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Audit detectives walking the beat at accountancies

Two Canadian firms have placed forensic investigators on their audit teams to screen clients for fraud risk.

By BEPPI CROSARIOL

In what might be described as the corporate governance equivalent of an airport metal detector, at least two Canadian accounting firms have begun placing forensic investigators on regular audit teams to screen clients for fraud risk -- before any specific wrongdoing is suspected.

The pre-emptive measure, encouraged by new accounting standards aimed at safeguarding against Enron Corp.-style abuses, indicates how far the industry is prepared to go to restore confidence in the public markets, and how urgently it wants to minimize its own liability in the new, high-anxiety world of public accounting.

"We think that this helps us better evaluate the risk of these things happening," says James Hunter, president of **KPMG Forensic**, a service area of the accounting firm's Canadian operations. "Frankly, we also think it helps us manage KPMG's risk in terms of what society expects of an auditor of a large entity."

So far, KPMG, which dubs its initiative Forensic in the Audit, has recently included numbercrunching sleuths on "six or seven" audit files in Canada, Mr. Hunter says, and he expects that number to grow considerably with the 2005 reporting year.

Also embracing the practice is **Deloitte & Touche LLP**, which calls its program Forensic Audit Assist.

The Canadian rollout at KPMG follows a similar program by the accounting giant in the United States, where it has used forensic specialists to help assure the integrity of about 400 audits.

Similar to the forensic detectives who assist police in linking crime-scene evidence with suspected criminals, forensic accountants belong to a special branch of the profession, highly trained in identifying suspicious money transfers and dubious accounting practices, such as late-night journal entries.

They're also well-versed in shoot-from-the-hip, detective-style interview techniques.

"If I say to the chair of the audit committee, 'Can you tell me -- I'm looking at you face-to-face -- that you believe in the integrity of the CEO and the CFO?' it's easy for somebody like me to ask that question, maybe a little bit more sensitive for the audit partners," Mr. Hunter says.

Besides grilling audit committee members and senior managers such as chief executive and chief financial officers about their responsibilities and perceived weaknesses in the reporting chain, forensic accountants might request key documents that can provide clues of nefarious activity, such as proxy statements, which often contain conflicts-of-interest declarations, and end-of-year journal entries, where doctored numbers are often found.

They will also often examine management's commitment to company conflict-of-interest policies and promoting anonymous whistle blower telephone hotlines mandated in some jurisdictions, Mr. Hunter says.

John Carchrae, chief accountant with the Ontario Securities Commission, says he welcomes any move that might add rigour to the auditing process.

“Nothing is, I think, going to guarantee their ability to detect fraud, but there are good steps that can be taken that can improve the chances,” he says. “Adding the mindset of a properly trained forensic accountant to an audit can only be, in my view, a positive development.”

Mr. Hunter stresses that the forensic partner’s role in the audit is intended to be diagnostic rather than investigative, like the difference between airport security procedures and a police investigation.

No criminal or regulatory penalty would ensue if a company failed the test. Rather, if investigators turn up something questionable, sanctions would fall into a range of categories, he says.

In minor cases, where the forensic accountant simply feels less than comfortable about the overall audit, it could lead to a qualified audit report, in which the auditor would back the numbers subject to the proviso that, for example, the accounts receivables had been fairly stated -- an uncommon measure not likely to inspire confidence among investors.

In extreme cases, KPMG could withdraw from signing off on the financial statements altogether.

“That is not a good thing,” Mr. Hunter says. “That is very, very serious.”

Deciding which clients will get the Sherlock Holmes treatment is a case-by-case matter. At KPMG, the criteria are several, such as whether the client is considered high risk; is new to the audit firm; was the subject of “regulatory attention” in the previous 12 months; or has been the subject of an independent investigation. “There’s an exercise of judgment because it’s something new,” Mr. Hunter says.

So far, Canada’s other Big Four accounting firms, **PricewaterhouseCoopers LLP** and **Ernst & Young**, say they have yet to institute a similar practice, although they will dispatch forensic specialists in cases of suspected fraud.

“We only do it when, as a result of our work, we think there is an issue,” says Laurie Woodruff, audit leader for Canada at PwC.

The initiatives by KPMG and Deloitte come partly as a result of new generally accepted accounting standards adopted by both the Canadian Institute of Chartered Accountants and the American Institute of Certified Public Accountants. Those standards essentially place auditors on notice that fraud may take place and that reasonable steps should be taken to satisfy themselves it does not, says Derek Rostant, chairman of the alliance for Excellence in Investigative and Forensic Accounting, a board of the CICA.

Mr. Hunter says the cost of the added forensic audit work, usually carried out by one senior forensic partner plus a few staff, amounts to a relatively minuscule component of the overall audit.

Despite the potential stigma of having an investigator on board, Mr. Hunter says so far KPMG has met no resistance to the practice.

“If I’m a member of an audit committee, I want to be pretty sure that the auditors are having a pretty good look at these things,” he says. “I think if they objected, we’d have to consider pretty seriously are we going to do the audit.”