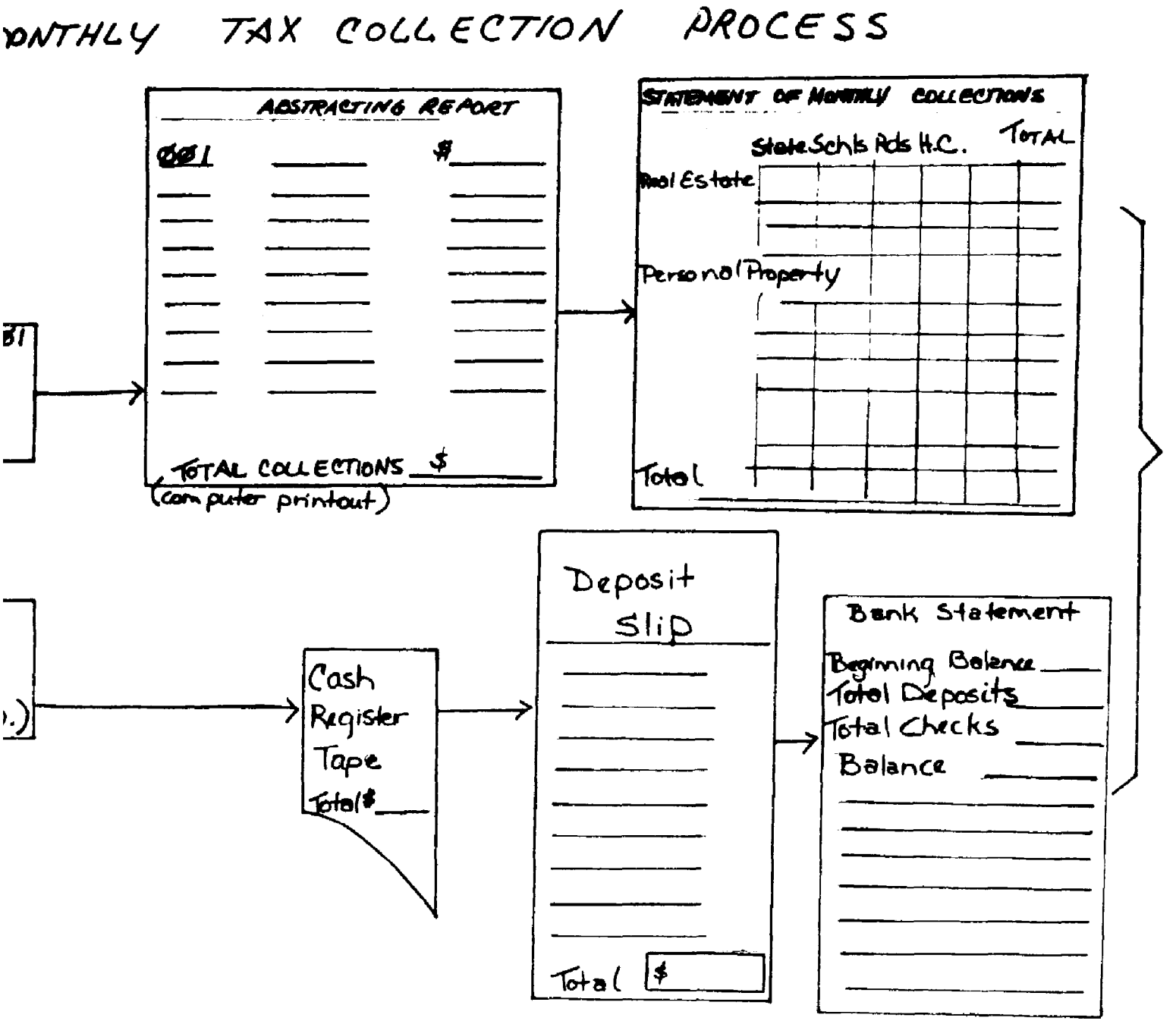


Fig. 1.8: Exhibit 8

Distributions:

Chk#	Payee	Amount
##	State	
##	Schools	
##	Roads	
##	Health Center	
##		
##		
##	Collection	

TOTAL MONTHLY DISTRIBUTIONS

$

Fig. 1.9: Exhibit 9

DELINQUENT TAX BOOKS

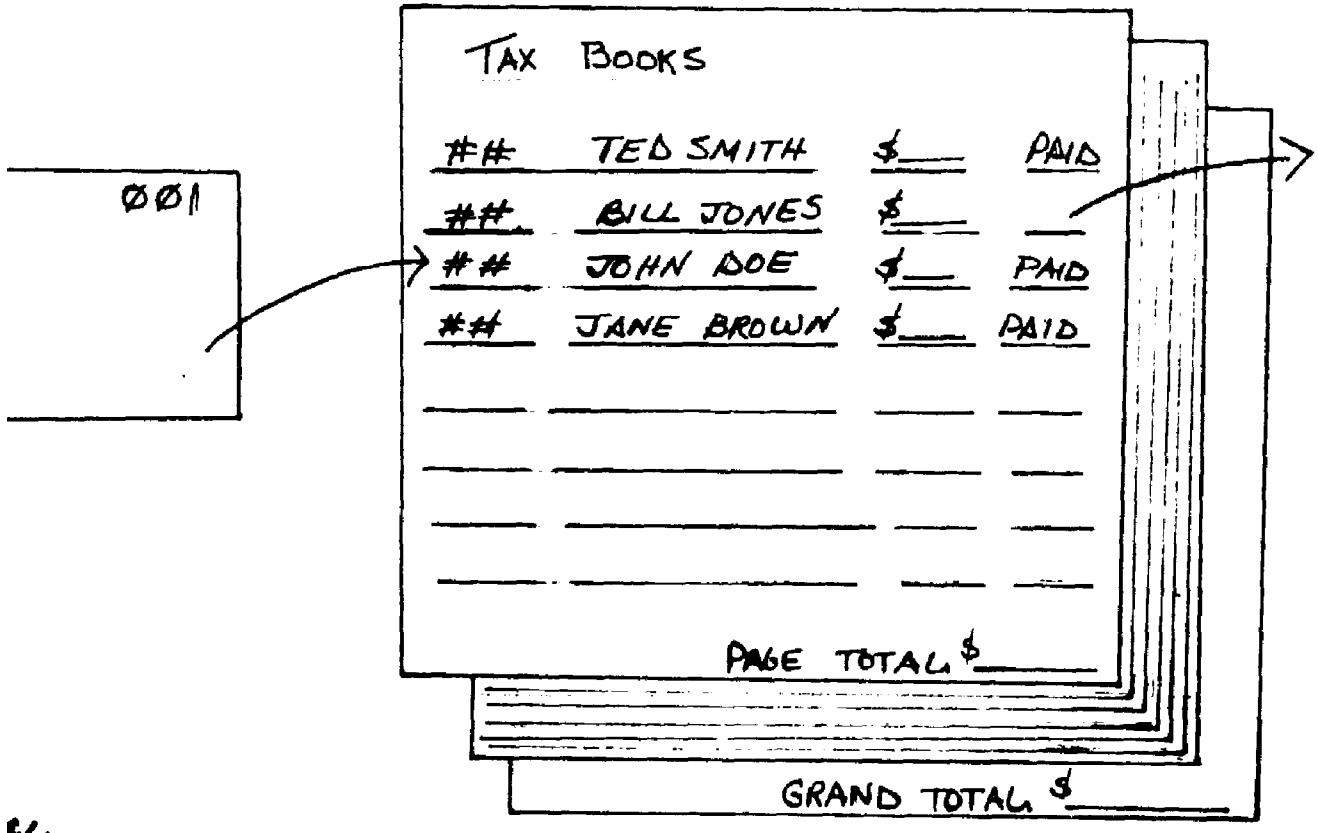


Fig. 1.9: Exhibit 9