

THE FRAUD BEAT

A fraudster is nipped in the bud.

The Quarter-Million-Dollar Caper

BY JOSEPH T. WELLS

Let's face it—conducting a routine audit of a good, stable client can be boring and repetitive. Every year seems much like the last: tracing and vouching, reconciling, ticking and footing, examining documents and ledgers, evaluating controls. But despite the humdrum, good auditors are always on the lookout for abnormalities. The following case study reveals how alert auditors uncovered a fraud and, by behaving with professional integrity, turned a potentially bad situation into a positive one.

THIS DOESN'T COMPUTE

An auditor for a Canadian firm in Westmont, Quebec, was performing an audit procedure at a client's business when she came across something that made no sense. It involved comparing the aged accounts-receivable list with the current month's sales. Except for normal reconciling items such as cash sales, freight and insurance charges, the amount sold should equal that month's charges to accounts receivable.

$$(\text{Total sales for month} + \text{sales taxes} + \text{freight charges}) - (\text{Cash sales} + \text{payments on current accounts receivable during month} + \text{sales returns and allowances}) = \text{Current accounts receivable}$$

When she found the total reflected on current accounts receivable was higher than sales by nearly \$250,000, she called the audit partner, Philip C. Levi, CPA, of Levi Katz, Montreal, who talked to us about his handling of the investigation.

Levi, an experienced certified fraud examiner, quickly discovered entries that alerted him to a possible problem: charge-backs on two different delinquent customer accounts. The net effect of the two entries was to simultaneously debit and credit the accounts-receivable subsidiary ledgers, which removed the customer charges from the 90-day aging column and reinstated the amounts as current. That was the reason why there was a \$250,000 discrepancy.

Fraud Theory Approach

All fraud cases can be resolved by following five steps.

- Examine or audit available documentation.
- Develop fraud theory based on one of the three types of fraud:
 - Asset misappropriation.
 - Corruption.
 - Fraudulent financial statement.
- Seek additional documentation to support theory.
- Confirm theory through interviews of potential witnesses.
- Confront suspect(s).

Source: *Corporate Fraud Handbook* by Joseph T. Wells, Wiley Publishing, Paterson, New Jersey, 2004.

DEVELOPING A FRAUD THEORY

Levi was concerned. Why, he wondered, would the client be motivated to restate these two delinquent accounts as current? The business, an importer and distributor, was a closely held family enterprise. Using generally accepted fraud examination techniques, Levi applied the fraud theory approach to see whether he could solve the mystery.

One possibility was that the charges in question were uncollectable. But he quickly discarded that theory; the amounts had been subsequently paid in full. Next, Levi reasoned that since the business was not public and the amounts involved did not affect profits or taxes, the overstatement of current receivables might have been done to satisfy the collateral requirements of a lender. Levi examined the client's bank loan documentation. Sure enough, the line of credit was limited to 80% of the company's receivables that were less than 90 days old. Had the accounts-receivable aging been stated correctly, the company probably would have been pressured by the bank to come up with money to correct the default. The client's cash position reflected that it did not have the funds to pay down the loan.

A 1999 COSO study of 200 financial statement fraud cases found that the CEO and/or CFO were involved at least 83% of the time. "In this case the charge-backs were actually made by a clerical employee," Levi said. "However, it made sense the clerk was acting on orders from upper management. Because the CEO was on vacation at the time of the charge-backs, I theorized that Tim, the CFO, was the one who had authorized the transactions. The clerk confirmed this."

When the CEO returned to the office, Levi interviewed him to determine whether he had any involvement in the scheme. "It was clear he was shocked at what the CFO had done," Levi said.

RESOURCES

AICPA Resources

Books

CPA's Handbook of Fraud and Commercial Crime Prevention (# 56504JA).
Financial Reporting Fraud: A Practical Guide to Detection and Internal Control (# 029879JA).
Fraud Detection in a GAAS Audit (# 006615JA).

CPE

Introduction to Fraud Examination and Criminal Behavior (# 730275JA).
Identifying Fraudulent Financial Transactions (# 730244JA).
Finding the Truth: Effective Techniques for Interview and Communication (# 730164JA).

For more information, to register or to place an order, go to www.cpa2biz.com or call the Institute at 888-777-7077.

AICPA Antifraud Initiatives

Antifraud and Corporate Responsibility Resource Center,
www.aicpa.org/antifraud.

SAS no. 99 information.
Management Antifraud Programs and Controls (SAS no. 99 exhibit).
Fraud Specialist Competency Model.
Free corporate fraud prevention training and CPE.
Academia outreach and assistance.
Other antifraud activities.

CONFRONTING THE SUSPECT

Before interviewing the CFO, Levi consulted the client's legal representative to ensure both the company and he were on solid footing to avoid any exposure to legal action by the CFO. Experienced in fraud examination and interviewing techniques, Levi made sure he would violate no individual rights. He brought a draft resignation letter to the meeting in the event the CFO was prepared to come clean and resign, and a second letter signed by the CEO that terminated the CFO immediately. Both letters had been drafted by the company's lawyer.

Armed with documentation and his suspicions, Levi interviewed the CFO. He conducted it by the book, questioning the CFO in private. "If you question someone in the presence of others, getting an admission can be very difficult," Levi said. Rather than ask *whether* Tim had authorized the charge-backs, Levi asked him *why* he had authorized them.

“When you are reasonably convinced someone has done something wrong, you need to persuade the suspect you know all of the facts—whether you do or not,” Levi said. “Otherwise, the person has the natural instinct to deny involvement. And once someone lies to you, it becomes harder for him or her to reverse course and tell the truth. If the person is innocent, you’ll know that immediately by his or her reaction. Innocent people who are accused of something will be vehement in their denials.”

The tactic worked with Tim. He readily admitted that he’d authorized the false charge-backs in order to avoid defaulting on the bank’s margin requirements. And he confirmed that upper management knew nothing about it. The CFO said he had decided to “fix the problem himself.” He knew the two customers would pay, which they had, so he didn’t see it as a big problem.

But the veteran CPA saw the matter in an entirely different light. The CFO had attempted to defraud the bank by submitting doctored accounts. Levi knew that most financial statement frauds start out small but don’t stay that way. If corrective action was not taken immediately, frauds at the company could quickly get out of hand.

Although the bank was not his client, Levi felt he could not sit on the knowledge. The easy thing would have been for him to resign from the engagement. Instead, he convinced the CEO to inform the bank. With a great deal of trepidation, the client finally agreed to tell the bank, and Tim was fired.

COMING CLEAN

Before contacting the financial institution, Levi and his staff performed additional testing on the aged accounts-receivable listings that had been submitted to the bank for the past 12 months to ensure there were no additional false statements sitting in the bank’s files with the CFO’s signature; there were none.

Levi next set up a meeting with the client and the bank. “I felt it was necessary to be proactive in this situation. Since the false documentation already had been submitted to the bank, there was the possibility the bank would discover it and lose faith in the client’s integrity. That would have been disastrous,” Levi said. At the meeting the CPA explained to the banker what had happened. “The bank officer was flabbergasted—and impressed. He said that in his entire career, no one ever had taken the initiative to come forward and admit wrongdoing simply because it was the right thing to do. The result was that the relationship between the client and the bank became stronger than ever.”

Because the audit partner had drawn from his experience and acted on his suspicions (as had the auditor who called him after she had become suspicious), he was able to uncover a fraud—and help his client turn what could have been a failed banking relationship into a stronger one based on uncommon respect. ■

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