<u>Section 4</u>

The Auditor as Financial Policeman

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UNDERSTANDING & DETECTING BUSINESS FRAUD: ACCOUNTING & LEGAL ISSUES

THE AUDITOR AS A FINANCIAL POLICEMAN

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TABLE OF CONTENTS

I. Auditing Fraud-An Introduction.

Auditors are being sued in record numbers for auditing negligence, internal fraud, and auditing oversights which rises to the level of reckless disregard for established auditing standards. These include criminal suits, generally brought by the federal government, or civil suits brought by the government or private individuals.

Regardless of whether auditors are defendants in civil suits, criminal suits, or administrative proceedings fueling this trend are several basic themes. These include allegations that auditing rules for corporations are too lax and are full of holes. Another major theme is that auditors fail to recognize and to detect or report fraud by clients because the auditors are dependent on their clients for fees. Recent reporting of financial fraud and "cooking the books" has caused a real crisis in our financial markets.

President George W. Bush appeared on Wall Street on July 9, 2002 to address the administration's real concerns about financial fraud issues, which are flooding daily newspapers and TV. In his prepared remarks the President pointed out that "the misdeeds now being uncovered in some quarters of corporate America are threatening the financial well being of many workers and many investors." The President called for a higher ethical standard, stating " at this moment America's greatest economic need is higher ethical standards enforced by strict laws and upheld by responsible business leaders". The President stated that there was a need for "a new ethic of personal responsibility in the business community, an ethic that will increase investor confidence." The President's purpose in the speech is to assure investors that their traditional confidence in the integrity of the United States financial system is well placed, even in light of financial abuses committed by a few business leaders. President Bush proposed the following to crack down on corporate fraud. Most of these proposals would require legislative or regulatory action before they could take effect.

- Creation of a corporate fraud task force to assist in investigation and prosecution of fraud cases.
- Provide additional enforcement funding to the Securities and Exchange Commission ($20 million this year and $100 million next year).
- Double the criminal penalties for wire and mail fraud from 5 years to 10-year terms for corporate executives convicted of financial fraud.
- SEC to be given the power to freeze payments to executives at companies that are under investigation and forfeit ill gotten gains from corporate fraud schemes.
- Require straight forward disclosure of executive compensation in annual reports.
- Requires top executives to personally sign their company's public disclosures and financial statements and to verify their accuracy.
- Require top executives and other corporate insiders to disclose stock transactions more quickly.
- Recommend that companies eliminate loans to their executives and other corporate insiders.

- Recommend that investors be able to vote on all stock option plans.
- Recommend that a majority of board members be independent and that all members of audit, nominating and compensation committees be outsiders.
- Recommend that an independent regulatory board be created to oversee the accounting industry.

At the same time as the President's speech, the SEC has ordered the leaders of nearly a thousand large public companies to certify that the financial information in their last year's filings is accurate. Additionally, the SEC has been asked to adopt new rules to ensure that the financial auditors will be independent and that there will be no conflicts of interest, which could impact the audit function. "Transparency and accountability" in American business have become watch words of both the Administration and in Congress when any elected official discusses "accounting irregularities" in American business.

It is extraordinary and almost paradoxical that the President of the United States would be on Wall Street trying to restore some confidence and order to the world's strongest financial system, badly battered by day to day disclosures of auditing fraud. Many in government and a few in the financial markets however do not think that the President's changes and recommendations go far enough. Congress is rushing far-reaching and more comprehensive legislation to confront these problems. The House has passed and the Senate is considering the following proposals to counter accounting fraud in corporate America.

A. Accounting Standards and Oversight.

- Creation of a new Oversight Panel to regulate the public accounting industry. Financing would be assessed from accounting firms and publicly traded corporations. The accounting industry would have some representation on the panel.
- Requires that accounting firms shall not provide a broad range of consulting services to the public companies that they audit.
- Requires accounting firms to change the audit and review partners for a company every five years. (Senate version only).

B. Analyst Conflict of Interest.

- Requires the SEC to examine the effectiveness of new analyst conflict of interest rules being promulgated by the National Association of Securities Dealers and the New York Stock Exchange. Prohibits investment firms from retaliating against any analyst who writes negative reports on the brokerage house clients.

C. Criminal Sanctions.

- Creation of a new felony for "any scheme or artifice" used to deceive shareholders and would tighten criminal laws on obstruction of justice and unlawful document destruction. (Senate version only)

D. Corporate Governance.

- Requires the SEC to study various corporate governance matters to see if the current practices are in the best interest of shareholders.
- Requires disclosure of off-balance sheet transactions with affiliated entities.
- Holds company directors directly responsible for the accountants preparing their financial statements.
- Chief executives would certify audits and financial statements.
- Forfeiture of bonuses and other compensation based on fraudulent financial information.

It would appear that the accounting industry is in for some fundamental changes in the current political climate. One must ask however, how such a huge credibility gap has come about in the American political landscape. The simple answer was recently posed as a question by the Enforcement Director of the SEC, Judge Stanley Sporkin. Judge Sporkin asked, "Where were the Gatekeepers" when all of these questionable financial practices took place. Judge Sporkin was referring to the accountants and lawyers who play such a large role in assuring that corporate financial reporting is accurate and fair. The failure of the Gatekeepers' to answer to that question properly identifies the real heart of the financial fraud crisis that is gripping financial markets today. Not many investors today have any confidence in the audited financial statements being produced by the public accounting industry. A current snapshot of the problem is enlightening.

E. Securities and Exchange Commission (SEC).

In August 1998, the SEC held a meeting to discuss accounting woes. The SEC believed auditing rules for corporations were too lax and full of holes. This concern comes from rise in corporate accounting fiascoes at publicly traded companies.

The SEC and its then chairman, Arthur Levitt, undertook an effort to crack down on what they consider earnings manipulation by companies. Chairman Levitt came up with a strong 10-point plan to eliminate questionable accounting practices. The most publicized part of the plan was the proposed prohibition of providing consulting or other services to audit clients. Congress shot the plan down and little was done to correct known issues of conflicts of interest, off the book transactions, etc. which continue to plague the financial industry.

F. Waste Management Inc. - November 2001.

The SEC instituted both administrative and judicial actions against Arthur Andersen and four of its partners in relation to Andersen's audits of Waste Management, Inc.'s ("WMI") financial statements during the period 1992 through 1996. Andersen and the partners entered into a permanent injunction, enjoining them from further violations of securities laws and related rules. Andersen agreed to pay a penalty of seven million dollars, and three of the partners were ordered to pay a total of $120,000 in penalties. In the administrative actions, the partners were all denied the privilege of practicing before the SEC for a period of one to five years, with the right to request reinstatement.

WMI was a prized client for Andersen, and the two companies had a close relationship; over the years, many of WMI's chief financial officers and chief accounting officers were former auditors at Andersen. The SEC claimed that Andersen knowingly or recklessly issued false and misleading unqualified audit reports on WMI's annual financial statements for the years 1993 through 1996. In the then largest restatement of financial statements in the SEC's history, WMI admitted that it had materially overstated its reported pre-tax earnings by $1.43 billion and had understated elements of its tax expense by $178 million. Through its partners had documented numerous accounting issues giving rise to the misstatements and likely misstatements, Andersen failed to quantify and estimate all the known and likely misstatements. Andersen was aware of and concerned about improper netting practices, but did not withdraw its 1995 audit report or take steps to keep WMI from continuing to use netting in the following year to eliminate current period expenses and prior period misstatements from its financial statements.

The SEC made it clear that an auditor must stand up to management to prevent the issuance of materially misstated financial statements. It also evidenced the SEC's willingness to pursue civil liability against any auditor who could have prevented the abuse. For instance, in this case, one of the partners was not even part of the engagement team. Nevertheless, he was liable on the basis that two of the engagement partners consulted him about the matter. According to the SEC, he should have known that WMI's use of netting warranted heightened scrutiny. Based on that knowledge, he should have acted to prevent Andersen from issuing an unqualified audit report based on materially misstated financial statements. Again, even peripheral players will be scrutinized.

G. Enron Corporation-October 2001.

SEC opens a massive investigation into the company's accounting practices, including off-book transactions. Enron has admitted to improper accounting and restated its earnings, resulting in massive losses for investors and bankruptcy for Enron. The company's auditor, Arthur Anderson, was indicted and convicted for destroying documents. That matter is on appeal.

H. Computer Associates-February 20, 2002.

SEC investigates company for improperly reporting revenues and overstatement of profits, including off the books accounting and debt reserves.

I. Xerox Corporation-April 15, 2002.

SEC settles accounting fraud case with Xerox. The SEC alleged that Xerox's top management led a four-year scheme to defraud investors by overstating the recognition of $3 billion in revenue by improper accounting treatment of copier leases which inflated earnings by about $1.5 billion. Xerox agreed to pay a $10 million dollar fine and restate its financial results from 1997 to 2000. Xerox restated its earnings by $1.9 billion dollars.

The SEC served notice to former Xerox auditor KPMG LLP that it would have to explain why they should not be sued.

J. Anicom Inc.-May 12, 2002.

United States Attorney indicts six executives accused of inflating revenues at wire and cable distribution company in massive financial fraud from January 1998 to March 2000. The SEC leads the investigation.

K. Elon Corp-May 2002.

Irish drug maker required to restate its earnings following admission of improper accounting treatment. SEC is investigating matter.

L. People-Soft Inc. and Ernst & Young-May 20, 2002.

SEC institutes proceeding against company and E&Y to resolve auditor independence allegation after People-Soft failed to file independently audited financial statements at the same time that the company and E&Y had entered into a joint venture to market software.

M. Rite Aid Corporation-June 21, 2002.

SEC institutes public cease and desist proceedings alleging that senior management of drug company engaged in a financial fraud that materially overstated the company's net income for the fiscal year 1998, 1999, and part of 2000. The Commission alleges that the company improperly inflated its income by reducing its vendor accounts payable and the cost of goods sold for unearned vendor credits by $1.6 billion dollars and improperly failed to record employee stock rights.

Four former and current executives of Rite Aid have been indicted for false financial reporting and false accounting practices. The SEC stated that "Rite Aid's former Sr. management employed an extensive bag of tricks to manipulate the companies reported earnings to defraud its investors".

N. Global Crossing Inc. –June 3, 2002.

International telecommunications company, Global Crossing Inc., faces bankruptcy following disclosure of improper accounting which resulted in overstatement of earnings. Federal investigators begin criminal investigation into possible shredding of documents by the company and obstruction of justice.

O. Ashford.com/Amazon.com-June 10, 2002.

SEC files cease and desist order against companies and two of its executives for improper accounting which deferred $1.5 million in contracts between the two companies. This deferment caused Ashford to materially understate it marketing expenses and reduce its operating losses.

P. AremisSoft Company-June 25, 2002.

Three company executives indicted for insider trading, accounting fraud, and other offenses. SEC alleges a scheme to inflate the company's stock by fabricating $90 million in fictitious earnings and announcing multimillion-dollar acquisitions of shame software company. The government has seized $175 million of illicit proceeds from the alleged fraud.

Q. WorldCom-June 27, 2002.

SEC charges WorldCom with $3.8 billion dollar accounting fraud for off book transaction and hidden debt reserves. SEC alleges that WorldCom fraudulently overstated its income by $3.05 billion dollars in 2001 and $797 million in the first quarter of 2002. The complaint further alleges that GAAP accounting rules were violated by capitalizing and deferring debt when it should have been immediately recognized. Top company management recently invoked their 5th Amendment rights against self-incrimination when subpoenaed before Congress.

R. Vivendi Universal-July 5, 2002.

Large entertainment and communications company admits to overstating value of an acquired company BskyB by $1.47 billion due to "faulty accounting practices" and will restate its earnings. French authorities are investigating.

The SEC states that the number of fraud cases it is investigating has jumped 41% in the last three years. According to SEC data, regulators investigated 112 cases in 2001 and 79 cases in 1998.

Regulators have stated that "cooking the books" cases are becoming all to common in an increasing cutthroat business climate where client pressures to make sure that the numbers add up often lead auditors and accountants to "shave the truth".

II. Fraud and the Auditor's Responsibility.

Fraud is a deception deliberately or intentionally practiced. Intent is what distinguishes fraud from an error. Fraud is often done in order to secure unfair or unlawful gain. The victim rarely suspects fraud and there is often a relationship of trust between the victim and the perpetrator of the fraud. Moreover, fraud frequently involves the pressure or incentive to commit fraud and a perceived opportunity to do so.

A. Common Types of Audit Fraud. [1]

Audit fraud, relevant to an auditor's consideration of fraud in a financial statement, can generally be broken down into the following two categories: (1) misstatements arising from fraudulent financial reporting, and (2) misstatements arising from misappropriation of assets.

Specific examples include the following:

1. manipulation, falsification or alteration of accounting records or supporting documents;

2. misrepresentation or omissions of accounting records or supporting documents;

3. intentional misapplication of accounting principles;

4. conflicts between the records and the inventory or the bank statements;

5. falsification of events, such as casualty losses; and

6. false or misleading entries to improve the financial health of the company, such as one time charges, etc.

B. Statement of Accounting Standard 82: Auditor's Responsibility to Identify Fraud.

A 1995 study by the Association of Certified Fraud Examiners (ACFE) estimated that fraud and financial malpractice costs the U.S. economy $400 billion dollars per year or 6% of revenue or $9.00 per day per employee. It is estimated that fraud will continue to increase 15% per year. A lack of internal controls leaves small

[1] SAS 82.4-.5.

companies most susceptible to fraud. In a 1994 fraud survey conducted by Forensic and Investigative Services, it was discovered that auditors detect only 5% of fraud.

It was these startling statistics that lead to the passing of Statement on Auditing Standards No. 82 (SAS 82), Consideration of Fraud in a Financial Statement Audit and the Private Securities Litigation Reform Act of 1995. Under SAS 82, it can be argued that auditors have an affirmative duty to detect fraud and illegal acts. Auditors now will be expected to take a more proactive view of addressing fraud in their financial statement audits. The new audit standard was driven primarily by two goals: (1) effective fundamental change in the auditor's attitude regarding material misstatements resulting from fraud; and (2) to provide auditors with tools to fulfill responsibilities to detect fraud.

Many commentators view SAS 82 as a double-edged sword. On one hand, it provides a minimum level of acceptable professional care and may even provide a defense if followed, even in the case where there is a failure to detect fraud. On the other hand, if it is not followed, it may road map a plaintiff's lawyer's lawsuit against an accountant.

SAS 82 provides that the "auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." Although SAS focuses on *material* misstatements, the same materiality standard may not be applicable in litigation related to the audit. Therefore, the real life standard is much higher. Auditors *must* look for, identify, and report fraud.

C. Risk Factors and Indicators of Fraud.

The following risk factors must be considered when attempting to identify fraud. It is important to note, however, that the presence of any one factor is not dispositive. Furthermore, it is impossible to rank these factors in any hierarchy because the presence of these risk factors and their effect on an entity's financials' are fact specific. These fraud risk factors are broken down into two categories: (1) risk factors related to fraudulent financial reporting;[2] and (2) risk factors related to misappropriation of assets.[3]

SAS 82 defines fraudulent financial reporting as intentional misstatements or omissions of amounts or disclosure in financial statements, which is usually committed by management to deceive financial statement users. The key element in fraudulent financial reporting is the intent to deceive. There are three categories of fraudulent financial reporting factors: (1) management characteristics and influence over the control of environment: management's abilities, pressures, style and attitude relating to internal control in the financial reporting process; (2) industry conditions: economic and regulatory environment in which the entity operates; and (3) operating characteristics and

[2] SAS 82.16-.17.
[3] SAS 82.18-.20.

financial stability: nature and complexity of the entity and its transactions, its financial condition and its profitability.[4]

There are two categories of risk factors related to misappropriation of assets. They are (1) susceptibility of assets to misappropriation and (2) internal controls that are

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[4]A complete list of these risk factors are as follows:

1. Management's characteristics and influence over the control environment:
   (a) A motivation for management to engage in fraudulent financial reporting;
   (b) A failure by management to display and communicate an appropriate attitude regarding internal control and the financial reporting process;
   (c) Non-financial management's excessive participation in, or preoccupation with, the selection of accounting principles or the determination of significant estimates;
   (d) High turnover of senior management, counsel or board members;
   (e) Strained relationship between management and the current or predecessor auditor; and
   (f) Known history of security law violations or claims against the entity or its senior management alleging fraud or violations of securities laws.

2. Risk factors relating to industry conditions:
   (a) New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity;
   (b) High degree of competition or market saturation, accompanied by declining margins;
   (c) Declining industry with increasing business failures and significant declines in customer demand; and
   (d) Rapid changes in the industry, such as high vulnerability to rapidly changing technology or product obsolescence.

3. Risk factors relating to operating characteristics and financial stability:
   (a) Inability to generate cash flows from operations while reporting earnings and earnings growth;
   (b) Significant pressure to obtain additional capital to stay competitive;
   (c) Assets, liabilities, revenues or expenses based on significant estimates that involve unusually subjective judgments or uncertainties, or that are subject to potential significant change in the near term in a manner that may have a financially disruptive on the entity;
   (d) Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm;
   (e) Significant, unusually or highly complex transactions – especially close to year-end;
   (f) Significant bank accounts or subsidiary operations in tax-haven jurisdictions for which there appears to be no clear business justification;
   (g) Overly complex organizational structure involving numerous or unusually legal entities, managerial lines of authority, or contractual arrangements without apparent business purpose;
   (h) Difficulty in determining the organization or individuals that control the entity;
   (i) Unusually rapid growth or profitability;
   (j) Especially high vulnerability to changes in interest rates;
   (k) Unusually high dependence on debt;
   (l) Unrealistically aggressive sales or profitability incentive programs;
   (m) Threat of imminent bankruptcy or foreclosure or hostile takeover;
   (n) Adverse consequences on significant pending transactions, such as a business combination or contract award, if poor financial results are reported; and
   (o) Poor or deteriorating financial position when management has personally guaranteed significant debts of the entity.

in place.[5] Although the auditor is not required to plan the audit to discover information that is indicative of financial stress of employees or adverse relationships between the entity and employees, he or she should consider such information in assessing the risk of material misstatements arising from misappropriation of assets.

D. Other Possible Indicators of Fraud.

Other possible indicators of fraud include the following.[6]

1. Transactions not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification or entity policy;
2. Unsupported or unauthorized balances or transactions;
3. Last-minute adjustments that significantly affect financial results;
4. Missing documents;
5. Unavailability of other than photocopied documents when original documents are expected to exist;
6. Significant unexplained items on reconciliations;
7. Inconsistent, vague or implausible responses from management or employees;
8. Unusual discrepancies between the entity's records and confirmation replies;
9. Missing inventory or physical assets of significant magnitude;
10. Denied access or records, facilities, certain employees, customers or vendors;[7]
11. Undue time pressure imposed by management to resolve complex issues;

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[5] A complete list of these risk factors is as follows:

1. Risk factors relating to susceptibility of assets to misappropriation:
   - (a) Large amounts of cash on hand;
   - (b) Dealing in cash;
   - (c) Inventory characteristics, such as small size, high value or high demand;
   - (d) Easily convertible assets; and
   - (e) Fixed asset characteristics, such as small size, marketability, or lack of ownership identification.

2. Risk factors relating to controls:
   - (a) Lack of appropriate management oversight;
   - (b) Lack of job applicant screening relating to employees with access to assets susceptible to misappropriation;
   - (c) Inadequate record-keeping regarding assets susceptible to misappropriation;
   - (d) Lack of appropriate segregation of duties or independent checks;
   - (e) Lack of appropriate system of authorization and approval of transactions;
   - (f) Poor physical safeguards over cash, investments, inventory or fixed assets;
   - (g) Lack of timely and appropriate documentation for transactions; and
   - (h) Lack of mandatory vacations for employees performing control functions.

[6] SAS 82.25.

[7] Denial of access to information may constitute a limitation on the scope of the audit that may require the auditor to consider qualifying or disclaiming an opinion on the financial statement. SAS 82, n.11.

12. Unusual delays by the entity in providing requested information; and
13. Complaints to the auditor regarding fraud.

E. The Auditor's Duty to Identify a Client's Illegal Acts: SAS 54.

In addition to SAS 82, which addresses the consideration of fraud in a financial statement, SAS 54 specifically addresses the nature and extent of the consideration an independent auditor should give to the possibility of illegal acts by a client in an audit of financial statements in accordance with generally accepted accounting standards. Although much of the concerns and practices are the same,[8] there are some special concerns applicable to illegal acts.

1. Illegal Acts.

Illegal acts, as defined in SAS 54, include violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity. They do not include personal misconduct by the entity's personnel unrelated to their business activities.

2. Determining if an Act is Illegal.

A central theme in SAS 54, is that it may sometimes be difficult to determine whether a particular act is illegal. The auditor must not only rely on their own professional judgment, but should also seek legal advice from a practicing attorney in such situations.

3. Types of Illegal Acts.

Illegal acts, under SAS 54, may fall into one of two general categories. These include illegal acts that (1) have a direct and material effect on the determination of financial statement amounts; and (2) may have material and indirect effects on financial statements. Although this SAS also focuses on materiality, it is important to note that the same materiality standard will often be inapplicable in litigation related to the audit.

4. Detecting Illegal Acts.

If the auditor becomes aware of evidence regarding possible illegal acts, the auditor should apply auditing procedures in order to determine whether an illegal act has occurred. Moreover, even where there is no indication of fraud, procedures applied for the purpose of forming an opinion on the financial statements may help an auditor determine the existence of illegal acts. These procedures include reading minutes;

[8] For those illegal acts that are defined in SAS 54 as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts is the same as that for errors. *See* SAS 82, n.1.

inquiring of the client's management and legal counsel concerning litigation, claims, and assessments; and performing substantive tests of details of transactions or balances. The auditor should make inquiries of management concerning the client's compliance with laws and regulations. Where applicable, the auditor should also inquire of management concerning (1) the client's policies relative to the prevention of illegal acts; and (2) the use of directives issued by the client and periodic representations obtained by the client from management at appropriate levels of authority concerning compliance with laws and regulations. The auditor should also ordinarily obtain written representations from management concerning the absence of violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

5. Indicators of Fraud Help Identify Illegal Acts.

Many of the indicators of fraud may also help identify illegal acts. The following indicators, however, are often used to specifically identify illegal acts.

(a) Unauthorized transactions, improperly recorded transactions, or transactions not recorded in a complete or timely manner in order to maintain accountability for assets;
(b) Investigation by a governmental agency, an enforcement proceeding, or payment of unusual fines or penalties;
(c) Violations of laws or regulations cited in reports of examinations by regulatory agencies that have been made available to the auditor;
(d) Large payments for unspecified services to consultants, affiliates, or employees;
(e) Sales commissions or agents' fees that appear excessive in relation to those normally paid by the client or to the services actually received;
(f) Unusually large payments in cash, purchases of bank cashiers' checks in large amounts payable to bearer, transfers to numbered bank accounts, or similar transactions;
(g) Unexplained payments made to government officials or employees; and
(h) Failure to file tax returns or pay government duties or similar fees that is common to the entity's industry or the nature of its business.

III. Auditor's Duties Upon Discovery of Fraud.

The course of the audit will likely change upon the discovery of fraud. The change may be as minor as performing additional tests or discussing the fraud with management to suggesting that the client consult with legal counsel or the auditor's withdrawing from the engagement. Regardless, the auditor will need to consider the implications of the fraud for other aspects of the audit.[9]

[9] SAS 82.33-.36.

A. SEC Public Company Audit Requirements—Law §10A.

1. Sec. 10A. (a)—In General.

Each Audit required pursuant to this title of the financial statements of an issuer by an independent public account shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the commission—

(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;
(2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and
(3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

2. Sec. 10A. (b)—Required Response to Audit Discoveries.

(1) **Investigation and Report to Management.** If, in the course of conducting an audit pursuant to this title to which subsection (a) applies, the independent public accountant detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the accountant shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

(A)(i) determine whether it is likely that an illegal act has occurred; and

(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties and damages; and

(B) as so as practicable, inform the appropriate level of management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such accountant in the course of the audit, unless the illegal act is clearly inconsequential.

(2) **Response to Failure to Take Remedial Action**. If, after determining that the audit committee or the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the accountant in the course of the audit of such accountant, the independent public accountant concludes that—

(A) the illegal act has a material effect on the financial statements of the issuer;

(B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial action with respect to the illegal act; and

(C) the failure to take remedial action is reasonable expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement; the independent public accountant shall, as soon as practicable, directly report its conclusions to the board of directors.

(3) **Notice to the Commission; Response to Failure to Notify**. An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the independent public accountant making such report with a copy of the notice furnished to the Commission. If the independent public accountant fails to receive a copy of the notice before the expiration of the required 1-business day period, the independent public accountant shall—

(A) resign from the engagement; or

(B) furnish to the Commission a copy of its report (or such documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4) **Report After Resignation.** If an independent public accountant resigns from an engagement under paragraph (3)(A), the accountant shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3),

furnish to the Commission a copy of the accountant's report (or the documentation of any oral report given).

3. Sec. 10A. (c)—Auditors Liability Limitation.

No independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b), including any rule promulgated pursuant thereto.

4. Sec. 10A. (d)—Civil Penalties In Cease-And-Desist Proceedings.

If the Commission finds, after notice and opportunity for hearing in a proceeding instituted pursuant to section 21C, that an independent public accountant has willfully violated paragraph (3) or (4) of subsection (b), the Commission may, in addition to entering an order under section 21C, impose a civil penalty against the independent public accountant and any other person that the Commission finds was a cause of such violation. The determination to impose a civil penalty and the amount of the penalty shall be governed by the standards set forth in section 21B.

5. Sec. 10A. (e)— Preservation of Existing Authority.

Except as provided in subsection (d), nothing in this section shall be held to limit or otherwise affect the authority of the Commission under this title.

6. Sec. 10A. (f)—Definition.

As used in this section, the term "illegal act" means an act or omission that violates any law, or any rule or regulation having the force of law.

B. Initial Critical Questions to be Addressed by the Auditor.

The auditor must address the following questions in order to determine the course the audit should take:

1. What is the alleged misconduct?
2. Who committed the fraud?
3. Who is the victim of the fraud?
4. Should the auditor modify the audit procedures or conduct additional tests?[10]
5. What government agency is involved, and was there any money lost?
6. Are there ethical conflicts - individuals or corporate?

[10] See SAS 82.29-.32 for specific additional inquiries and tests.

C. Reporting Fraud.

The auditor should document, in the work papers, the performance of the assessment of the risk of material misstatement due to fraud. As stated earlier, a lack of documentation supporting such may provide a plaintiff with a roadmap for a lawsuit.

The auditor also needs to report the fraud. The fraud probably should be reported to senior management, the audit committee and/or the board of directors. It is important to note that the disclosure of fraud to outsiders will generally be a violation of the auditor's ethical obligations.

However, in limited situations external disclosure is permissible, or even required. For example, disclosure to a government agency may be required by statute. An auditor may also have to disclose information pursuant to a subpoena.

D. What If You Report and the Fraud Continues?

The auditor's obligation includes counseling the client to stop the fraudulent activity or practice. If the client persists with the fraudulent activity, the auditor should withdraw from representation. Finally, the auditor should refuse to sign any financial statement that does not disclose the issue.

E. Disclosure and Privilege Problems.

The 1998 Taxpayer Relief Act includes a provision extending the confidentiality privilege to accountants.[11] However, as the following discussion illustrates, this privilege probably will not apply to communications made to an auditor.

1. Limitations on the Scope of the Accountant-Client Privilege.

The legislation extends the accountant-client privilege of confidentiality to tax advice furnished to a client taxpayer or potential client taxpayer by a CPA. Tax advice is specifically described as advice which is within the scope of authority for a CPA's practice with respect to matters under the Internal Revenue Code. At first glance, it may be difficult to imagine how communications learned by a CPA, in the course of an audit, may qualify as tax advice so as to be privileged under the new accountant-client privilege. An audit report, which is intended to be disseminated to the general public, would appear to have even less of the right to confidentiality than information gathered for the preparation of a tax return, which, in itself, is not automatically privileged. However, certain fraud information gathered by the auditor for internal use only, is not expected to be released in any form. Accordingly, the question arises whether certain discussions regarding fraud in the company may rise to the level of tax advice.

Assuming that the CPA has qualified as providing tax advice, the communications between the CPA and the client may nonetheless, not be entitled to the

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[11] I.R.C. § 7525.

accountant-client privilege because the accountant-client privilege is *not* applicable in the following circumstances:

(a) the disclosure of information to any regulatory body other than the Internal Revenue Service. Specifically, the legislative history described that the ability of any other regulatory body, including the Securities and Exchange Commission, to gain or compel information is unchanged by the accountant/client privilege;

(b) administrative or court proceedings involving regulatory bodies other than the Internal Revenue Service; and

(c) criminal proceedings involving the Internal Revenue Service and any other regulatory bodies.

2. <u>Young & Company</u>.

The Supreme Court's decision in *United States v. A. Young & Company,* 465 U.S. 805, 104 S. Ct. 1495 (1984) also supports an interpretation that the accountant-client privilege would not be available to communications made to an auditor or the auditor's work papers. In *A. Young & Company*, the Court ruled that there is no accountant-client privilege with respect to work papers prepared by an independent auditor. The court rejected the claim of work product immunity under an accountant-client privilege used to bar enforcement of an IRS summons for work papers prepared by an independent certified public accounting firm during an audit of its' clients' corporation finances. The Supreme Court stated that independent auditors that certify public reports serve the public interests more than their clients' interests. Therefore, the documents were not privileged. The court further noted that, without an express statutory provision to the contrary, it could not accept the accounting and work product immunity doctrine in the face of strong congressional policy and statutory language favoring broad IRS summons authority.

IV. The Auditor As a Target.

There is a fine line between being a victim in a financial fraud and being an aider and abettor or a co-conspirator. The real issue before a civil or criminal jury will be what did the auditors know, when did they know and what did they do about it.

In many instances, the plaintiffs will argue that the fraud was so bad that there is no way that the auditor could not have known about the fraud. The counterpart to this theme is that the auditors failed to disclose the fraud because they were more interested in their fees, than their ethical and professional obligations.

A. Intent Standards-Criminal and Civil.

Whether a case is criminal or civil depends on who brings the suit – a private party or the government. However, the government often files civil suits arising from misstatements on financial statements. Although practical considerations, such as the amount and scope of misstatements and the effect on victims are considered when deciding if the government should pursue a case criminally or civilly, the legal standard distinguishing the two types of cases is the defendant's state of mind.

A criminal prosecution requires a knowing, willful violation of a legal duty or willful blindness of a known legal duty. The government must prove the elements of the crime beyond a reasonable doubt. On the other hand, a civil case must only be proved by a preponderance of evidence supporting a violation of known legal duty

B. Criminal Issues for the Auditor.

There are several criminal statutes under which an auditor can be prosecuted, in relation to his or her duties regarding auditing financial statements. The following are some of the more general, and commonly used, statutes used in such federal prosecutions.

It is important to note that, under federal criminal law, an aider or abettor, such as an auditor, is treated the same as whoever committed the offense, usually the client. 18 U.S.C. § 2. Section 2 provides that whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal; and whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.

1. Conspiracy to Commit Offense or to Defraud United States (18 U.S.C. § 371).

Section 371 makes it illegal for "two or more persons [to] conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy." The sentence for a violation of §371 can be a fine and up to five years imprisonment.

A conspiracy charge is standard in most federal indictments. It is also probably the statue under which the auditor has the most exposure. Under this statute, the auditor can be convicted where there is an implicit agreement, which may be inferred, that he or she will look the other way while the client defrauds the United States or commit an offense.

2. Misprison of a Felony (18 U.S.C. §4).

The misprision statute makes it a crime to conceal or not report a felony. This statute provides that "[w]hoever, having knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be fined under this title or imprisoned not more than three years, or both." This statute may also be troublesome for an auditor because the failure to report an illegal act – a felony could lead to a misprison conviction.

3. Obstruction of Criminal Justice (18 U.S.C. §1510).

Once a criminal investigation is underway, the auditor must be careful to ensure that their actions could not be construed as an obstruction of justice. This section makes it a felony, punishable by a fine and up to five years imprisonment, to "willfully endeavor by means of bribery to obstruct, delay, or prevent the communication of information relating to a violation of any criminal statute of the United States by any person to a criminal investigator."

4. Tampering with a Witness (18 U.S.C. § 1512).

This section makes witness tampering a crime. The following subsections, regarding documentary evidence, are particularly potentially applicable to an auditor.

This statute provides that it is a crime to knowingly use intimidation or physical force, threaten or corruptly persuade another person, or attempt to do so, or engage in misleading conduct toward another person, with intent to cause any person to (1) withhold testimony, or withhold a record, document, or other object, from an official proceeding; or (2) alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding. Notably, the testimony, record, document, or other object need not be admissible in evidence or free of a claim of privilege.

5. Bank Fraud (18 U.S.C. § 1014).

18 U.S.C. §1014 makes it a crime for any person to make a false statement to essentially any federally chartered or federally insured financial institution for the purpose of influencing in any way, the action of the institution. To convict under 18 U.S.C. 1014 the government must prove: (1) the defendant made a false statement or report, or willfully overvalued any land, property, or security; and (2) that the false statement was made for the purpose of influencing in any way, the action of the financial institution. *U.S. v. McDow*, 27 F.3d 132, 135 (5th Cir. 1994).

(a) Must the Government Prove That the False Statement Was Provided Directly to a Financial Institution?

United States v. McDow, 27 F.3d 132 (5th Cir. 1994). In this case, the McDows purchased a house and lot from Sunbelt Savings and in so doing, made four material false statements on their loan application. The McDows submitted their loan application to Sunbelt Mortgage, a wholly-owned subsidiary of Sunbelt Savings. The distinction between Sunbelt Savings and Sunbelt Mortgage was important because only the savings entity was federally insured. The court explained that Fifth Circuit precedent did not require that the defendant actually make a false statement directly to an insured institution. Nor was it required for the government to show that the defendant knew the institution was insured. The government must prove only that the defendant received notice sufficient to create a reasonable expectation that the false statement would reach an institution of the type included in the statute. The counts under §1014 were vacated because the government put on no direct evidence that McDow knew Sunbelt Mortgage would eventually acquire the proceeds of the loan. The court also believed that the defendant was unaware that the federally insured funds played a role in the transaction.

(b) Is the Government Saddled With the Burden of Proving That the False Statement Was Material?

United States v. Wells, 117 S.Ct. 921 (1997). In this case the Supreme Court reviewed the Eighth Circuit's determination that the materiality of the false statement was to be evaluated by the judge and not the jury. The court abrogated the holdings of several prior cases when it determined that materiality was not an essential element in a conviction under 18 U.S.C. §1014.

U.S. v. Johnson, 585 F.2d 199 (5th Cir. 1978). In this case the court held that the focus of the offense under 18 U.S.C. §1014 is on the defendant's intent rather than on the victim. The court further held that the false statement must merely have the "capacity to influence."

6. Forfeitures.

Another concern for auditors, in cases in which the Government is the plaintiff, is that their auditing fees may be subject to forfeiture if they are the proceeds of fraud. The government may bring a civil forfeiture case against the property or the fees may be forfeited as a result of a criminal conviction. In a case arising from some type of white-collar financial reporting fraud, the auditor's exposure in a forfeiture allegation would most likely be in a criminal instead of a civil suit.

C. Civil Liability for the Auditor.

The auditor, as a deep pocket, presents an ideal target in a financial fraud case. Potential plaintiffs include the government or private litigants.

1. Concerns in Cases Where the Government is the Plaintiff.

The government may include governmental agencies, such as the SEC or Internal Revenue Service. These suits may be for statutory or regulatory violations.

A *qui tam* suit is a type of suit brought by the United States Government, under the False Claims Act,[12] alleging that the defendants have submitted a false

[12] 31 U.S.C. § 3729, *et seq.*

"claim"[13] against the United States. Either the United States Government or a private litigant can bring suit under the False Claims Act. In cases where a private litigant brings the suit, the United States may intervene in the matter. Regardless of whether the United States intervenes in a suit brought by a private litigant, the United States will receive the majority of the funds recovered in the suit. The individual *qui tam* plaintiff, called the relator, will also receive a portion of the recovery.

Qui tam plaintiffs are often disgruntled former employees. The defendants in these suits generally tend to be businesses because a *qui tam* plaintiff must have direct and particular information regarding the alleged wrongdoing. Therefore, the workplace is the perfect environment to gather such information. Consequently, these suits often involve potential exposure for the businesses' auditors.

Amendments to the False Claims Act, in 1986, have made these suits more appealing for the Government and the private plaintiffs. Therefore, the trend showing a marked increase in such suits is expected to continue.[14]

2. Cases Brought by Private Litigants.

Private litigants may include shareholders, third-party classes, auditors or officers of a company, the client financial institutions and others relying on financial statements. A *qui tam* case, in which the Government does not intervene, can also be characterized as a suit brought by a private litigant.

An example of a shareholder class action suit is a recent suit brought against Sirena Apparel Group, Inc., in November 1998. Plaintiffs have alleged that Sirena filed false financial statements, containing misleading statements about Sirena's operations and earnings. On June 7, 1999, Sirena announced that there were accounting irregularities at the company and that it would have to restate its financial results for the first three quarters of fiscal 1999.

Another such suit is a shareholder class action filed against Alydaar Software Corporation, on June 17, 1999. This suit alleges violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. According to the complaint, Alydar's financial results for 1997 and 1998 were materially misstated. On April 5, 1999, Alydaar revealed, in its form 10-K, that its revenues and earnings had been overstated due to improper revenue recognition and understatement of expenses.

V. Conclusion.

[13] Claim is broadly defined under the act and is not limited to situations where a formal claim is presented to the government. A claim may include a situation where somebody receives a monetary benefit at the expense of the federal government.

[14] One of the many high profile *qui tam* suits currently underway is the Madera International Inc. case discussed in Section I.

In July 2002, the New York Times reported that a record number of lawsuits have been brought against accountants for fraud. Major accounting firms have countered and stated that they are the scapegoats in these suits. They have also complained of being forced to reserve 10% of profits to defend these types of suits.

Regardless of whether one thinks that these suits are justified, this trend is expected to continue. Therefore, auditors must be aware of their fraud detecting and reporting responsibilities. In order to insulate themselves from liability, auditors must not only satisfy the SAS 82 and SAS 54 standards but also take additional measures, when necessary, to detect and report fraud.

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Section 5

Principles of Fraud Detection

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PRINCIPLES
OF
<u>FRAUD DETECTION</u>

- Common Forms of Fraud

- Detection Techniques

- How to Obtain and Examine Records

PRINCIPLES OF FRAUD DETECTION

I. Fundamental Principles

- Definitions
- Role of the Human Mind
- Common Forms of Fraud

II. Detection of Fraud and Deceptive Business Activity

- Reason Detection is Difficult
- Detection Techniques
- How to Examine Business Records

III. Sources of Information

- How Acquired Knowledge is Obtained
- Sources of Information Fall into Three Groups

- General Rules in Developing Sources of Information

I.

Fundamental Principles of Fraudulent Business Activity

As a preliminary matter, I note that the views expressed herein and in the satellite broadcast are mine alone. My views in no way represent the official position of the Federal Bureau of Investigation. Nonetheless, I believe the comments I make and the issues I raise are representative of the viewpoints of experienced FBI investigators.

The continued prevalence of fraudulent and deceptive activity in the government and the business community has created an abundance of work for auditors and fraud investigators. The increased number of fraud incidents coupled with the increasing difficulty of obtaining convictions in our legal system has caused many entities, both commercial and governmental, to ignore or downplay incidents of suspected fraud or deception.

Ironically, many experienced investigators and auditors are intimidated by a feeling that they lack the education, training and experience to fully investigate a complex fraud matter. The idea of interviewing uncooperative witnesses coupled with reviewing complex transactions can be overwhelming to an auditor much less an experience fraud investigator. This anxiety does not have to occur. An embezzlement case is no different from any other theft case once you understand the underlying principles exhibited in a typical white-collar crime incident. The successful fraud investigator and auditor should possess a thorough understanding of the following fundamentals:

1. Factors that will cause a long term, trusted employee to misappropriate assets or deceive the company or governmental agency. Corporate insiders do not "cook the books" unless there is a strong motivation to do so.
2. The personality characteristics are unique to a typical white-collar crime perpetrator.
3. The components of a typically business accounting system will assist the auditor/investigators in confirming fraudulent activity.

The average business, whether a small sole proprietorship or a large Fortune 500 corporation, can be victimized by a number of different schemes. Some of the more common schemes would include (1) theft or embezzlement of cash, (2) fraudulent invoices or loan documents, (3) kickbacks and briberies, (4) theft or diversion of physical inventory. The list at the end of this chapter (Exhibit 1-1) will identify other schemes used to defraud American and international businesses.

DEFINITION OF KEY TERMS

The successful fraud investigator/accountant possesses an understanding of some of the following terms that are unique to white-collar crime inquiries:

1. **Fraud** – Any intentional or deliberate misrepresentation of the truth by which one person, through misappropriation or manipulation, attempts to gain an advantage over another person. It is an act done to deceive or cheat another individual. It also includes embezzlement by executives or employees either against or for the benefit of their companies.
2. **False Entry** – Any entry in the books or records of a business entity which is intentionally made to represent what is not true or does not exist with intent to deceive the officers, directors, stockholders, or federal regulators.
3. **Criminal Intent** – A knowingly committed act of deceit, ordinarily for the purpose of causing financial loss to someone and/or a gain to others.
4. **Deceit** – The fraudulent misrepresentation by one or more individuals to deceive or trick another person who is ignorant of the facts of the situation.
5. **Embezzlement** – The act of stealing money, securities, or economic wealth which has been previously entrusted to one's care. The act is carried out without violence or the threat of violence.

The definitions for "fraud" and "embezzlement" are relatively clear-cut and easy to grasp by the law enforcement community and the criminal justice system (police, prosecutor, judiciary). The concept of "criminal intent," however, can become extremely difficult to quantify to the satisfaction of all parties involved. We have no way of reading a criminal subject's mind. What one party may view as an error in judgment or carelessness, another may view as a willful act designed to conceal theft, deceptive or embezzlement. The investigator's task is to prove beyond a "reasonable doubt" that an act is deceptive and intentional rather than the result of carelessness. A system of strong internal controls applied consistently makes the task of determining "criminal intent" much easier by forcing the culprit to commit obvious, overt acts in an effort to overcome management's internal controls. Those acts make it easier for the criminal system to verify "criminal intent" on the part of the perpetrator.

THE ROLE OF THE HUMAN MIND IN CRIMINAL ACTIVITY

The reasoning and evaluating process of the human mind has defied understanding by members of the scientific and medical community. The same mental process that has created great works of arts, music, or literature can also manifest itself in crimes that seem to defy all explanation. The same mental creativity that is seen in a mathematical or scientific breakthrough can just as easily be seen in a complex scheme to defraud an employer or the public. Many times the same individual makes this transitional move from rational behavior to bizarre activity. Greed or an overwhelming financial crisis is often the catalyst that brings about this metamorphosis.

The classic human transformation from "good to evil" will generally occur when the individual feels trapped by dire circumstances beyond his or her control. The circumstances, even if exaggerated, present a real trauma to the distressed individual. The individual then feels compelled to eliminate the crisis by the most expeditious means. The result is that it often becomes easier to over-exaggerate the circumstances, rationalize a wrongful solution, and/or distort the truth when confronted.

The classic white-collar criminal does not possess the same characteristics or personality traits as the so-called "career-criminal type". The stereotypical "thief" is generally viewed as someone who is economically disadvantaged, poorly educated, hostile toward society, and who thinks in terms of immediate gratification rather than planning for the future. The career criminals historically do not learn from their own mistakes or the mistakes of others. This causes them to be in constant conflict with the accepted norms of social behavior towards honesty and truthfulness. The career criminal thinks not in terms of the consequences of his or her actions, but in the immediate gain or personal gratification.

The traditional white-collar criminal differs in that he or she tends to be educated, employed, emotionally stable and motivated. The intentional commission of a fraudulent act runs counter to everything the person has identified with in the past. Society has great difficulty in understanding why an employee or executive of a corporation who has significantly contributed to the community and who has been traditionally characterized as a family-oriented individual can be found guilty of fraud or embezzlement. The irony is that in most cases, neither does the individual involved understand the reason.

The propensity to commit a fraudulent act exists in all of us, what sets off the activity may be one of many, including:

1. The opportunity presented through weak or inadequate internal controls;
2. A conscious decision to act, irregardless of the consequences;
3. A change in financial need whether perceived or real.

The financial need of a person committing a criminal act can be either (1) a real need, or (2) a perceived need. Many individuals can find themselves in a financial crisis through excessive spending habits (keeping up with the Jones), a new girlfriend/boyfriend which creates two households, medical bills, or present circumstances that appear beyond their control to handle. The mind can make a conscious decision to commit an act of fraud through a warped sense of reasoning. Many times the human mind will react in a bizarre and irrational manner that is precipitated by:

1. Severe emotional crisis;
2. Mental illness;
3. Rationalization of a need within the mind;
4. Dramatic over-emphasis of a relatively minor financial need.

The emotional stability of an individual can dramatically depend upon their perception of the present circumstances. An individual of unquestionable honesty and integrity may react quite differently when confronted with a crisis, specially a financial crisis. The will to survive the crisis may result in a solution based upon the availability of the financial resources available to him or her at their place of employment, financial institution, or the government. To the emotionally stressed individual, the consequences of the decision does not become a part of the deciding factor at the time of the act, in most cases.

Deception, embezzlement or the misappropriation of assets then becomes the only option seemingly available to the distraught and troubled individual. A genuine concern for the consequences of such action generally is not a factor in the decision to deceive. The necessity to deceive the auditor and take advantage of a weakness in the internal controls becomes an acceptable risk to the employee bent on theft or deception.

The deceptive employee can effectively and convincingly deny involvement even when confronted with overwhelming evidence to the contrary. The ability to give a convincing explanation, in spite of documentation to the contrary has allowed a significant number of fraudulent schemes to continue undetected. The convincing denial of involvement should not be taken as the ultimate proof of innocence.

EXHIBIT 1-1

Common Forms of Fraud

The types and magnitude of acts of fraud are varied. Some common forms of fraud include the following:

- Capitalizing assets that should be expensed in an effort to make a company appear profitable when it is not
- Providing financial statements to a financial institution for the purpose of obtaining a loan or letter of credit containing overstated income and/or assets and/or understated liabilities
- Providing false collateral to secure a loan from the company or financial institution
- Removing small amounts from petty cash
- Failing to record sales and pocketing cash
- Overloading expense accounts or diverting advances to personal use
- Pocketing payments on customer accounts and issuing receipts on scraps of paper or in self-designed receipt books, or not giving receipts at all
- Collecting an account, pocketing the money, and writing it off or collecting write-offs and then not reporting the collections
- Failing to make bank deposits daily or deposing only part of the money
- Altering dates on deposits slips to cover up stealing
- Carrying fictitious extra help on payroll, increasing pay rates or hours worked per books, carrying employees on the payroll beyond severance dates, falsifying additions to payrolls, or withholding unclaimed wages
- Destroying, altering, or voiding cash sales tickets and pocketing the cash
- Using personal expenditure receipts to support false paid-out items
- Paying false invoices, either self-prepared or obtained through collusion with suppliers

- Increasing the amounts of suppliers' invoices through collusion or misstating discounts provided
- Charging personal purchases to the company through the misuse of purchase orders
- Billing stolen merchandise to fictitious accounts
- Falsifying inventories to cover thefts or delinquencies using such creative approaches as stacking empty boxes
- Selling waste and scrap and pocketing the cash
- Obtaining unprotected blank checks and forging the signature. Other blank documents can similarly be abused
- Permitting special prices or privileges to customers or family
- Providing large loans to high ranking officers, directors or their families in order to influence their decisions
- Accepting bribes or kickbacks from suppliers

II.

Detection of Fraud And Deceptive Business Activity

The detection or corroboration of fraudulent activity within a business is one of the most difficult tasks facing a CPA, private investigator, or law enforcement official. Experience shows that most fraud schemes collapse when the perpetrator is removed for unrelated reasons. Several key factors that make detection difficult are as follows:

1. The perpetrator is generally a trusted employee with unlimited access to the business and the business records.

2. In spite of mounting evidence, company executives are unwilling to believe that a key employee is responsible for fraudulent activity.

3. The perpetrator is willing to destroy or alter records in an effort to further conceal the scheme.

4. Company executives, auditors, or co-workers are not willing to take the time to investigate an unusual transaction because they don't have the time or don't feel it is their responsibility.

As the scheme continues to grow, the perpetrator hides, alters or destroys more and more records of the victim company. This activity provides the trained investigator/CPA with a greater chance of discovering physical evidence to corroborate the clandestine activity. Two points will make this task easier for the auditor or investigator:

1. An understanding of the thought-process of the typical fraud perpetrator.

2. A fundamental knowledge of the principles of business records and how they relate to each other.

The experienced auditor, also, has the opportunity to corroborate the existence of fraudulent activity by other fraud indicators. The indicators that can consistently provide the evidence are:

1. Indicators of financial difficulties

2. Life style changes of individual

3. Outside business activities

The following (3) step review is designed to provide a comprehensive process to assist auditors in the effort to uncover possible fraudulent business activity. Results of the review's points are not going to be evident in every case. The role of the auditor is to intuitively and reasonably review each of these in a methodical approach to uncover a suspected scheme. The more negative responses to these points, the greater the confidence that the investigator is on the right track. The (3) step review is as follows:

1) Observe the tone and style of management

Management-level employees from the first-line supervisor to senior executive, should noticeably display certain characteristics that are consistent with competence, integrity and honesty within the business environment. Some of the common denominators for ethical management are as follows:

- Strong decision-making ability
- Strong sense of responsibility to rules and regulations
- Consistent control of the unit or group
- Professional approach to the conduct of daily business activities
- Unquestioned adherence to integrity and ethics in his or her personal and professional life
- Observable public support of a strong disciplinary policy against acts of thefts, fraud, or conflict of interest.

If there are indications that are opposite to any of the above listed factors, it should be noted as a possible warning indicator to problems. If the top of the organization is corrupt, it is possible for corruption and dishonesty to flow through out the organization.

2) Observe the dynamics of the personnel within the organization

Sometimes the actions of the employees, whether obvious or subtle, will present the auditor with warning signs hinting at trouble within the unit. Specific activities to watch for are the following:

- **Dramatic increase in resignations or terminations**

- **Increase or decrease in disciplinary action, particularly concerning theft, dishonesty, etc**

- **Department personnel withdrawing into what appears to be a closed, non-communicative group**

- **Excessive transfers, either in or out of a department or section**

- **Persistent rumor or innuendo concerning questionable activity within the unit**

The organization should constantly monitor all levels of management, taking note of any change in style or philosophy. Some questions that the auditor should ask are:

- Does the individual manager or supervisor appear to be well respected among his peer group of comparable-level supervisors?
- Does the management group project a sense of honesty, integrity, and an acceptable morale standard consistent with the standards of the organization?
- Does the manager comply with and enforce the organization's code of ethics and code of conduct?
- Do employees within the unit feel oppressed or exploited by hostile management?
- Does the management level personnel place an excessive reliance on increased production or profitability?

3) Be alert to indications of drug abuse among employees

No single force has been as deteriorating to the moral fiber of the country as has been the abuse of illegal drugs by a significant segment of the population. The turmoil, psychosis and corruption comes with the abuse of illegal drugs does reflect itself among the abuser-employees within the workplace. The drug abuser will display certain characteristics that will lead to his discovery by an alert organization. The importance of early detection can be seen as a prevention or early discovery of fraudulent activity by the drug-abusing employee.

Some of the signs and characteristics that should be observed are as follows:

- Increase absence from the workplace for sickness, "emergencies," unexplained disappearance or absence on Monday or Friday

- Mood changes such as depression, argumentativeness, suspiciousness, excessive gregariousness

- Outward physical indicators such as excessive weariness, slurred speech, blank stares, dark glasses worn at inappropriate times

- Complaints coming from co-workers

- Significant increase in the number of mistakes or general carelessness in work performance

Examination of Appropriate Business Records

The critical physical evidence necessary to corroborate fraudulent business activity will generally be found within the books and records of the victim company and its financial institution. The perpetrator is forced to alter the company records in a continuing effort to conceal the fraudulent activity from discovery. The auditor is confronted with the task of discovering the false records, recognizing them as being false and then interviewing all known parties who have knowledge of the transaction.

A review of the appropriate records will improve the investigator's ability to corroborate the suspected activity. The task is made easier when the auditor understands how the proper records should appear. It then becomes important to recognize a deviation from the acceptable pattern. Examples of the key records to examine and the questions to ask appears below:

1. **Review the master vendor's list –** The perpetrator is aware that it is going to be difficult, if not impossible, to get a check sent to an unauthorized vendor. Efforts will be made to bypass the control measures or to create a counterfeit vendor file that will give credibility to the fraudulently prepared check.

   The analysis should concentrate on additions or deletions to the list of vendors. The questions that should be addressed are: Why did we add or drop this particular vendor? Is this a legitimate vendor that actually exists? Who are the owners of this particular vendor company? If a new supplier of a product has been added, then who has been dropped from our vendor list and why?

2. **Review canceled checks -** The embezzler is aware that he cannot openly convince the company to create a legitimate company check that is obviously unwarranted or unsubstantiated. The plan will involve the creation of false data that will substantiate the creation of a valid company check.

The start of the search for fraud might begin with the systematic review of a series of canceled checks. The checks could be chosen by time frame, vendor or vendors in a certain group, geographic region, product line or random selection. When examining the check(s), concentrate on information on the reverse side of the instrument – Where was it deposited? Who endorsed the check? Look for secondary endorsements on the check. Is this a legitimate person or entity? What goods or services are represented by this payment? Do these goods or services actually exist? When looking at a series of checks, is any questionable pattern starting to emerge?

3. **Budget variance –** many times the perpetrator will create a false vendor file for a product the corporation buys on a regular basis, an example would be office supplies. The fraudulent check will give the impression that office supplies are being purchased when, in fact, cash is being diverted for personal use. This activity may be detected through an unexplained increase or decrease in a particular commodity, in this case, office supplies.

   Questions should be asked to assure the company that an increase or decrease in a particular item or service is not the result of clandestine, fraudulent activity. Why are we buying our supplies from four vendors when last year there were only three? Why has the budget doubled in a certain expense when the number of employees has not increase?

4. **Inventory analysis –** The probability always exists that the valuation of existing inventory has been used to conceal the existence of a fraud scheme or the theft of large quantities of material or finished product. Again, the approach is to question the inventory figures as a part of the scheme to conceal clandestine activity. Has a less expensive item been placed in the carton of a more expensive item? Have we independently observed inventory maintained in a distant, hard to reach location? Are there false bottoms or hollow empty spaces in large stacks of inventory?

5. **Evaluate payroll figures –**A fraud scheme involving non-existent or "ghost employees" is always a possibility, especially in a large number of hourly employees located in remote locations and where there are few internal controls. The goal of the perpetrator is to obtain control over the payroll checks of the employees that do not exist and convert the funds to his own use.

   Detection methods would include review of payroll checks, in particular the endorsement on the checks. The auditor should review the checks to determine: (1) Is there a pattern of similar endorsements? (2) Is there a pattern of secondary endorsements on the checks reviewed? (3) Do several employees share the same address and bank at the same place? (4) Remember that nonexistent employees (a) Don't take vacations, (b) Don't work, they only exist on payday. (c) Don't take sick leave or supplemental insurance.

6. **Review the customer complaint file –** One of the difficulties faced by the perpetrator is the enormous task faced by doing his normal routine and at the same time struggling to keep the clandestine activity from being discovered. Invariably, his actions will result in mistakes, accounting errors or entries that could be reflected in complaints coming from customers.

   The complaint file should be reviewed with the goal of uncovering a pattern of complaints that may lead to discovery of fraudulent activity, to include: (1) Is there an inordinate number of complaints on one particular customer, vendor, employee or department in the company? (2) Does the pattern of complaints or the corrective action defy logic?

7. **Utilities, rent, telephone and taxes –** These expenses can generally be identified with a physical location known or unknown to the company. Some questions to ask would include: (1) Why do we pay rent (taxes) on a particular address? (2) Who is on the receiving end of suspected or unexplained long distance phone calls?

8. **Verify the integrity of sensitive or valuable commodities –** The company may possess a commodity that is extremely vulnerable to theft, manipulation or conversion. Examples would be large quantities of cash, drugs, rare coins, diamonds, or sensitive and valuable computer data. The examiner should always be concerned if efforts have been made to inflate the value of the data, substitute a less valuable commodity or conceal the fact that the item is completely missing.

9. **Review loan documents –** If a company is experiencing financial problems one of the first things it might do is borrow money from a financial institution. Because most financial institutions don't have the personnel to verify every line item on a financial statement, the applicant could provide false statements without the institution ever knowing it. Reviewing the loan documents can provide a wealth of information for any auditor.

   The analysis of loan documents should include a comparison of other financial statements provided to other institutions and the companies' financial statement for significant differences. Comparing the assets, liabilities, collateral, income and expenses may provide clues to a significant problem. It might reflect unusual discrepancies in transactions not recorded in a complete or timely manner, missing inventory or physical assets of significant magnitude, unrealistic aggressive sales or profitability incentive programs, unusually high dependence on debt, or inability to generate cash flows from operations to meet debt obligations.

III.

SOURCES OF INFORMATION

I. **Definition of Information - Acquired knowledge obtained through study, communication, research and observation**

   A. **Study**

      1. **Books**
      2. **Magazines**
      3. **Other publications**

   B. **Communication**

      1. **Tips, angles, advice from other auditors, assistants and sources**
      2. **Informants --- Paid and Unpaid**
      3. **Witnesses**

   C. **Research**

      1. **Federal/State/Local**
      2. **Public Records (Bankruptcy Court, Incorporation records)**
      3. **Credit Bureaus**
      4. **Financial Institutions**
      5. **Personnel Records**
      6. **Educational**

7. License and Regulatory
8. Private data bases for hundreds of businesses (Dominos, Marriott Hotels)
9. Better Business Bureau
10. Dunn & Bradstreet (Rates individual businesses and provides historical information)
11. Internet
12. Prior Litigation Files

D. Observation

1. Auditor's own observation and cataloging possible sources
2. Observation of events by employees and others
3. General knowledge. An auditor should know a little about everything

II. Generally sources of information fall into three groups

A. Information obtained from persons

1. Witnesses
2. Informants or Cooperative Witnesses
3. Custodians of records – Financial Institution, Title Company, etc.
4. Subject of the examination/audit
5. Specialist and hobbyist

B. Information obtained from outside audit written sources – books, records, documents

   1. Great possibility for background information

   2. Frequently overlooked by auditors/investigators in their haste and desire to close a matter and move on

   3. Value of checking records even in such minor case

C. Information obtained from physical properties

III. General rules

A. Learn sources in your locality and strive to develop new sources

   1. A source of information is any:

      i. business person

      ii. record

      iii. custodian of records

      iv. directory

      v. public official

      vi. as well as any person who might be of assistance to the audit

B. Develop sources of information before they are needed

   1. Frequently information can be obtained on a personal basis in spite of rules against giving out the information

2. **Nobody but the Courts can force any person or corporation to divulge information or produce records**
3. **Exceptions – Public records and privileged information**

Section 6

Criminal Issues Facing Auditors and Accountants

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CRIMINAL ISSUES FACING AUDITORS AND ACCOUNTANTS

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I. INTRODUCTION

Today, in the later half of 2002, the news headlines are filled with stories of massive business frauds and accounting failures.[2] The recent Enron-related scandals (and the role of accountants and auditors in those scandals)[3] and the collapse of Worldcom Communications[4] as a result of allegedly deliberate overstating of income are but two of the most prominent and recent examples.

Accountants[5] should not be surprised to find themselves in the center of such financial nightmares as the public and the legal system have traditionally imposed on accountants, and particularly on outside auditors, responsibilities to the public at large that transcend their obligations and loyalties to their clients.

> The independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well

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1 The opinions and observations expressed in this outline are the author's alone and do not reflect the official or unofficial positions of the United States Department of Justice, the United States Attorney's Office for the Northern District of Texas, or of any other federal or state agency.

2 ***E.g., Burden of Doubt: Stocks Take a Beating As Accounting Worries Spread Beyond Enron***, The Wall Street Journal, January 30, 2002, at A1, 2002 WL-WSJ 3384444; ***Welfare Reform for Accountants***, The Wall Street Journal, January 16, 2002, at A17, 2002 WL-WSJ 3383008.

3 ***Fall of an Energy Giant: Arthur Levitt Says Enron Case Shows Need for More Curbs***, The Wall Street Journal, January 11, 2002, at A4, 2002 WL-WSJ 3382680.

4 ***Disconnected: Inside WorldCom's Unearthing Of a Vast Accounting Scandal***, The Wall Street Journal, June 27, 2002, at A1, 2002 WL-WSJ 3399122; ***WorldCom Admits $3.8 Billion Error In Its Accounting***, The Wall Street Journal, June 26, 2002, at A1, 2002 WL-WSJ 3398938.

5 Although their roles differ significantly, all references to "accountants" in this paper should be understood to include financial accountants, inside auditors and independent outside auditors.

> as to the investing public. ***This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust***. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of ***the accountant's role as a disinterested analyst charged with public obligations***.

(Emphasis added). ***United States v. Arthur Young & Co.***, 465 U.S. 805, 817 (1984) (holding that tax accountant could not withhold from IRS workpapers relevant to tax work performed for client).

> The certified public accountant, particularly in her role as auditor, occupies a unique place among white-collar professionals. Although selected and compensated by her client, her duties may extend beyond her client to certain third parties and public investors. While attorneys and physicians act as advocates, advisors, and confidants, ***an auditor must remain a disinterested and independent party and may be engaged to protect and promote interests other than those of her client.***
>
> Although the auditor is selected and compensated by [the] client, her ultimate allegiance extends beyond the interests of [the] client, and she may, at times, actually work against the interests of [the] client. ***In other words, the goal of the audit is not to further the client's interest but to determine whether the financial statements are fairly stated.***

(Emphasis added). T. Dodd, ***Accounting Malpractice and Contributory Negligence: Justifying Disparate Treatment Based Upon the Auditor's Unique Role***; 80 Geo.L.J. 909 (1992).

In spite of this exalted status, or perhaps because of it, through modern economic history accountants have found themselves at the center of some of the most outrageous criminal and civil financial frauds and swindles of our times. Most commonly, the accountant finds himself or herself in the role of either a witness in a fraud case (because he discovered it) or a victim of fraud (because the perpetrator took pains to conceal the fraud from the accountant, thus either cheating the accountant's employer or exposing the accountant to civil liability for failing to detect the fraud sooner).

However, accountants may also wittingly or unwittingly become enmeshed themselves in criminal schemes. Because accountants are probably most often concerned with the prospects for civil monetary liability where something goes wrong, they may not fully appreciate the possibility of criminal liability for involvement in a financial fraud scheme – either as a participant in the fraud itself or because of their conduct after the existence of the criminal conduct becomes known to them. The balance of this outline addresses some issues relevant to accountants who may find themselves involved – either as participants or as victim/witnesses – in a criminal fraud scheme.

II. GOVERNMENTAL AGENCIES CHARGED WITH INVESTIGATING AND PROSECUTING CRIMINAL FRAUD.

Often, both State and Federal law enforcement and prosecuting offices may have interests in the investigation and prosecution of a particular criminal scheme. Thus, the accountant may find himself dealing with any number of investigating agencies.

A. STATE & LOCAL AGENCIES

Each state has its own structures for investigating and prosecuting criminal conduct. A sampling of some of the agencies that may be involved in the investigation and prosecution of fraudulent conduct at the state level includes:

- State Attorney Generals Office
- District Attorney's Office
- State Police
- County Sheriff's Office
- Local Police Departments
- State Regulatory Agencies
  - Department of Insurance
  - Department of Banking
  - State Securities Board
  - State Health Department
  - State Auditors Office
  - State Medical Boards
  - State Bar Associations

Not all of these agencies will necessarily have responsibilities for enforcement of criminal laws; some have only administrative or licensing responsibilities. Nevertheless, facts gathered by one agency as part of a civil investigation may find their way to a district attorney's office or even a federal law enforcement agency.

B. FEDERAL LAW ENFORCEMENT AGENCIES

At the Federal level, responsibility for the investigation and prosecution of criminal offenses is vested in the Department of Justice, through its various divisions in Washington, D.C. and in the 94 U.S. Attorneys offices located throughout the country. The U.S. Attorneys offices, however, do not have their own investigative staffs. Rather, the responsibility for the investigation of possible violations of federal statutes has been allocated by Congress among numerous federal law enforcement agencies who may have overlapping or concurrent jurisdiction with regard to potential violations of various federal statutes.

The Federal Bureau of Investigation has general responsibility for investigating financial frauds of all types. However, that authority is shared with a number of other investigating agencies that either have expertise in particular areas or are charged by law with responsibility for policing certain areas of commerce. The U.S. Postal Inspection Service, for example, is charged with investigating frauds that use the United States mails. The United States Secret Service, through an agreement with the FBI and other federal agencies, makes investigation of large-scale credit card fraud and abuse a particular focus of its law enforcement efforts. Additionally, each Department and many of the major federal Agencies have an Office of Inspector General that is responsible for policing frauds targeting that particular Department or Agency and the funds administered by it.

A partial listing of federal law enforcement agencies with responsibility for policing at least some forms of financial fraud include:

Federal Bureau of Investigation
United States Secret Service
Internal Revenue Service
United States Custom Service
United States Postal Inspection Service
Offices of Inspectors General
Department of Agriculture
Department of Defense
Department of Education
Department of Health and Human Services (HHS)
Department of Housing and Urban Development (HUD)
Department of Labor
    Office of Workers Compensation Programs
    Pension and Welfare Benefits Administration
Small Business Administration
Department of Transportation
Department of Veterans Affairs

III. PRIORITY PROGRAMS OF THE DEPARTMENT OF JUSTICE

From time to time, the Department of Justice and its affiliated investigative agencies have undertaken initiatives in response to increased criminal activity in a particular industry and/or in response to Congressional mandate. These initiatives are often carried out with the allocation of additional resources and manpower directed at increased investigations and prosecutions of certain types of crimes.

The initiatives often include the hiring and training of additional federal agents and investigators as well as additional prosecutors and support staff. Depending on the size of the office of the particular investigating agency or prosecutor, these added personnel are often dedicated exclusively to devote all of their activities to the investigation and prosecution of a particular type of criminal activity. Specialized training is provided to these agents and attorneys in the practices and standards in a particular industry such as banking, insurance or health care as well as training on the applicable statutes and regulations which govern the activities within that industry.

The establishment of such program priorities often includes the creation of task forces or working groups made up of both state and federal prosecutors, agents and investigators, representatives from regulatory boards and agencies as well as representatives from private sector associations directed toward the detection and elimination of fraud or other criminal activity within and against the industry.

Some of the current program priorities of the Department of Justice include the following areas:

Bankruptcy fraud
Computer fraud
Defense procurement fraud
Financial institution fraud
Health Care fraud
HUD program fraud
Insurance fraud
Securities fraud
Fraud against senior citizens
Frauds against government agencies in general

I. EXAMPLES OF CRIMES AND THE CRIMINAL STATUTES USED TO PROSECUTE AT THE FEDERAL LEVEL

A. EXAMPLES OF TYPICAL FRAUD SCHEMES

The range of fraudulent schemes is limited only by the imagination. However, there are a couple of patterns of criminal conduct that recur with some frequency.

2. Embezzlements**: A common scheme encountered (and sometimes perpetrated) by accountants is embezzlement. By definition, embezzlements are perpetrated by insiders. Typically a valued and trusted employee, the embezzler has access to the books and records of the company and is able to juggle accounts and reports in such a way that his or her superiors do not discover the missing or misapplied funds. As the scheme continues and more and more money is misappropriated, it becomes harder and harder to disguise the theft. Thus, embezzlers often refuse to take vacations, particularly during the time of month when the bank statements are received and reconciled. Ironically, the embezzler's apparent dedication to his or her job often results in the employer placing even more trust and responsibility in the dishonest employee!!**

3. False appraisals/over-valuation of specific assets**: The bank fraud crisis of the 1980s, which virtually destroyed the savings and loan industry, could not have happened without the willingness of professional appraisers to deliberately overstate the value of the real property pledged as collateral for the questionable loans. However, the problem is not confined to real property: inventory of all types, accounts receivables, art work and oil and gas interests have all been central to fraud schemes using overvalued assets. Accountants may find themselves involved – at least as witnesses and possibly as participants in crime – when they are asked to opine on the fairness and accuracy of financial statements utilizing these valuations.**

4. False financial statements**: Although somewhat rarer than other sorts of financial fraud, the ones posing perhaps the most serious risk to the integrity of the accountants and accounting profession are the ones in which entire sets of false financial statements are created and used to mislead investors, lenders or customers.**

B. STATUTES TARGETING CRIMINAL FRAUD THAT ARE OF INTEREST TO ACCOUNTANTS

Federal criminal law contains a number of statutory tools used to address fraud schemes. The ones of general application are, of course the mail and wire fraud statutes. Another statute frequently used by prosecutors is 18 U.S.C. Section 1001, which criminalizes the making of all manner of false statements to any federal Department, Agency or investigator.

Mail Fraud: 18 U.S.C. Section 1341

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, . . . for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized depository for mail matter, any matter or thing whatever to be sent or delivered by the Postal Service, or deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier . . . [commits an offense].

> ***Note***: Congress has closed the loophole that once allowed criminals to ship false representations through private courier services; now, use of UPS, FedEx, DHL and the like will also run afoul of the Mail Fraud statute.

Wire Fraud: 18 U.S.C. Section 1343

> Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses,

representations, or promises, transmits or causes to be transmitted by means of wire, radio, or television communication in interstate or foreign commerce, any writings, signs, signals, pictures, or sounds for the purpose of executing such scheme or artifice [commits an offense].

False Statements to a federal agency: 18 U.S.C. 1001

Except as otherwise provided in this section, whoever, in any matter within the jurisdiction of the executive, legislative, or judicial branch of the Government of the United States, knowingly and willfully –

(1) falsifies, conceals, or covers up by any trick, scheme, or device a material fact;

(2) makes any materially false, fictitious, or fraudulent statement or representation; or

(3) makes or uses any false writing or document knowing the same to contain any materially false, fictitious, or fraudulent statement or entry;

[commits an offense].

In addition to the statutes of general applicability above, Congress has seen fit over the years to pass criminal statutes targeting frauds and thefts against specific types of victims. In many cases, conduct that is a violation of one of these specialized statutes can also be prosecuted under one of the statutes of general applicability discussed above.

Bank Fraud, 18 U.S.C. Section 1344

Whoever knowingly executes, or attempts to execute, a scheme or artifice –

(1) to defraud a financial institution; or

(2) to obtain any of the moneys, funds, credits, assets, securities, or other property owned by, or under the custody or control of, a financial institution, by means of false or fraudulent pretenses, representations, or promises;

[commits an offense].

Health Care Fraud, 18 U.S.C. Section 1347

Whoever knowingly and willfully executes, or attempts to execute, a scheme or artifice –

(1) to defraud any health care benefit program; or

(2) to obtain, by means of false or fraudulent pretenses, representations, or promises, any of the money or property owned by, or under the custody or control of, any health care benefit program,

in connection with the delivery of or payment for health care benefits, items, or services [commits and offense].

Securities Fraud: Securities Act of 1933, 15 U.S.C. Section 77q(a)

> It shall be unlawful for any person in the offer or sale of any securities . . . by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Securities Fraud: Securities Act of 1934, 15 U.S.C. Section 78j(b)

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange–
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
>
> **Note:** the "rules and regulations" referenced in 15 U.S.C. Section 78j(b) are found at **17 C.F.R. § 240.10b-5**, which provides:
>
> > It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
> >
> > (a) To employ any device, scheme, or artifice to defraud,
> > (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> > (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Accountants may be liable for their involvement in a criminal scheme even if they did not originate, plan, organize or mastermind the operation. Where the accountant is aware of criminal conduct and takes some affirmative step to either prevent its discovery or aid the main actors, criminal liability may exist under several theories of vicarious liability.

Conspiracy, 18 U.S.C. Section 371

> If two or more persons conspire either to commit an offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each person [shall be guilty of an offense against the United States].

Aiding and Abetting, 18 U.S.C. Section 2

> Whoever aids, abets, counsels, commands, induces, procures . . . the commission of an offense is chargeable as a principal.

Accessory After the Fact, 18 U.S.C. Section 3

> Whoever, knowing that an offense against the United States has been committed, receives, relieves, comforts or assists the offender in order to hinder or prevent his apprehension, trial or punishment, is an accessory after the fact [and commits an offense against the United States].

Misprision of a Felony, 18 U.S.C. Section 4

> Whoever, having knowledge of the actual commission of a felony cognizable by a court of the United States, conceals and does not as soon as possible make known the same to some judge or other person in civil or military authority under the United States, shall be [guilty of an offense against the United States].

Obstruction of Justice, 18 U.S.C. Sections 1501, et. seq.: There are a number of statutes that criminalize various methods of impeding or interfering with criminal and administrative investigations by state and federal agencies, as the former "Big Five" accounting firm Arthur Andersen, LLP recently learned. Appended to this outline as "Attachment A" is a verbatim reproduction of the indictment on which Arthur Andersen was recently tried and convicted in Houston, Texas for obstruction of justice in violation of 18 U.S.C. Section 1512(b)(2) as a result of "corrupt" efforts by some Andersen employees to persuade other Andersen employees to destroy documents.

Perjury, 18 U.S.C. Section 1623

> Whoever under oath . . . in any proceeding before or ancillary to any court or grand jury of the United States knowingly makes any false material declaration or makes or uses any other information, including any book, paper, document, record, recording, or other material, knowing the same to contain any false material declaration [commits an offense].

Generally speaking, criminal liability is imposed only on individuals who knowingly and deliberately engage in criminal conduct. In most cases it is not necessary that the subject realize that he or she is breaking the law – thus the maxim, "ignorance of the law is no excuse."

However, an individual who has knowledge of a criminal scheme and thereafter joins with or aid the perpetrators may be punished under the concepts of vicarious liability (aiding and abetting, conspiracy, etc.) described above.

In this regard, the law provides that one cannot escape criminal responsibility for his or her conduct by deliberately avoiding learning all the facts, a concept that is sometime referred to as "willful blindness," or "the Ostrich defense." When a defendant (such as, perhaps, an accountant who learns of the possibility of criminal conduct and does nothing to investigate it or report it) asserts that "he didn't know," the court may give the following instruction.

> You may find that a defendant had knowledge of a fact if you find that the defendant deliberately closed his eyes to what would otherwise have been obvious to him. While knowledge on the part of the defendant cannot be established merely by demonstrating that the defendant was negligent, careless, or foolish, knowledge can be inferred if the defendant deliberately blinded himself to the existence of a fact.

V. RESPONSIBILITIES OF THE ACCOUNTANT AS VICTIM OR WITNESS TO THE CRIME

A. DUTY TO REPORT THE CRIME

Accountants who are not part of the criminal conduct itself but who become aware of it have both legal and moral duties to a number of different constituencies.

6. Duties to clients

7. Duties to anyone specifically known to be relying on false or misleading representations or otherwise to be a victim of the criminal conduct

8. Duties to the public at large

The duties owed to these various constituencies may, obviously, conflict. As a matter of professional ethics, accountants owe a duty of confidentiality to their clients. However, if the accountant learn of criminal or other prohibited conduct by his client (or an individual employee of his corporate client) he almost certainly has an obligation to report the discovery to someone.

At a minimum, the conduct should be reported to someone in authority within the client organization (e.g., the Owner (in the case of a sole proprietorship), the Board of Directors, Audit Committee, Corporate Counsel) who is not suspected of being part of the criminal conduct. In some cases, there may be a statutory duty to report the discovery to a regulatory agency, such as the SEC in the case of publicly traded companies. A more difficult issue is whether the accountant should, on his or her own, report the discovery to law enforcement agencies. While the author believes that accountants who discover fraud or other criminal conduct have at least a moral duty to notify the appropriate law enforcement officials, contractual obligations and rules of professional ethics make the choice to do so somewhat complicated. The bottom line is that the decision to report the discovery of a crime to law enforcement is one that probably should be made only after consultation with personal counsel not affiliated with the client at issue.

If the accountant elects not to report the crime, he then faces the risk that his silence may be construed as aiding and abetting, being an accessory after the fact or a violation of one of the other statutes enumerated above that prohibit conduct that aids the perpetrator or that makes discovery or investigation of the crime more difficult. ***If contacted by investigators, it is absolutely essential, for the accountant's own protection, that he or she not make any false or misleading statements as to do so constitutes a crime (making false statements in violation of 18 U.S.C. 1001, obstruction of justice, perjury) independent of the original offense.***

B. DUTY TO PRESERVE EVIDENCE

A critical responsibility for all accountants is the duty to preserve evidence in whatever form it may be found. Once the accountant has knowledge of the institution of civil litigation or of a federal civil or criminal investigation (whether by the FBI or other law enforcement agency, or by a civil regulatory body such as the SEC or the Federal Trade Commission), the destruction or alteration of evidence is a criminal offense, as the accounting firm Arthur Andersen, LLP recently learned.

Federal agencies have a number of tools at their disposal for gathering evidence. Some of the ones accountants may encounter are:

1. <u>IRS enforcement summons</u>.

2. <u>Inspector General subpoenas</u>. Issued under the authority of the Inspector General Act. Similar to the IRS summons.

3. <u>Grand jury subpoenas</u>. Issued on the authority of the federal grand jury. May call for the production of documents or testimony or both.

4. <u>U.S. Attorney Investigative Demand</u>. Available in a limited number of investigations, such as health care fraud cases. 18 U.S.C. 3480.

5. <u>Search warrant</u>. Issued by federal magistrate upon finding of probable cause to believe that a crime has been committed and that evidence is likely to be found at the location to be searched.

If the accountant is the recipient of one of the evidence-gathering tools listed above, or if he or she hears that the client or other witness is the recipient of such a demand for evidence, the client is on notice that an investigation is ongoing and the accountant ***MUST*** preserve all potential evidence. At this point, it is too late to initiate "document retention policies" that call for elimination of notes, drafts or other extraneous materials.

C. SPECIAL PROBLEMS INVOLVING "ELECTRONIC" OR "COMPUTER" EVIDENCE

An area of evidence that should be of particular concern to accountants is "electronic" or "computer" evidence. Some of the best and most damning evidence in recent civil and criminal litigation has been recovered from a company's computer system in the form of "deleted" files, "erased" e-mails, and forgotten file directories. Assuming that an accountant is not deliberately trying to destroy evidence, one of the worst mistakes that can be made by him or her is to fail to preserve such electronic evidence once the accountant is aware that a demand has been or may be made for it.

Accountants should be warned that the Department of Justice is very aggressive and knowledgeable regarding computer crimes and the use of computers to perpetrate crimes. The Computer Crime and Intellectual Property Section ("CCIPS") attorney staff consists of about two dozen lawyers who focus exclusively on the issues raised by computer and intellectual property crime. Section attorneys advise federal prosecutors and law enforcement agents; comment upon and propose legislation; coordinate international efforts to combat computer crime; litigate cases; and train all law enforcement groups. Other areas of expertise possessed by CCIPS attorneys include encryption, electronic privacy laws, search and seizure of computers, e-commerce, hacker investigations, and intellectual property crimes.

The bottom line: if the FBI or other federal law enforcement agency finds the computer, they have an excellent chance of recovering any evidence that was on it. In such a case, an accountant who has deleted or attempted to delete a file after becoming aware of an investigation has likely bought himself a criminal charge for obstruction of justice even if the accountant was not involved in the underlying crime under investigation.

D. NO RIGHT TO WITHHOLD EVIDENCE UNDER "ACCOUNTANT-CLIENT" PRIVILEGE

A minority of states provide that communications between an accountant and his or her client that are necessary for the rendition of professional advice are "privileged" and not subject to discovery by law enforcement authorities or civil litigants. Federal courts, however, have consistently declined to recognize such a privilege. ***Couch v. United States***, 409 U.S. 322, 335 (1973) ("No confidential accountant-client privilege exists under federal law, and no state created privilege has been recognized in federal cases"); ***United States v. Arthur Young & Co.***, 465 U.S. 805, 817 (1984) (holding that tax accountant could not withhold from IRS workpapers relevant to tax work performed for client who was under investigation).

Recently, however, Congress has granted a limited privilege to accountants in the area of civil tax preparation work. The U.S. Tax Code now provides, at 26 U.S.C. Section 7525:

(a) (1) General rule. – With respect to tax advice, the same common law protections of confidentiality which apply to a communication between a taxpayer and an attorney shall also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney.
(2) Limitations.--Paragraph (1) may only be asserted in –
(A) any noncriminal tax matter before the Internal Revenue Service; and
(B) any noncriminal tax proceeding in Federal court brought by or against the United States.

The provision applies only to communications made after July 22, 1998 (the effective date of the statute). Additionally, it is applicable only to tax work. Moreover, the statute specifically carves out criminal investigations; thus, it cannot be used by accountants as a basis for refusing to provide documents or testimony in any criminal investigation.

VI. OBSERVATIONS CONCERNING SENTENCING FOR FRAUD-TYPE OFFENSES IN FEDERAL COURT

Prior to 1986 perceived unfairness in the way individual defendants were treated in federal court was seen as a problem with the federal criminal justice system. Some judges believed that because you can steal just as effectively with a pen as with a gun, white collar criminals should always go to prison. Other judges rarely imposed prison sentences on non-violent offenders, regardless of how much money they had stolen.

In an effort to reduce sentencing disparities Congress created the Sentencing Guidelines, which provide an elaborate system for "grading" both an offender and his conduct. Using a set of specific rules and guidelines a judge now determines both an "Offense Level" for the crime and a "Criminal History" score for the defendant's past convictions. The two scores are then graphed onto a matrix, with a presumptive range of imprisonment set forth in each box of the matrix.

1. SENTENCING OF INDIVIDUALS

Generally speaking, the single most significant component in a fraud case is the amount of the loss suffered by the victims. If the defendant intended for the loss to be higher than actually suffered, the intended loss is used instead. The greater the actual or intended loss, the higher the sentence will be.

In addition to the loss amount, other factors will also effect the sentence. Of particular interest to accountants is an enhancement that is to be applied where the defendant uses a professional skill not possessed by the general public (such as expertise in accounting) to commit or conceal the crime. U.S. Sentencing Guideline Section 3B1.3 provides:

> If the defendant abused a position of public or private trust, ***or used a special skill***, in a manner that significantly facilitated the commission or concealment of the offense, [increase the offense level].

Emphasis added. Case law has repeatedly held that accountants who use their training to facilitate the commission or concealment of a crime will receive increased sentences under this provision.

2. SENTENCING OF ORGANIZATIONS

Because an organization, such as a corporation, cannot be imprisoned the Sentencing Guidelines provide for separate guidelines to be utilized in determining the sentence of an organization. These guidelines include such sentencing options as fines, restitution, community service, and remedial orders requiring specific performance by an organization defendant.

In determining the sentence to be imposed on an organization, the guidelines require the court to determine the degree of culpability of the organization by examining factors such as:

1. How widespread was the criminal activity within the organization (and preliminarily, how large was the organization)?
2. What was the extent of the involvement of the management of the organization?
3. Does the organization have a prior history of having engaged in other misconduct, including civil and administrative misconduct?
4. Did the organization violate an existing judicial order such as an injunction or cease and desist order during the time of the criminal activity?
5. Did the organization engage in any type of effort to obstruct the investigation or prosecution of the case against it at any time?
6. Did the organization have in place any type of effective program to prevent and/or detect violations of law at the time of the commission of the offense?
7. Did the organization, prior to any government investigation or threat of disclosure of the offense, promptly report the offense to the appropriate governmental authorities, cooperate with the investigation and clearly demonstrate an acceptance of responsibility for its criminal conduct?

An affirmative finding by the court as to the last two factors, can, under most circumstances, result in a more lenient sentence for the corporate defendant. It should be noted, therefore, that the implementation of a serious and aggressive audit system such as that required by SAS 82 can provide an effective means to demonstrate an organization’s commitment to preventing and detecting fraud and perhaps reduce any future criminal liability on the part of the organization should it find itself in that situation.

ATTACHMENT A FOLLOWS:

ATTACHMENT A:
FACSIMILE OF INDICTMENT OF ARTHUR ANDERSEN, LLP

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UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF TEXAS

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UNITED STATES OF AMERICA,	**I N D I C T M E N T**
- against -	**Criminal No. H-02-121**
ARTHUR ANDERSEN, LLP,	
Defendant.	**T.18, U.S.C., §§ 1512(b)(2) and 3551 *et seq*.**

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THE GRAND JURY CHARGES:

I. <u>ANDERSEN AND ENRON</u>

1. ARTHUR ANDERSEN, LLP (“ANDERSEN”), is a partnership that performs, among other things, accounting and consulting services for clients that operate businesses throughout the United States and the world. ANDERSEN is one of the so-called “Big Five” accounting firms in the United States. ANDERSEN has its headquarters in Chicago, Illinois, and maintains offices throughout the world, including in Houston, Texas.

2. Enron Corp. (“Enron”) was an Oregon corporation with its principal place of business in Houston, Texas. For most of 2001, Enron was considered the seventh largest corporation in the United States based on its reported revenues. In the previous ten years, Enron had evolved from a regional natural gas provider to, among other things, a trader of natural gas, electricity and other commodities, with retail operations in energy and other products.

3. For the past 16 years, up until it filed for bankruptcy in December 2001, Enron retained ANDERSEN to be its auditor. Enron was one of ANDERSEN’s largest clients

worldwide, and became ANDERSEN'S largest client in ANDERSEN's Gulf Coast region. ANDERSEN earned tens of millions of dollars from Enron in annual auditing and other fees.

4. ANDERSEN performed both internal and external auditing work for Enron mainly in Houston, Texas. ANDERSEN established within Enron's offices in Houston a work space for the ANDERSEN team that had primary responsibility for performing audit work for Enron. In addition to Houston, ANDERSEN personnel performed work for Enron in, among other locations, Chicago, Illinois, Portland, Oregon, and London, England.

II. THE ANTICIPATION OF LITIGATION AGAINST ENRON AND ANDERSEN

5. In the summer and fall of 2001, a series of significant developments led to ANDERSEN'S foreseeing imminent civil litigation against, and government investigations of, Enron and ANDERSEN.

6. On or about October 16, 2001, Enron issued a press release announcing a $618 million net loss for the third quarter of 2001. That same day, but not as part of the press release, Enron announced to analysts that it would reduce shareholder equity by approximately $1.2 billion. The market reacted immediately and the stock price of Enron shares plummeted.

7. The Securities and Exchange Commission ("SEC"), which investigates possible violations of the federal securities laws, opened an inquiry into Enron the very next day, requesting in writing information from Enron.

8. In addition to the negative financial information disclosed by Enron to the public and to analysts on October 16, 2001, ANDERSEN was aware by this time of additional significant facts unknown to the public.

> The approximately $1.2 billion reduction in shareholder equity disclosed to analysts on October 16, 2001, was necessitated by ANDERSEN and Enron having previously improperly categorized hundreds of millions of dollars as an *increase*, rather than a *decrease*, to Enron shareholder equity.
>
> The Enron October 16, 2001, press release characterized numerous charges against income for the third quarter as "non-recurring" even though

ANDERSEN believed the company did not have a basis for concluding that the charges would in fact be non-recurring. Indeed, ANDERSEN advised Enron against using that term, and documented its objections internally in the event of litigation, but did not report its objections or otherwise take steps to cure the public statement.

ANDERSEN was put on direct notice of the allegations of Sherron Watkins, a current Enron employee and former ANDERSEN employee, regarding possible fraud and other improprieties at Enron, and in particular, Enron's use of off-balance-sheet "special purpose entities" that enabled the company to camouflage the true financial condition of the company. Watkins had reported her concerns to a partner at ANDERSEN, who thereafter disseminated them within ANDERSEN, including to the team working on the Enron audit. In addition, the team had received warnings about possible undisclosed side-agreements at Enron.

The ANDERSEN team handling the Enron audit directly contravened the accounting methodology approved by ANDERSEN's own specialists working in its Professional Standards Group. In opposition to the views of its own experts, the ANDERSEN auditors had advised Enron in the spring of 2001 that it could use a favorable accounting method for its "special purpose entities."

In 2000, an internal review conducted by senior management within ANDERSEN had evaluated the ANDERSEN team assigned to audit Enron and rated the team as only a "2" on a scale of one to five, with five being the highest rating.

On or about October 9, 2001, correctly anticipating litigation and government investigations, ANDERSEN, which had an internal department of lawyers for routine legal matters, retrained an experienced New York law firm to handle future Enron-related litigation.

III. <u>THE WHOLESALE DESTRUCTION OF DOCUMENTS BY ANDERSEN</u>

9. By Friday, October 19, 2001, Enron alerted the ANDERSEN audit team that the SEC had begun an inquiry regarding the Enron "special purpose entities" and the involvement of Enron's Chief Financial Officer. The next morning, an emergency conference call among high-level ANDERSEN management was convened to address the SEC inquiry. During the call, it was decided that documentation that could assist Enron in responding to the SEC was to be assembled by the ANDERSEN auditors.

10. After spending Monday, October 22, 2001 at Enron, ANDERSEN partners assigned to the Enron engagement team launched on October 23, 2001, a wholesale destruction of documents at ANDERSEN's offices in Houston, Texas. ANDERSEN personnel were called to urgent and mandatory meetings. Instead of being advised to preserve documentation so as to assist Enron and the SEC, ANDERSEN employees on the Enron engagement team were instructed by ANDERSEN partners and others to destroy immediately documentation relating to Enron, and told to work overtime if necessary to accomplish the destruction. During the next few weeks, an unparalleled initiative was undertaken to shred physical documentation and delete computer files. Tons of paper relating to the Enron audit were promptly shredded as part of the orchestrated document destruction. The shredder at the ANDERSEN office at the Enron building was used virtually constantly and, to handle the overload, dozens of large trunks filled with Enron documents were sent to ANDERSEN's main Houston office to be shredded. A systematic effort was also undertaken and carried out to purge the computer hard-drives and E-mail system of Enron-related files.

11. In addition to shredding and deleting documents in Houston, Texas, instructions were given to ANDERSEN personnel working on Enron audit matters in Portland, Oregon, Chicago, Illinois, and London, England, to make sure that Enron documents were destroyed there as well. Indeed, in London, a coordinated effort by ANDERSEN partners and others, similar to the initiative undertaken in Houston, was put into place to destroy Enron-related documents within days of notice of the SEC inquiry. Enron-related documents also were destroyed by ANDERSEN partners in Chicago.

12. On or about November 8, 2001, the SEC served ANDERSEN with the anticipated subpoena relating to its work for Enron. In response, members of the ANDERSEN team on the Enron audit were alerted finally that there could be "no more shredding" because the firm had been "officially served" for documents.

THE CHARGE: OBSTRUCTION OF JUSTICE

13. On or about and between October 10, 2001, and November 9, 2001, within the Southern District of Texas and elsewhere, including Chicago, Illinois, Portland, Oregon, and London, England, ANDERSEN, through its partners and others, did knowingly, intentionally and corruptly persuade and attempt to persuade other persons, to wit: ANDERSEN employees, with intent to cause and induce such persons to (a) withhold records, documents and other objects from official proceedings, namely: regulatory and criminal proceedings and investigations, and (b) alter, destroy, mutilate and conceal objects with intent to impair the objects' integrity and availability for use in such official proceedings.

(Title 18, United States Code, Sections 1512(b)(2) and 3551, *et seq*.).

A TRUE BILL
.....................*-S-*.......................
FOREPERSON

JOSHUA R. HOCHBERG
ACTING UNITED STATES ATTORNEY
SOUTHERN DISTRICT OF TEXAS

LESLIE R. CALDWELL
DIRECTOR, ENRON TASK FORCE

BY: *- S -*
Samuel W. Buell
Andrew Weissmann
Special Attorneys
Department of Justice

<u>Section 7</u>

Appointments as Special Master & Receiverships

Ralph S. Janvey, JD
Krage & Janvey, LLP
Dallas, Texas

APPOINTMENTS AS SPECIAL MASTER

AND

RECEIVERSHIPS

UNDERSTANDING & CONTROLLING BUSINESS FRAUD: ACCOUNTING & LEGAL ISSUES

AUGUST 21, 2002

RALPH S. JANVEY

KRAGE & JANVEY, L.L.P.
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APPOINTMENTS AS SPECIAL MASTER

AND

RECEIVERSHIPS

POWERS/DUTIES

Affirmative Duties

Identify and collect assets

Value tangible and intangible assets including:

Illiquid, emerging market assets

Potential assets in foreign jurisdictions with secrecy laws

Foreign judgments or arbitration awards

Potential legal claims held by the estate

Pursue uncollected assets

Identify claims against the assets

Investigate and determine potentially unique claims

Defend and settle claims against the estate

Recommend a distribution method

Distribute assets

Implied Duties

Explaining process to investors

Buffering correspondence from investors

Controlling access to documents

Deciding when attempts at collection are not in the best interests of the investors

Limits on Powers

Role

Protect assets v. investigate defendant

CAVEAT-Identifying assets through analyzing the flow of funds is similar to investigating defendant

Language of order appointing Special Master

Duties which are affirmatively addressed

Duties which are implied

Type of Order appointing Special Master

Agreed Orders limit abilities

Limited case law

Most case law addresses powers of Receivers not Special Masters

Conflicting Duties

Allowing access by outsiders to value claims versus assisting them with pursuing claims against the estate

Who does the Special Master represent?

The Company? The officers? The assets only?

The U.S. Supreme Court in Commodity Futures Trading Commission v. Weintraub in 1985 held that

> "… the trustee of a corporation in bankruptcy has the power to waive the corporation's attorney-client privilege with respect to pre-bankruptcy communications"

PARTIES INVOLVED

<u>SEC Investigators</u>

<u>Defendants</u>

<u>Relief Defendants</u>

<u>Investors</u>

Assisting/avenging investors
(parties involved, addresses, flows of information, newspaper articles)

"I'm Special" investors

Visiting investors

<u>Auditors/Accountants/Consultants</u>

<u>Legal Counsel</u>

To the "I'm Special" investors

To various groups of investors

To individual defendants

To defendant companies

To possible defendants (former employees or affiliates)

To foreign entities or persons which may be Relief Defendants, asset custodians, fellow asset creditors or are linked to defendants in some way

<u>Attorney General</u>

Asset Custodians

Prior custodians

Special Master’s custodian

Custodians which hold participated or partial interests in the assets

Creditors

CIVIL AND CRIMINAL IMPLICATIONS

The Defendant Can't Help

The defendants can't assist in evaluating cash flow analyses, asset settlements, or claims w/o violating the 5th amendment

High Risk of Creating Additional Claims Against the Estate

Allowing access to the documents might encourage development of additional claims against the state resulting in reduced funds available for distribution to the investors

Potential Criminal Liability Inhibits Fact Finding

MANAGING THE ESTATE

Determine the Hidden Players

- Interviews with the SEC and state investigators
- Interviews with defense counsel
- Interviews with prior asset custodians
- Interviews with prior employees
- Review documents

Obtain an Asset Custodian

- Interview prior custodians
  - Review potential criminal liability
  - Review potential conflicts
    - Dealings with defendants
    - Interest in assets-incentive to liquidate at low prices
- Compare bids
- Consider specialized expertise in certain markets

Obtain Accounting Expertise Immediately

Solicit bids

Check conflicts

Predetermine the level of expertise and hourly rate of consultants

Discuss acceptable administrative costs of secretaries, copies, faxes, travel, etc.

Obtain Control Over Documents and Computers

Beware possible difficulties caused by defendant's possession

Timeliness of turn over of documents

Who pays for copying hundreds of boxes?

Redacted documents

Retention of "attorney-client" privileged documents-

Research computer files

Determine passwords

Determine value of and search files in unknown software programs.

Review requests for and supervise access to documents

By investors, "I'm Special" claimants, the SEC, criminal authorities, litigants, etc.

Interview and Retain a Good Translator if Necessary

Check that the translator does not "interpret" your documents but translates word for word

Compare prices

Identify the Assets

Review hundreds of documents page by page for indications of possible assets and asset custodians

Establish authority as Special Master with all potential financial custodians

Demand information on all current and past assets

Determine ownership of assets in apparently related entities

Obtain foreign counsel and request assistance of foreign governments where necessary

Value the Assets

Obtain bids for hard to value assets

Review strength of litigation claims both foreign and domestic

Interview specialists re: likelihood of collection on litigation claims and foreign assets both tangible and intangible

Review economic and social factors impacting the value of emerging markets type assets

Pursue the Assets

File litigation/arbitration claims where necessary

Contact foreign authorities to request information re: foreign accounts

Interview employees of defendant entities re: possible hidden assets and the uniqueness of special investor claims

Preserve the Assets

Periodically value the assets

Review the appropriateness of liquidation to preserve value of the assets

Liquidate assets where appropriate

Asset Settlements

Research "I'm Special" factual and legal claims

File responsive motions re: attempts to intervene and motions requesting premature or preferential distributions of assets

Enter into settlement negotiations where appropriate

Find the Investors

Recreate investor lists from partial, hidden, or cumulative lists

Update addresses and claims by reviewing investor correspondence

Value the Investors' Claims

Review account statements to establish claims

Determine how to value claims-Are account statements accurate?

Determine if any investors assisted with fraud-Is reduction of claim appropriate?

Determine the existence of varying types of claims

Deal With the Media

Respond to newspaper and TV reporters' questions and sometimes false reports

Respond to investors' concerns regarding misleading reports of released assets or claims that all monies will be repaid

Report on Findings and Recommendations

File report on assets found with the Court

Periodically update value estimates on assets

File a report on claims against and updated value of the assets

Value and prioritize claims

Prepare recommendations regarding preserving assets including sales of assets

Prepare distribution recommendation for Court

Obtain comments on recommendations by all parties

File responses to recommendations filed by other parties with the Court

Communicate with Investors

Draft and translate a letter to investors each time a report is filed

Obtain approval of investor letters by all parties

Mail hundreds of letters to investors

Review floods of correspondence from investors with supporting documentation

Interview investors that request in person meetings

Answer investor concerns and requests for monthly updates over the telephone, by fax and by e-mail

Review assertions that claims are misrepresented

Distribute the Assets

Prepare pro rata distributions and deliver to all investors

Respond to claims against the estate regarding unfair distributions

Monitor assets that pay as annuities and distribute periodically

Monitor assets until liquidated and distributed