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Second EDITION



CASE STUDIES

in Forensic Accounting and Fraud Auditing

CRUMBLEY | LaGRAIZE | PETERS



Wolters Kluwer

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CASE STUDIES

in Forensic Accounting and Fraud Auditing 2nd Edition

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Preface

Willis Emmons, Senior Lecturer at the Harvard Business School, states that there are three levels of learning from using the case method to teach:

- **Level One:** Transmittal of information, concepts, frameworks, tools, and techniques.
- **Level Two:** Development of capabilities with respect to analysis, critical thinking/judgment, decision-making, and execution.
- **Level Three:** Development of values, self-awareness, leadership, temperament, and capacity for on-going learning.

Case Studies in Forensic Accounting and Fraud Auditing, 2nd edition, will reach these three levels of learning by bringing together in a single volume a number of short, medium, and longer case studies covering the broad approach to forensic and investigative accounting. These cases have been prepared by a variety of academic and practitioner authors. This book can be used as a supplement to any of the forensic accounting or fraud examination textbooks on the market. Or it could be used as a stand-alone text by an instructor who has extensive power point slides or prefers not to use a textbook. Auditing professors should find these cases to be helpful in an auditing or ethics class.

The use of case studies is a form of the scenario principle. A “scenario” presents information using characters performing activities in a specialized setting. Previous research indicates that applications of the scenario principle enhances students’ communication and interpersonal skills, stimulates students’ creativity, and enables instructors to improve their teaching performance. These benefits are due to the fact that students are either reading about or portraying characters interacting, formulating solutions to dilemmas, putting textbook information into practice and, hopefully, enjoying the process.

The cases in this second edition have been improved and include the following new cases:

- Is the Current Use of Impression Management by Professors in the Classroom Similar to Earnings Management by Corporate Executives?
- Is the Widespread Use of Test Banks by Students Fraud?
- Fighting International Fraud with the FCPA
- Consideration of Fraud in a Financial Statement Audit
- The Valuation of Economic Damages
- Adding Mathematical Statistics to the Auditor’s Tool Box
- Green Tech Manufacturing: Fraud and the Independent Auditor
- The Fraud at High Flying Corporation: Developing Audit Interview Skills

- Uncovering Majority Shareholder Fraud in a Closely Held Corporation: A Case Study to Develop Forensic/Tax Investigation Skills
- Diamond Foods' Payments to Nut Growers
- The Dixon City Embezzlement: A Rita Crundwell Story
- Mani/Pedi? Credit Cards Not Accepted
- Exclusive Restaurant or a Front for Illegal Gambling

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A frequent contributor to the forensic accounting literature, Professor Crumbley is an author of more than 60 books and 370 articles. His latest book entitled *Forensic and Investigative Accounting*, 7th edition, is published by Wolters Kluwer (900-224-7477). Some of his 13 educational novels, e.g., *Trap Doors* and *Trojan Horses* and *The Big R: A Forensic Accounting Action Adventure*, have as the main character a forensic accountant. His goal is to create a television series based upon the exciting life of a forensic accountant and litigation consultant. dcrumbl@lsu.edu

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CASE STUDY 1:

What Is A One Cent Error Worth?

Dr. Donald L. Ariail, CPA, CFF, CGMA, CVA
Kennesaw State University

LEARNING OBJECTIVES

After completing and discussing this case, you should be able to:

- Appreciate the value of bank reconciliations.
- Understand that materiality is not important in a fraud investigation.
- Understand the purpose of a proper cut-off date.

A bar/restaurant that an accounting firm serviced for a number of years (compiling quarterly financial statements and preparing the annual tax returns) was audited by the IRS with an audit that was not a regular field audit. This Taxpayer Compliance Measurement Program (TCMP) audit (United States General Accounting Office, 1994) is now called the National Research Program (NRP; Department of the Treasury, Internal Revenue Service, 2005) and is used by the IRS to develop the statistical basis for selecting audit targets. This type of examination checks everything—including every number and every other representation (such as proof of incorporation, stock ownership, and citizenship).

After working on the audit for about a week, the IRS agent gave the CPA partner a list of questions which included a request to explain a one cent error in the bank reconciliation for the prior year-end (the compiled financial statements for the first quarter of the current year had not yet been prepared). When the accountant looked at the reconciliation, he saw that a staff accountant had reconciled the account and that the “checker,” a CPA with 30 plus years of experience, had “passed” the reconciliation even though it was out of balance by one cent. He had written “Passed—Immaterial” on the reconciliation.

So the partner stayed at the office late that night and re-reconciled the account. What he found was disturbing and cost him his first and only IRS penalty for which he was (in 34 years of practice) responsible. How can a one cent error cause an IRS penalty? Is it not immaterial?

CASE STUDY 2:

That Trusted Employee

D. Larry Crumbley, Ph.D., CPA, CFF, Cr.FA
Louisiana State University

LEARNING OBJECTIVES

After completing and discussing this case, you should be able to:

- Appreciate the importance of skepticism with respect to employees.
- Understand the importance of segregation of duties.
- Appreciate the importance of reconciliation of bank statements.

Jim Aaron owned a successful energy service company in Baton Rouge, Louisiana for 14 years. Stacy Oxner helps Mr. Aaron with his recordkeeping. Mr. Aaron considers Stacy to be a trusted employee, having worked for him for eleven years. She has worked long hours, often coming in early and working late. She is an excellent employee.

Stacy had to go to the hospital for a hip replacement. While Stacy was away from work the canceled checks came from the bank to Mr. Aaron's home. Feeling somewhat guilty for forcing Stacy to work such long hours, Mr. Aaron opens the bank envelope. He is surprised to find several large checks made out to Stacy: one for \$14,000, another for \$17,500, and a third one for \$11,300.

Mr. Aaron never signs blank checks. He does not have a check writing machine, and the signatures on these questionable checks are his signature. The signatures have not been forged.

How did this fraud occur? Discuss segregation of duties. Discuss opportunity in the fraud triangle with respect to this situation.

CASE STUDY 3:

Employee Fraud at Miami Rehabilitation Center

Jeffrey E. Michelman, Ph.D., CPA, CMA

University of North Florida

Bobby E. Waldrup, Ph.D., CPA

Loyola University

Alex Bird, MBA, CPA, CIA

Wells Fargo

LEARNING OBJECTIVES

After completing and discussing this case, you should be able to

- Understand investigative accounting where forensic data is scarce.
- Learn how to find missing cash.
- Recognize the importance of bank statements.
- Understand the importance of internal controls in a small business.
- Learn about the fraud triangle.

INTRODUCTION

Juan Martinez sat motionless in his small office and reflected on the day's events. By this time, the police were long gone. The police officer remarked that, without a confession, they really had no valid reason to arrest anyone. There were so many signs, and Juan had been certain that the police would be able to resolve the issue of the missing \$1,400. Juan continued to rehash the recent events in his mind. He could not understand how things had gone wrong. He was heartbroken. He had always approached his employees like they were family. How could any of them have stolen from him?

It was almost 10:00 pm on Friday, November 22, 2009, and Juan was nowhere closer to fully understanding or solving the theft. After all the decisions that Juan had made relative to his business, he still had no clue what to do next. Was this problem merely a discrepancy due to sloppy bookkeeping, or did he have a bigger problem of fraud in his organization? As he gathered his thoughts and began to reflect on the company's history and how he had gotten to this point, he wondered what to do next. How would he tell his wife that he didn't have any answers? The business represented their children's future.

He called his wife.

Juan: Isabella, I can't determine what happened to the missing \$1,400. I'm really angry that I didn't do something to avoid this.

Isabella: Juan, when are you coming home? I know you must be extremely tired. I'm certain that we will get this resolved. Please come home.

Juan: I am going to stay a little longer. I'll be home in a little while.

THE COMPANY'S HISTORY

Juan remembered how he and four other physical therapists had started the original company in 1994. It was a very exciting time, and everyone was thinking about the company's potential. The five physical therapists decided to name the company Miami Rehabilitation Services (MRS). The company was located in Miami, Florida and began in one office with five owners. During the next eight years, MRS grew steadily as the demand for physical therapy had grown. Juan reflected on all the conversations he had with his business partners about other healthcare providers that had been covered by the local press when they encountered difficulty and even fraud.

Juan felt strongly that one reason why MRS had a good reputation was the way they treated their patients. MRS had also developed a good reputation among insurance companies, HMOs, and local attorneys who referred patients from motor vehicle accidents, personal injury cases, and workers' compensation cases. Juan thought for a moment about these third-party payers. During 2008, third-party payers represented about 90 percent of Miami's annual revenues of nearly \$1 million. These were the good times Juan was remembering. From 1994 until 2002, Juan and his partners expanded the business to seven locations. Juan even remembered all the attorney meetings when they separated the business into three corporations. The business had gotten so large he and his partners wanted to limit their liability.

In 2002, Juan and his partners took advantage of an opportunity to sell their business to the U.S. subsidiary of a publicly owned Canadian health care company called Canada Health. The opportunity provided the partners with cash from the sale, and the sale also allowed the partners to continue their physical therapy activity. For his part, Juan agreed to manage the Miami operations as a regional vice president. To take advantage of their brand recognition, the name of the business was maintained as Miami Rehabilitation Services.

Canada Health owned and operated numerous nursing homes, assisted living centers, and other health care providers in the United States and Canada. In 2005, Canada Health began to experience losses in the United States. The company's difficulty had stemmed from operational problems, Medicare and Medicaid

reimbursement declines, and liability issues. Juan could definitely relate. At that point, Juan and one of his partners were able to repurchase the business. Juan bought two locations, and Don Smith bought one location. They closed the remaining locations. This time, each individual purchased their locations separately. However, they again retained the trade name, Miami Rehabilitation Services.

Juan thought about how problems were always arising in the billing and collection side of the business. These problems were the reason he and Don decided to establish a separate company to handle these functions. As he thought back on it, he remembered the frustration that he had experienced each year as the third-party payers had reduced reimbursement for physical therapy services, while at the same time the claims filing process continued to become more complicated. Estimating revenues became increasingly difficult. Juan and Don decided that they would create a separate billing company to handle the reimbursement for their three clinics. They had named it MS Billing (MSB). The ownership was 50/50. Juan had felt that MSB would be able to focus more closely on collections and reimbursement with the third-party payers. Later in 2007, Juan closed one of his two locations. MSB's office was then located within walking distance to Juan's remaining MRS location.

THE NEW EMPLOYEE AND THE DISCOVERY

Juan considered how Canada Health had run into trouble and several of the recent bankruptcies of healthcare providers that he had heard about from his physician friends. Juan felt he was now in a similar position. For Juan, the big issue was survival in a business where the healthcare provider was being squeezed out by the third-party payers. By 2007, payments from the third-party payers represented nearly all of the company's revenue. Juan did not like the payment percentages they were receiving from these third parties, but he had to accept it. The percentages were very inconsistent. In September 2009, he hired a new employee to work part-time as a second accounts receivable coordinator. After a few weeks on the job, Angelita López approached Juan because something didn't seem right.

Angelita: Juan, I offered to pick up the mail and receipts from the two physical therapy clinics, but Helen said it was on her way home, and she liked doing it. She seemed adamant that she would do it herself.

Juan: That is interesting. Helen has always been a good employee, and I am sure she is just trying to be helpful. However, if I recall that job was assigned to María Vega, my office manager.

Juan was wondering why he didn't act sooner when approached with his new employee's concern. Although he and Angelita started to look closer at the books and records after business hours, he wasn't able to put his finger on the problem. Juan spoke with Angelita a week later.

- Juan:** What you are finding scares me. Business has been really tough these past few years, and increasingly, I seem to have been spending less time managing the operations of the clinic and more time seeing patients. The office appeared to be running smoothly, so I didn't get involved.
- Angelita:** I am not sure yet what I have found, but if you give me a little time, I am happy to continue to investigate.
- Juan:** Yes, I think that would be good, but at this point, let's keep the investigation between us.

They had looked at the bank statements together, and there were a lot of inconsistencies. Some of the deposit slips were incomplete, and some were missing signatures. Together, they totaled some of the slips, and compared the bank copies with the office copies. They quickly noticed that the totals did not match. (See Exhibit 1). By quickly analyzing the difference between the two deposit slips in just this one situation, he started to get nervous. A quick comparison showed him just how bad this might be. (See Exhibit 2). Juan began to realize that there was very little control over the deposit slip books. The deposit slips were not sequentially numbered, and that was making it difficult to verify the deposit activity. Based on their efforts, Juan concluded that at least \$1,400 had been stolen. Juan was really angry with himself. He simply could not understand how the deposits could have been wrong, and why the office manager had not made the discovery. How was his newest employee able to develop this suspicion when he had practically been clueless? (See Exhibits 1 and 2).

Exhibit 1: Deposit Slips

Bank Copy

Florida Sun Bank
 WE BANK ON BUILDING DREAMS. IF TYPING: Signature required when cash is received. IF HAND WRITTEN: Stamp attached when cash is received.

Name and account number will be verified when presented.
 Name: *Miami Rehabilitation Services* Date: *3/19/09*
 Address: *4698 Pinecrest Avenue*
Miami, FL 33156

Signature: _____ Sign here only if cash is received from deposit.
 Store Number (Commercial Accounts Only): _____ Account Number (For CAP Accounts, use 10-digit number): _____

ITEMS DEPOSITED: Currency: *378.11*
 Coin: _____
 Checks: *1,014.05*
 1: _____
 2: _____
 Sub Total: *1,392.16*
 Less Cash: *0.*
 Total Deposit: *1,392.16*

* *089-002-969* * *199969282966* \$

0000 581133 (500mg) Rev 01/04/990002

Bank Copy
 Record of Checks for Deposit

Check	Dollars	Cents
8723	87	25
179	19	33
339	13	32
166934	359	69
962	32	35
769	99	01
666	103	10
Total This Slide		1,014.05

Office Copy

Florida Sun Bank
 WE BANK ON BUILDING DREAMS. IF TYPING: Signature required when cash is received. IF HAND WRITTEN: Stamp attached when cash is received.

Name and account number will be verified when presented.
 Name: *Miami Rehabilitation Services* Date: *3/19/2009*
 Address: *4698 Pine Crest Avenue*
Miami, FL 33156

Signature: _____ Sign here only if cash is received from deposit.
 Store Number (Commercial Accounts Only): _____ Account Number (For CAP Accounts, use 10-digit number): _____

ITEMS DEPOSITED: Currency: *428.11*
 Coin: _____
 Checks: *1,109.55*
 1: _____
 2: _____
 Sub Total: *1,537.66*
 Less Cash: *0.*
 Total Deposit: *1,537.66*

* *089-002-969* * *199969282966* \$

0000 581133 (500mg) Rev 01/04/990002

Office Copy
 Record of Checks for Deposit

Check	Dollars	Cents
8723	87	25
179	19	33
339	13	32
166934	359	69
962	32	35
322	20	00
1579	75	50
769	99	01
666	103	10
Total This Slide		1,109.55

Exhibit 2: Deposit Reconciliation					
Office Copy			Bank Copy		
	Amount			Amount	
Currency	\$428.11		Currency	\$378.11	
Checks			Checks		
8723	\$87.25		8723	\$87.25	
179	\$197.33		179	\$197.33	
339	\$135.32		339	\$135.32	
166934	\$359.69		166934	\$359.69	
962	\$32.35		962	\$32.35	
322	\$20.00		769	\$99.01	
1579	\$75.50		666	\$103.10	
769	\$99.01				
666	\$103.10				
Totals	\$1,537.66		Totals	\$1,392.16	

HELEN, THE ACCOUNTS RECEIVABLE COORDINATOR

Helen Fagan was MRS’s primary accounts receivable coordinator. Juan recalled that Helen was an employee that he and his partner had essentially inherited from one of their previous partners. She had worked for the organization since 1997. Except for one earlier period, around 2002, just after they split the practices, Juan remembered that Helen had complained to her coworkers about being underpaid, so he met with her and discussed the situation.

- Juan:

Helen, what is going on here? I have heard you complaining about your pay to others in the office. We discussed your compensation after the organization’s split, and you decided to stay with me. I felt that your compensation level was appropriate. You have always been a satisfactory employee, but your pay is set and talking with others isn’t going to raise it.
- Helen:

I know this was wrong, I really enjoy working here, but things have been really tight at home with medical expenses, you know.
- Juan:

I know that times are tough; they are for all of us, but if I hear you complaining again about your pay at work I will fire you on the spot. Are we clear?
- Helen:

Yes, Juan, I am really sorry. I really need this job; it will not happen again.

Helen got the message and stopped complaining. Around this time \$600 was stolen from the business in 2003. Juan had no idea who had committed the theft. However, there was one woman who was suspected. She quit the company because the suspicions were widely known. Juan recalled how the woman said, "You all are crazy for thinking that I stole that \$600." The scene created quite a commotion. Unfortunately, her resignation ended the inquiry.

Then there were the previous rumors about Helen's husband having a substance abuse problem. Her husband was a painter, and Juan also recalled that money was always an issue. Helen and her husband had three children. He thought about all her comments related to the oldest child's learning problems. She often spoke about his hyperactive behavior, and how they had tried several different schools. The second child had juvenile diabetes. He recalled the time that he had confronted her about her complaining. Juan always imagined how difficult that must have been. There were many occasions when Helen had to take time from work for the child's doctor visits. Juan thought about the fact that Helen, her husband, and their children lived with Helen's parents. She drove an old car, and she was always having money problems. She never seemed to be wearing any new clothes. This was despite the fact that he and his partner had paid periodic bonuses to their employees for obtaining certain business goals.

After he talked to her in 2002, Helen's attitude had improved and she received the bonuses when they were given out. If Helen had stolen the money, he could not figure out what she had done with it. He had never noticed any changes in Helen that would have tipped him to the fact that she was stealing money. It just did not make sense that she could have been the perpetrator.

Juan considered the tasks that Helen performed on a daily basis. She collected the mail from the post office box, opened the mail, and collected the patients' co-payments from the two physical therapy clinics. Helen also posted the payments into the patient account computer software system. He knew that these payments included both cash and checks. He also knew that she totaled the payments received from the clinics and through the mail, completed the bank deposit slips, and prepared the deposit. Helen made the bank deposits twice weekly on her way home.

But why did the office manager not check Helen's work. This was not the way he had designed Helen's job. She was doing practically everything. He was disappointed that he had never really followed her activities closer. This function was his business; why had he become so removed from the financial operations? Honestly, as the reimbursements became slower, he had to let a therapist go. After all, he had hired people that he thought he could trust. He knew that he had placed too much trust in his staff. He and his wife Isabella had strong values, and Juan expected that everyone operated with the same set of values.

Juan also recalled how the daily front desk logs listed patient and payment information. The front desk receptionist was supposed to tally the log amounts at the end of each day. The logs included whether the patient payments were cash, check, or credit card. Copies of patient receipts were attached to the logs.

In retrospect he recalled on several occasions Helen tallied the log amounts instead of the receptionist. He should have questioned that activity at the time, however, he failed to do so. Her involvement in the tallying activity was again contrary to the policy that he and his partner at MSB, Don, had established.

Helen also printed two computer reports daily that listed the payments received by mail and payments received at the clinics. These reports were supposed to be used to verify that all payments had been posted and deposited. He did not recall any discussion on the office manager's part about those reports being reviewed. Furthermore, when he and Angelita had tried to determine the amount of the theft, the reports were not found. In addition to these reports, Helen also made and received collection calls from patients. On a monthly basis, Helen would prepare a "write-off" list, and Juan would review the list. Occasionally, Juan would ask that an account be referred for collection. Beyond that, Juan didn't recall any further involvement on his or the office manager's part. Where was his office manager when all of this was happening? Was she just a bad supervisor or was she involved?

Juan never thought that something might have been wrong when Isabella, Juan's wife, complained bitterly about the waste of the time it had been for her to sit with Helen and learn her job. Isabella had volunteered to substitute for Helen during the upcoming birth of her baby. Juan reluctantly recalled his wife's displeasure with Helen and his unwillingness to act.

Isabella: I am really getting tired of Helen's attitude. I really wanted to help when she had the baby. A mother needs to spend time with a newborn. Instead, she is bound and determined to immediately return to work. Doesn't she get any time off to have a baby?

Juan: Yes, she has accrued sick leave, but she has always refused to take it.

Isabella: I asked her numerous times to explain her job to me, but each time she had an excuse. She has never taught me anything about her job. Helen will not let anyone into her world.

Juan: I don't understand what the big deal is. She is not planning on being gone more than a day or two.

Juan also remembered that Helen had not relinquished the post office box key despite the fact that she had been asked several times. He even thought about all the times he walked past Helen's desk and repeatedly noticed uncashed checks. He could not understand why he had accepted that as common practice. He was beginning to get angry with himself. He became more upset when he realized that he had noticed Helen making mistakes recently. She never asked for any vacation time, EVER.

Suddenly, he recalled a discussion with his friend, Will, who had bought a business in Tampa.

Will: You remember when I bought the restaurant; I decided to keep all of the employees that were there. Some of them, including waitresses had been there over 15 years. I figured things were good and the business valuation had come in like I expected.

Juan: Yeah, so what's your point?

Will: Well I did not do any background screening on the employee that had been doing all of the bookkeeping and payroll. It turns out that she had a criminal record, had been stealing from the previous owner, and just continued the stealing when I took over the business. How was I supposed to know?

Juan: Oh my, so what happened?

Will: Well, the employee messed up her plan when she got pregnant and was planning on a single week of leave. Unfortunately for her that day happened to be payroll day, and a substitute employee discovered that "wonderful bookkeeper" had been embezzling money.

The similarities were startling. The pregnancy, Helen's unwillingness to let anyone into her world, and her refusal to relinquish the post office box key were all creating a sinking feeling in Juan's stomach. Over and over, he kept reflecting on how angry Isabella had been after trying to train with Helen.

MARIA, THE OFFICE MANAGER

María Vega had worked for Juan and Don for approximately seven years prior to her leaving in 2002. She was rehired as the office manager for MSB in 2005. María was responsible for managing the office staff and maintaining the control environment. She also was responsible for handling Medicare and workers' compensation accounts, reconciling bank statements, and entering information into the accounting system. Although María did check the copies of bank deposit slips against the bank statement amounts, she didn't compare the bank deposit slip copies to the office copies. Had she completed this step, she would have discovered the theft.

Thus, Helen was clearly involved with the missing \$1,400. But was María involved? He simply couldn't understand why María had not discovered the theft. He and his partner had established certain policies long ago. But many of those policies hadn't been followed in years. There was no performance review system

in place that might have contributed to why policies hadn't been followed. Also, Helen always seemed to volunteer for additional responsibility, particularly when money was involved. Was it possible that María and Helen had acted together to steal the money? At this point, it seemed like a distinct possibility.

BUSINESS DECISIONS

It was close to midnight, and Juan was tired and frustrated. He called Isabella again and explained,

Juan: I want to stay at the office a little longer to work through this problem.

Isabella: Juan, don't you remember how upset I was about the time when I tried to train with Helen....? Juan, everything is going to be okay. Do you want me to come to the office?

Juan: No, I need to sort this out myself.

After the call, Juan recalled some of the decisions his partner, Don, and he had made in the early days of the billing company's establishment. One of the first decisions they made was to purchase software to perform the patient billing function. There were so many vendors and programs from which to select. Juan considered himself better suited to handling the clinical side of the business. He also was very comfortable making personnel decisions. His previous partners, including Don, were self-proclaimed business experts. He remembered how his previous partners would micro-manage expenses, particularly when an equipment purchase was being considered. The partners rationalized that they didn't want to spend money on anything they or their staff could do. So, Don persuaded Juan not to purchase the available report generation features offered by Health Payment Computer Services. These features included reports that separated patient payments from third-party payments. The features also separated the payments by cash, check, and credit card. Juan now realized that if he had purchased these software features, it would have been much easier to determine an estimate of the missing money. The current system only showed historic billings and payments.

When María reviewed and reconciled the monthly bank statements, she would pass them along to the CPA. Juan seldom even looked at the bank statements. Juan also recalled that he and Don had consulted with their CPA about the software. The CPA provided tax preparation and bookkeeping services as well as prepared monthly financial statements.

Juan: Don and I are considering buying some new software that has a number of different features. I am not really sure what features we should be looking at.

- CPA:** I know. This stuff is even confusing to me. The only thing I really want you to pay attention to is how the G/L relates to the tax module. You know right now my staff and I have to do a lot of data entry, and we would rather not because your system is not compatible with ours.
- Juan:** The vendor has lots of options including one that will allow us to better track revenues by payer type. They have even offered to come by and make a presentation for us. Are you interested in attending?
- CPA:** Like I said, that stuff is all really great for complex businesses. Your business is pretty simple. My recommendation is just make sure that they include a download module so that I can complete the tax filing.

Reflecting back Juan wondered why the CPA had never offered to provide other services. Perhaps there might have been something she could have offered that would have prevented the theft. At least he might have been able to better understand what had been stolen. Was there a malpractice problem? Could he sue the CPA?

Juan thought about some comments from his neighbor, an accounting professor at a nearby university. The neighbor had mentioned from time to time how CPA firms had diversified their businesses and offered many types of consulting services, specifically for small businesses, but since his CPA seemed content to prepare the basic financial statement, quarterly tax filings and the annual tax return, he figured there was no need to spend any extra money.

Juan remembered when he suggested the purchase of a credit card processing machine to his partner. Don objected because of the \$500 price. María also objected. Don claimed they would never be able to recover that investment; however, his presumption was wrong. They found that an increasing number of customers preferred to pay with credit cards, and the two found it necessary to buy a second machine. Juan realized that the credit card machine certainly must have reduced the amount of the theft. The arrangement with the credit card machine provider caused the credit card amounts to be deposited directly to the companies' bank accounts.

For a moment, Juan thought about why he and his partners never completed any background verification of their employees. He realized that Helen and María had both been employed prior to Canada Health's ownership; however, he and Don had never discussed doing a background check. He remembered some radio advertisements for local firms that completed those types of checks. He wondered if an employee check would have uncovered any unfavorable information. Perhaps they should have paid better attention to all current employees.

THE DAY'S EVENTS

The day had started with the packing of all the evidence in boxes and placing the boxes on Helen's desk. Juan and Isabella were in the office early waiting for the police, Helen, and María to arrive. They were prepared for the confrontation. Helen arrived and unsuccessfully tried her door key. Juan had changed the locks the previous evening. She had brought her new born baby to work that day, and she questioned why her key didn't work. After Juan let her in, Helen went in and out several times to ensure she had everything the baby needed. Helen noticed all the boxes on her desk and questioned Juan about them. He replied, "We are going to have to talk about that."

María arrived next, and she was suspicious immediately. Isabella was seldom at the office in the morning. María also noticed the boxes. Then two police officers arrived. One officer took Juan, Isabella, and Helen into one office. Juan was amazed how Helen maintained the straightest face during some very intense questioning by the officer. It was as if she had been in this position before. The other officer questioned María, and the officer determined that María was negligent in her oversight but not involved in the theft. After several hours of questioning, the police officers told Juan and Isabella that they didn't have anything concrete and were unable to make an arrest. María was feeling appropriately guilty, and she was blowing off steam. Helen went home.

THE NEXT STEP

By now, it was as if Juan had been in a terrifying daydream for several hours. He was exhausted. He left the office and arrived home fifteen minutes later. Isabella was waiting and once again offered her support. She wanted to know what they were going to do. Juan said they would talk about it in the morning. They could survive a loss of \$1,400 if that was all it was, but what if it was more. How much more?

REQUIREMENTS

1. Like fuel, air, and heat come together to make fire, the likelihood of fraud increases when the three elements of the fraud triangle come together. Analyze how the three elements of the fraud triangle are important and how all three elements were present in Helen's case.
2. In 2006, The Committee of Sponsoring Organizations (COSO) published a small company version of their 1992 *Internal Control—Integrated Framework* model to help small public companies improve their internal control systems. The basis for this model is that internal control is composed of five interrelated components. Control activities represent one of the five components.

Define control activities and discuss at least two control activities and their application or lack of application in MRS and MSB's case.

3. Two other components of COSO's model are the control environment and monitoring. Name and describe at least three recommendations that you would make regarding these two components.
4. Brainstorm about the red flags that Juan and Maria missed during the commission of this financial fraud. Describe how you would go about conducting a forensic audit of Juan's records.
5. With regard to segregation of duties, what recommendations would you make to Juan and his partner to improve this control activity?
6. Analyze how the accounting system is both a preventive and detective control.

CASE STUDY 4:

Big Oil versus Big Ideals

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LEARNING OBJECTIVES

After completing and discussing this case, you should be able to

- Identify the laws and regulations governing whistleblowing and whistleblower retaliation in the U.S.
- Analyze the pros and cons of whistleblowing, especially from the individual whistleblower's point of view.
- Recognize the difficulty of changing an existing corporate culture.
- Apply the Ethical Dilemma Resolution Framework.

In writing this case, our goal is to provide a window into the life of a whistleblower, showing the long, often torturous path a whistleblower may follow. Although we do provide a time line for the events in his/her life, it is not our aim to document the detailed chronology of the court case. Indeed, we have obscured some facts and purposely omitted others, including the identity of the whistleblower and the company he worked for.

THE CASE

Part I:

After graduating from a large southwestern university in 1995 with a degree in accounting, George began his career at a Big-4 public accounting firm. He worked his way up to audit senior manager before taking a position in the spring of 2005 at a Fortune-500 company ("the Corporation") as Director of Technical Accounting Research and Training. George was directly responsible for supervising, evaluating, and improving technical research and training for the entire finance and accounting ("F&A") organization. During his job interview, the Corporation's Senior Vice President and Chief Accounting Officer (CAO)

emphasized that the Corporation had recently faced questions about its accounting practices and needed to 'clean up' its accounting. They were looking for someone to keep abreast of SEC, FASB, and international rules and train their in-house accountants at locations throughout the world. George was aware of the negative publicity surrounding the Corporation's accounting practices, and was wary of their offer. Despite his concerns, based on the CAO's statements, George thought the job sounded like a great opportunity to 'fix a company in need.' Besides, although George did not know them personally, several other former auditors from his firm worked at the Corporation.

Similar to a consultation partner in the national office of a public accounting firm, George was the 'go-to' person for questions about proper application of GAAP at the Corporation. His job took him around the globe. Some of his presentations focused on accounting for joint ventures, while others taught proper application of GAAP in revenue recognition. His technical presentations were well-received by the Corporation's accountants, who were eager to learn about appropriate treatment of unique, industry-specific transactions and FASB developments. Individual accountants at the Corporation came to George with their questions and he felt that they valued his opinion.

In summer 2005, George reviewed the Bill-and-Hold decision tree the Corporation used to determine timing of revenue recognition (The decision tree actually violated the Corporation's written policy on revenue recognition). George concluded they were recording revenue prematurely, based on an improper application of GAAP (the SEC's SAB104 and EITF-0021). In short, as part of service contracts with their clients, the Corporation was required to manufacture custom-designed equipment in order to actually perform the required services for their customers. The equipment was manufactured in advance by the Corporation and stored in their warehouses until the service was performed. The Corporation recorded the sale of the equipment when it was manufactured and placed in the warehouse, before it was used in the service.

George considered this treatment to fit the characteristics of a classic Bill-and-Hold scheme, which can result in improper acceleration of revenue recognition. Prior year e-mails and documents from Internal Audit raised concerns that this practice did not comply with company policy. The same documents made it clear the Corporation responded by adding a clause to their sales orders in an effort to evidence the passing title of such manufactured repair equipment to the customer at the time the sales order was issued, although the company's policy was never changed. Thus, accounting practice remained out of compliance with GAAP. In fact, the passage of title or risk of loss is only one of the seven bill-and-hold criteria, all of which must be met in order to recognize revenue. In addition, the title passage clause did not change prior contracts, whose revenue had already been recorded. George did some additional research and found an article on Bill-and-Hold in the industry, written by a manager at the Corporation's external audit firm.

Based on his understanding of company practices and his research, George published an internal memo describing his findings; he also sent a copy to the audit firm's engagement team. The Corporation responded by conducting a survey to analyze the materiality level of the questionable transactions. According to George, they found the issue was widespread and material as it was 20-25% of total revenue. The third quarter was coming to a close and the external auditors were onsite. George discussed the issue with both the Chief Accounting Officer and the audit engagement manager. Both assured him the Corporation would restate revenue and correct the error. However, when the quarterly financial statements were issued, there was no correction or restatement. George was surprised, but he received no explanation. The controller, George's boss, left the Corporation soon afterward, and the CAO refused to meet with George to discuss the matter.

Faced with a dilemma, George considered his choices. He could go along with the Corporation's treatment and let the issue drop. In other words, he could 'take no action,' keep his job, and continue to train the Corporation's accounting staff. Or he could resign and find work at a different organization, leaving the Corporation to continue to file what George felt were inaccurate statements to the public. Alternatively, George could continue working within the Corporation, trying to gain support for his concerns internally. Last, George could pursue the issue and report his concerns externally, either to a regulatory body or to the media.

George carefully weighed his options. He had not faced a dilemma this serious in the past. His actions would affect his career, his family, the Corporation, and even the investing public. He took his wife and children on a short trip. He thought about the situation and asked himself, "What would my dad do?" In his heart, he just wanted the company to change its accounting practice, but he had been unsuccessful. In addition, the external audit manager knew of the situation, agreed with George, and still the audit firm gave the financial statements a clean opinion. George made a decision.

Required: Complete the following questions before proceeding with the case.

Prevention

1. Discuss how each of the following questions might have alerted George to the corporate culture of the organization when he was interviewing for the job. Could George have predicted ahead of time how the organization would react if he challenged their accounting practices?
 - a. How is the company perceived in the media?
 - b. How do employees describe the organization's culture? What could George have done to investigate the "mood in the middle" and the "buzz at the bottom"?

- c. Is it enough to know that others from your current firm work there?
- d. Do you have any information about how the firm has handled prior whistleblowing reports? For instance, have they required whistleblowers to sign arbitration agreements either before or after a whistleblower has made a report?

Choices

1. Professional guidance:
 - a. Consult the AICPA Code of Professional Conduct. What components might guide a CPA working in a corporate environment?
 - b. Consult the IMA Statement of Ethical Professional Practice. Describe how this case presents a conflict between Confidentiality and Integrity.
2. If you were in George's position, whom would you talk to at the company? Outside the company?
3. Complete the Ethical Dilemma Resolution Framework, contained in the Appendix.

PART II:

George's position:

George continued in his attempts to persuade the Corporation to modify their practices, but to no avail. Finally, in November 2005, after the Corporation had filed its third-quarter financial statements with no revised revenue recognition policies, George sent a confidential e-mail to the SEC and the PCAOB, outlining his concerns and implicating the CAO and external auditors. The SEC interviewed George about the Bill-and-Hold practice. After the Corporation filed their 2005 annual financial statements, the SEC opened an inquiry into their reporting practices. According to George, the SEC also encouraged him to contact the Corporation's audit committee. On February 4, 2006, George learned the Corporation had been contacted by the SEC and so he sent what he believed would be a confidential e-mail, outlining his concerns, to the audit committee via a link on the company's webpage. George was not prepared for what happened next.

The Corporation hired a law firm to investigate the Bill-and-Hold practices; after approximately 5-6 months, they reported that any issues with improper revenue recognition were immaterial to the company's financial statements. The SEC also closed their case.

Meanwhile, contrary to promises made on the website, the legal department, rather than the Board of Directors, was first to receive George's e-mail. The General Counsel forwarded the e-mail to the Chief Financial Officer, who shared it with others including the VP of Investor Relations, the Chief Accounting

Officer, and the external audit partner. The CAO then sent e-mails to others in the company identifying George and his complaints to the SEC and company hotline; he further instructed his staff to investigate whether George had violated the company's Code of Business Conduct by contacting the SEC. The audit committee eventually also received the e-mail. When the SEC notified the Corporation they were opening an investigation of accounting practices, the General Counsel sent out an e-mail notifying key individuals the SEC was investigating "George's complaint"; this e-mail was shared widely throughout the organization.

Disclosure of George's e-mail to these parties resulted in retaliation in many forms. George was shunned by Corporation employees. The Corporation's executives excluded him from all meetings with the external auditor, removed him from major projects and, worst, they took away his training responsibilities. With his job decimated, he asked to go on administrative leave.

Stunned by the Corporation's actions, George sent the SEC a 50 page report with over 100 exhibits detailing the accounting practices he felt were questionable. He supplied his estimates of the amount in question, which he later found out were much larger than those the Corporation had reported to the SEC. George did not meet with the SEC until March 28, 2006. About the same time, April 1, 2006, George agreed to a 6-month administrative leave of absence from Corporation.

In September, the Corporation notified George his leave would expire at the beginning of October, and they expected him to return to work. George believed the Corporation had not provided the SEC with enough evidence about the case, and that the SEC's decision to close the case was based on incomplete evidence. The Corporation refused to allow George to have access to their final report to the SEC. On October 17, 2006, George submitted his resignation and retained his own counsel. In his letter of resignation, George stated, "I have every reason to believe that the Corporation intends to persist in violating securities laws and filing inaccurate and misleading financial information. Professionally and ethically, I cannot return to active employment under these conditions."

The Corporation had informed him that when he returned to work in October, he would be reporting to someone at his own level. In addition, the conditions that existed before his leave would persist. He would not be placed back on projects, he would continue to be excluded from meetings, and he would not be able to train in-house accountants. He would not be able to meet with the external auditors, who George was told refused to include him in their meetings, which precluded him from carrying out his responsibilities as the company contact person in regard to accounting policy. George believed all of these changes were retaliation for his whistleblowing actions.

The Corporation's Position:

Although company personnel initially did not disagree with George's concerns, they did ask for further analysis of the issue in the fall of 2005. Because the person to whom he reported, the CAO, felt George had invested too much time

and effort on this one accounting issue, they asked a senior accounting manager to perform the analysis (who did not consult George during this process), and this individual arrived at a conclusion opposite to George's position. George's superiors were also concerned about George's leadership, stating that he was not collaborative or acting in the best interest of the company.

The Corporation further investigated the accounting issue by asking their internal lawyer (from the U.K.) to consider the issue. That attorney concluded the accounting treatment met revenue recognition requirements.

The SEC investigated George's claim and formally notified the Corporation in September of 2006, that no enforcement action was being recommended. The Audit Committee's investigation likewise concluded that no changes in the company's accounting practices were needed.

EPILOGUE

Between May 2006 and September 2011, George pursued his cause through the U.S. Court system. The Sarbanes-Oxley Act (SOX) was the prevailing regulation protecting whistleblowers at the time. Under SOX, George claimed he whistleblow in good faith and the Corporation retaliated against him. The retaliation included the disclosure of his identity to other employees and constructive discharge from his job. George lost his initial case, and the Department of Labor (DOL) Administrative Law Judge dismissed his appeal.

After these losses, George's attorney gave up, but George did not. He put together a petition for review and submitted it to the DOL Administrative Review Board (ARB). In September 2011, the ARB ruled that George was protected under SOX, and the Corporation did retaliate against him. They remanded the case back to the lower court. After more back-and-forth between the courts, George was notified in early 2013 of the appeal court's finding in his favor. This landmark decision took George years to reach.

George has moved on professionally; he is employed as an accountant again and despite his long and arduous journey, feels he has been able to effect positive change for future whistleblowers.

While you may never come across as serious a situation as George has, you will likely encounter situations where accounting judgments and decisions appear unclear. You may have to make a choice to stay, go, or whistleblow. It is beneficial to consider what you might do in such a situation, before the situation presents itself. Below are some discussion questions and exercises that can help you develop a strategy and perhaps lessen the chance you will find yourself in a dilemma like George's.

Required: Complete the following questions.

PROTECTION AND THE REGULATORY ENVIRONMENT

1. What is the SEC authority for and policy on investigating financial statement misstatement?
2. Read the whistleblower provisions of the Sarbanes Oxley Act (SOX). Note that some provisions address required hotlines and others address retaliation against those who use the hotlines. Now, search the business press for articles and opinion pieces on these provisions. Based on your research, discuss whether SOX has sufficiently increased the likelihood an individual will report fraudulent financial reporting. Examples of questions you might address include: What real protection does SOX offer whistleblowers? How are whistleblower retaliation reports investigated under this law? Is the law producing its intended effect?
3. Read the section of the Dodd-Frank Act of 2010 related to whistleblowers. How does this newer act change protections and motivations for corporate whistleblowers? Search the business press for articles and opinion pieces on these provisions. Describe the provisions and contrast them to those of SOX. Based on your research, discuss whether the Dodd-Frank Act of 2010 is likely to be more effective than SOX.
4. Based on your research, is there evidence whistleblowers are not equally protected and taken seriously across industries, company types (public/private), or levels of authority (their own) in the organization? Consider the reactions of the SEC and the PCAOB to George. Did each organization react as you would have expected?

INDIVIDUAL EXERCISES

1. Research a recent (past 2 years) whistleblower case. Summarize the details of the case, including its resolution, if known. Identify and discuss key factors that influenced the whistleblower's actions. Consider the individual's personal characteristics, the corporate culture, and the subject of the whistleblower's report.
2. Visit the SEC and PCAOB websites. Locate each agency's confidential hotline and analyze and evaluate their policies regarding their hotline use.

Case Learning Objectives and Implementation Guidance

In Part I of this case, we describe an actual ethical dilemma faced by an accountant and, in Part II, we discuss his actions and the resulting ramifications. Our goal is not to discourage whistleblowing - quite the contrary. However, it is important for

accounting professionals and students to understand the possible consequences of corporate misconduct and regulatory failure by humanizing the discussion.

We divided the case into two parts in order to encourage students to think through the full array of possible actions available to “George,” before they narrow their perspective by reading about the course George actually took. Possible solutions to the questions are provided in the Teaching Notes, although you may be surprised to find your students suggesting answers that you, and we, had not considered. Ethical dilemmas are a uniquely personal conundrum, and individuals must forge a solution that is satisfactory to their individual combination of ethical, religious, cultural, and social influences. However, the resolution framework (see Appendix) encourages them to pay particular attention to laws, regulations, and codes of conduct to which they may be subject.

Our goal is to stimulate thought and discussion among accounting students, as an aid to ethical reasoning development. While this case is based on actual events, we write primarily from the whistleblower’s perspective. We do not assert that “George” was correct in every evaluation he made regarding the actions of the Corporation and regulators. That is for the courts to decide.¹

We provide questions compatible for either in-class discussion or outside completion. To develop research and critical thinking skills, we include questions requiring students to form opinions based on news stories and published articles. Our students have greatly enjoyed discussing the case both in groups and in an open class setting. We wrote the case to address primarily ethical decision-making, which is accounting issue-neutral. However, for those instructors who would like their students to delve more deeply into Bill-and-Hold, we suggested they refer students to the related article accessible at <http://www.trinity.edu/rjensen/BillandHold.pdf>.

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3. EthicsWeb: <http://www.ethicsweb.ca/resources/decision-making/index.html>.
4. Ethics Line: <http://www.acfe.com/resources/ethicsline.asp>.

¹ The press covered the actual lawsuit. Related news stories and legal filings are located online. It is possible that students may locate these items and bring them into class discussions.

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APPENDIX:

ETHICAL DILEMMA RESOLUTION FRAMEWORK*

1. Determine the facts and identify the ethical dilemma involved

Facts: List the facts relevant to the ethical dilemma - describe the situation and how the person or firm got into the situation.

Dilemma: Identify from whose perspective you are analyzing the case and explain the ethical dilemma the person or firm is facing.

2. Determine the affected parties and identify their rights²

² Rights are having a claim or title to an item or a particular behavior. Many individual rights arise from basic human rights, such as life, liberty and the pursuit of happiness. Beliefs about such rights may differ among individuals; for example, one person may believe that individuals have a right to gainful employment, while others may view this as a privilege. Additionally, laws and moral obligations confer rights upon a person, such that individuals have the right to meet their obligations or legal responsibilities. The critical point here is that individuals affected by this dilemma have 'rights' that could be impeded by our decision regarding resolution of the dilemma. Additionally, one person's rights can conflict with another's rights, and the individual with the ethical dilemma must first recognize all rights, and then prioritize them.

For each party currently affected by the problem or who could be affected by the solution, describe their interest and identify their rights in regard to this situation. (Note: Just because someone may want or prefer something, doesn't mean it is their *right* to have it.)

3. Determine the party with the most important rights

Identify who you feel has the most important (prevailing) rights. Obviously, if you are resolving the situation, you will be the one determining the most important rights — recognize in your write-up that this is only one person's opinion.

You must pick only one party here. Two parties typically have at least some rights in conflict and you cannot give the two conflicting rights equal status. Thus, when selecting your solution strategy, you must know whose interests must prevail when those interests are mutually exclusive.

4. Identify the applicable laws or codes of conduct

For each law or rule, completely identify its origin. Then describe what the rule or law is and why it is applicable to this particular case. It must be applicable to the person or firm having the ethical dilemma (identified in Step 1).

5. Develop alternative courses of action

This is a brainstorming process. List *all* the options available to the individual or firm with the ethical dilemma. Do not evaluate the options at this point, but do completely explain each.

Then use the results of your brainstorming to create 3 or 4 possible courses of action. These should be mutually exclusive. Additionally, when you pick the best alternative in step 8, you can pick only one of the courses of action you list here; thus, each must be complete as to the process.

Example: it may be that a person is violating company policy. Two options are to speak to the person about it or to report them. Therefore, one course of action might be to first speak to the person, and if they don't correct their behavior, you will report them to their superior. An alternative course of action would be to report the violation, without taking the step of speaking to the person first.

Note: In resolving an ethical dilemma, you can only decide on your own actions; you cannot decide on the actions of others. Others may or may not act as you desire, therefore you must build contingencies into your plan. You also cannot change what has already occurred, you can only plan for what will happen in the future.

6. Determine the possible consequences of each proposed course of action.

Again, this is a brainstorming process. For each possible course of action, list ALL of the possible consequences to each affected person for each alternative. Some may not be very probable, but now is not the time to eliminate them. An incomplete solution to this step is a common cause of unsatisfactory resolution of a dilemma. Then, organize your brainstorming ideas. Consider each of the affected parties in finalizing your list of possible consequences.

7. Assess the likelihood of each possible consequence of each proposed action.

For each possible consequence you listed in step 6 above, assess the likelihood of the consequence occurring, if the individual or firm with the ethical dilemma takes that course of action.

8. Decide on the appropriate course of action

Based on your analyses in steps 1 through 7, select one of the alternatives as your solution strategy. This should be an action favoring the party with the most important rights, as identified in step 3. If there are multiple steps you would like to take, they must be completely contained within one alternative in step 5. For example, if you want to talk with management and then withdraw if they don't agree to your recommendations, then this must be completely explained in one alternative in step 5.

Note: Why can we not select two alternatives? The reason lies with the possible consequences of the alternatives. Consequences of possible courses of action should significantly impact your selection of the most appropriate course of action. Unfortunately, when you string two courses of action together, the first action may change the consequences of the second action, compared to taking only the second action alone.

Example: You win \$25,000. Possible courses of action include: (1) buying a pool table, (2) buying a car, (3) investing for retirement, (4) paying off credit cards. Each is less than \$25,000, so any one course of action alone is possible. But, if you buy a car and then invest for retirement, the

investment you could make would be significantly less than if you chose this as your initial and only option. Thus, the first action has changed the scenario for the second.

Example: You get stopped by the police for running a yellow light. Your possible courses of action include: (1) scream at the officer for inconveniencing you, (2) explain to the policeman the sun was in your eyes and you couldn't see, (3) tell him the person behind you was going so fast that you thought they might rear-end you if you didn't go on through the light, (4) take the ticket and pay it. Alternative 3 may be very productive and result in a positive solution, depending on how convincing you are. However, if you take course of action 1 (screaming) before taking action 3, you probably won't care for the ultimate outcome. Taking action 1 changes the possible consequences and the likelihood of those consequences for action 3. Although this is an extreme example, there are many parallels in the business world.

* This framework is derived from that presented in Rittenberg, Johnstone and Grambling (2012). Alternative decision frameworks may be employed, including Rest (1986).

CASE STUDY 5:

American Food Suppliers Inc.: A Case Study in Fraud and Forensic Accounting

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LEARNING OBJECTIVES

After completing and discussing this case, you should be able to

- Understand the basics of accounting for vendor rebates.
- Understand the dangers of over relying on third party confirmations as an audit procedure.
- Understand the responsibilities of the external auditor for detecting fraud.
- Appreciate the importance of professional skepticism.
- Understand the difference between a financial statement audit and a forensic audit.
- Appreciate the importance of ethical behavior in the accounting profession.

INTRODUCTION

American Food Suppliers was acquired by the company Barnacle in 2000. American Food Suppliers was the largest distributor of food to restaurants, hotels, schools, hospitals, and Barnacle's extensive chains of U.S. grocery stores. A material portion of American Food Suppliers' balance sheet was promotional allowances receivable from vendors (vendor rebates). As part of their normal audit procedures for American Food Suppliers, Barnacle's independent auditors, Doodle Auditors LLP, sent confirmations for these receivables. Confirmations were mailed to vendors' salespeople and were returned without exceptions. For the first two years after the acquisition, the auditors issued unqualified opinions. During the 2002 audit, however, Barnacle's independent auditors discovered problems and promptly withdrew their audit opinions for 2000 and 2001, and suspended their 2002 audit. On February 28, 2003, Barnacle announced that it would restate earnings downward for the fiscal years 2000 and 2001, and for the first three quarters of 2002 by a combined total of at least \$500 million and

that a forensic accounting investigation would be launched, mostly because of irregularities at Barnacle's subsidiary American Food Suppliers.

The company's stock price lost nearly two-thirds of its value on the day of the announcement. Barnacle's chief executive and chief financial officers resigned when the announcement was made, and subsequently other high-level managers at both the parent company and American Food Suppliers also stepped down. On March 28, 2003, Barnacle's audit committee ordered investigations at the parent company and at 22 Barnacle subsidiaries to look for accounting errors, irregularities, and other issues as well as assess internal controls and management integrity. After a forensic audit, Barnacle eventually reported that the overstatement of American Food Suppliers' earnings was more than \$900 million. A large component of the overstatement resulted from improper recognition of promotional allowances. Several American Food Suppliers' employees and vendors either admitted to or were convicted of playing a role in the fraud.

In this case, students will gain insights into the proper accounting for and disclosure of promotional allowances and also the risk of over-reliance on third party confirmation as an audit procedure. Students will also distinguish between a financial statement audit and a forensic audit.

SOME BACKGROUND

Accounting for cash consideration from vendor rebates, also known as "promotional allowances," was at the center of the American Food Suppliers's earnings restatement. Rebates of this type are common in the grocery and foodservice industries and are frequently material in amount, sometimes exceeding 5% of sales. Vendors can offer rebates to customers in exchange for favorable display space in stores, or they may give volume rebates to provide an incentive to a retailer to increase sales of the vendor's products, with the rebate percentage increasing as the retailer's sales volume increases. However, these rebates are problematic in several respects. At the time of American Food Suppliers's accounting irregularities, there was no standardized accounting treatment of these rebates. Companies have accounted for them differently, and there have been differing levels of disclosure regarding their amounts. The investigation at American Food Suppliers revealed that determination of rebates receivable can be problematic.

Even before the investigation into American Food Suppliers's accounting practices, supplier rebate issues have come under scrutiny and have even resulted in regulatory action against other retailers. The Securities and Exchange Commission (SEC), as an example, alleged that among the accounting irregularities that occurred at Rite Aid in the late 1990's was how the company accounted for its vendor rebates. In June 2002, the SEC's Accounting and Auditing Enforcement Release No. 1581 indicated that Rite Aid improperly recognized \$75 million in vendor rebates, which represented 37% of the company's pre-tax income in 1999 (SEC, 2002). Kroger Co. of Cincinnati had to restate its earnings from 1998 to 2000 as a result of how one of its acquired companies had accounted for such

rebates. Similar irregularities and allegations of impropriety regarding recognition of vendor rebates have led to earnings restatements and/or regulatory actions at other companies, including Just for Feet, Fleming Cos., and Great Atlantic & Pacific Tea Co. More recently, the SEC filed a suit with Penn Traffic grocery stores in which the SEC alleged that Penn Traffic intentionally inflated income by prematurely recognizing income from promotional allowances (SEC, 2008).

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR VENDOR REBATES

Prior to 2002, there was no standardization regarding the accounting for or disclosure of these vendor rebates. Companies often “buried” the rebates in their financial statements, even though they were frequently material in amount, particularly for retailers such as American Food Suppliers. In August 2002, the Financial Accounting Standards Board (FASB) released Emerging Issues Task Force (EITF) Issue No. 02-16, *Accounting by a Reseller for Cash Consideration Received from a Vendor*, which addressed the accounting for and disclosure of these rebates. In the EITF, the FASB outlined three possible views of these rebates. Depending upon the circumstances under which it is being offered, a vendor rebate may represent: 1) a reduction in the cost of sales to the reseller; 2) a reduction in some other expense, e.g., advertising; or 3) a type of revenue for the reseller. Generally, cash consideration from a vendor is presumed to be a reduction of the price of the vendor’s products or services and should, therefore, be a reduction in the cost of sales when recognized in the reseller’s income statement. That presumption can be overcome, however, under two different sets of circumstances: 1) if the cash consideration is intended to reimburse the reseller for costs incurred (e.g., advertising), then the consideration received by the reseller should be recorded as a reduction in that expense; or 2) if the cash consideration is primarily payment for the reseller’s expertise and efforts in a particular endeavor (e.g., market research), then the consideration should be recognized as revenue by the reseller (FASB, 2002).

Additionally, the Task Force concurred that if the cash consideration is primarily an incentive for the reseller to achieve certain sales levels, or to remain a customer of the vendor for a specified period of time, then the consideration should reduce the reseller’s cost of sales. This reduction in cost of sales should be systematic and rational, reflecting the underlying progress of earning the incentive, assuming that the reseller’s progress is probable and reasonably estimable. If the progress is not probable, or it cannot be reasonably estimated, the consideration should reduce the reseller’s cost of sales as the relevant milestone is achieved (FASB, 2002).¹

As an example, assume that retailer ABC Company is entitled to a 10% rebate of the purchase price of merchandise purchased from vendor XYZ Company if ABC Company is able to sell \$1,000 of XYZ Company’s products during the

¹ This EITF has been codified into FASB ASC 605-50.

coming year. If it is probable that ABC will meet the \$1,000 target and the company can also reasonably estimate its progress towards achieving the milestone, ABC should recognize the 10% rebate in a systematic and rational manner. If, on the other hand, the probability of ABC achieving the \$1,000 sales level is uncertain or if ABC cannot reasonably estimate its progress in reaching the milestone, ABC should recognize the entire 10% rebate as a reduction in cost of sales only upon reaching the \$1,000 target. The Task Force's position was clear that *immediate* recognition of cash consideration as a reduction of cost of sales or as revenue was *not* acceptable. American Food Suppliers appears to have been recognizing the vendor rebates as it *purchased* the product not when it was sold. Additionally, federal authorities alleged that American Food Suppliers deliberately booked vendor rebates to which they were not entitled. Thus, not only is this an accounting issue with respect to the *timing* of recognition of the rebates, but it is also an issue of fraudulently recognizing rebates that did not exist.

WHAT HAPPENED AT AMERICAN FOOD SUPPLIERS

During their 2002 audit of Barnacle's financial statements, as part of their confirmation process at American Food Suppliers, Doodle Auditors LLP discovered that certain accrued vendor allowance receivable balances were overstated. Doodle uncovered a series of accounting irregularities at American Food Suppliers and other Barnacle subsidiaries. Doodle immediately withdrew their audit opinions for 2000 and 2001 and suspended work on the 2002 audit.

There appeared to be a confluence of economic conditions, managerial "inventiveness," and failures of internal controls that led to the accounting irregularities at American Food Suppliers. Company sales for the year 2002 had been decreasing. In last quarter of 2002, upper management held a conference call with its divisional managers advising them that their annual bonuses were at risk if sales were not boosted. According to testimony provided by those inside the company, in that conference call, the company's chief operating officer described an "initiative" that would increase the likelihood of managers receiving their bonuses and help the company achieve its sales target for the year. Quite simply, the strategy was to order large amounts of inventory and immediately recognize the vendor rebates that accompanied them. The rebates were in many cases substantial and, according to some sources, ranged from 8.5% to 46% of the purchase price. Divisional managers stated that they were told by upper management that if they did not place orders for additional inventory, then it would be done for them. These managers reported that it was made clear that if they did not go along with the "initiative," not only were their bonuses in jeopardy, but perhaps their jobs were as well.

Soon the warehouses at American Food Suppliers were overflowing with inventory of food-related items and paper products. The amount of inventory the company purchased was so large that it had to rent additional space and refrigerator trucks to store it. As purchases increased, the vendor rebates to which

American Food Suppliers were entitled also increased. Supplier rebates increased from approximately \$150 million in 2000 to about \$800 million in 2003. These rebates were recognized immediately as products were purchased in an attempt to boost earnings. The excess inventory was so immense; however, that even after the announcement of the earnings restatement, it was questionable whether the company would be able to sell it. In an effort to unload the massive amount of product in its warehouses, the company had to reduce its selling price below its original cost in some cases.

During the audit of American Food Suppliers, third party confirmations of rebates receivable had been provided by the vendors' salespeople, not their accounting departments. According to complaints filed by the SEC, employees at American Food Suppliers urged their vendors to complete and return to the auditors false confirmation letters with dollar amounts intentionally overstated, sometimes by as much as millions of dollars. Some vendors were pressured, some were provided with secret "side letters" assuring the vendors that they did not owe the amounts listed on the confirmations.

In a span of several months, the "initiative" proposed by the company's COO unraveled. Rather than helping the company out of its economic doldrums, the scheme instead resulted in earnings restatements, plunging stock price, several high-level managers losing their jobs, regulatory investigation of the company's accounting practices, and allegations that company officers had criminal intent to deceive and defraud the investing public. In September 2003, officials raided Barnacle's headquarters and began a criminal probe. One year later, U.S. officials announced that three former American Food Suppliers executives were being formally charged with conspiracy, securities fraud, and making false filings. Prosecutors also announced at the same time that four other American Food Suppliers managers had admitted to their roles in the same alleged scheme of overstating earnings.

THE FORENSIC AUDIT

After the irregularities were uncovered by the external auditors, a criminal investigation was launched by the U.S. Department of Justice. In addition, Barnacle appointed a team of forensic accountants to work alongside the SEC. The forensic accountants had to sort through tens of thousands of documents.

The forensic audit revealed fraud at American Food Suppliers totaling over \$900 million, with over \$150 relating to 2000, over \$300 million relating to 2001 and the rest relating to 2002. The fraud related to fictitious and/or overstated vendor allowance receivables and improper or premature recognition of vendor allowances and an understatement of cost of goods sold. Numerous American Food Suppliers employees were involved in the fraud, and it was discovered that the fraud went back as far as 2000. American Food Suppliers employees were found to have been using inflated recognition rates for vendor allowances and intentionally misapplying GAAP. Doodle's audit testing using third party

confirmations failed to detect management's misrepresentation of the reduction in cost of sales resulting from these manufacturer rebates.

The probe of American Food Suppliers expanded to investigate several of the company's suppliers to determine if they might have been complicit in American Food Suppliers intent to misrepresent certain financial statement assertions. The investigation revealed that American Food Suppliers employees asked salespeople at their vendors to sign false documentation for Doodle and that some vendors cooperated with this fraudulent scheme. Four salespeople at Vendor A admitted that they had signed off on, and forwarded to American Food Suppliers external auditors, erroneous documents that reflected inflated amounts owed to the company by Vendor A. Similarly, at Vendor B, three salespeople also admitted to signing off on inflated amounts for manufacturer rebates due to American Food Suppliers. Vendor B claimed, however, that the erroneous confirmation amounts were discovered and that American Food Suppliers external auditor was notified before news of the accounting scandal broke. The forensic examination at American Food Suppliers also revealed numerous weaknesses in internal controls, including failure to properly record and track vendor allowances, inadequate accounting and financial reporting systems for vendor allowances, and failure to follow GAAP.

The investigation revealed fraud at not only American Food Suppliers, but also at several other Barnacle subsidiaries and the parent company. It was discovered at one subsidiary that fictitious invoices were used to conceal payments, and in some cases, payments were improperly capitalized rather than expensed. It was also discovered that the consolidation of certain joint ventures into Barnacle's financial statements was in error and that secret side letters had been concealed from Barnacle's audit committee and external auditors. Further, accounting irregularities and earnings management were uncovered at other subsidiaries and at the parent company.

Overall, more than 800 separate items related to internal control weaknesses and accounting issues were identified at Barnacle and its subsidiaries. This extensive forensic examination led to a lengthy delay in the announcement of 2002 audited earnings numbers. Barnacle's 2002 annual report was released on December of 2003, which included restatements for the years 2000 and 2001.

The total fraud at Barnacle was revealed to be over \$1.2 billion. Of this, approximately \$925 million related to American Food Suppliers. Upon conclusion of the forensic investigation, Barnacle announced the creation of a task force reporting to the audit committee to address the internal control weaknesses and improper accounting practices uncovered during the investigation. Barnacle announced in their 2002 annual report that the internal audit department would now report directly to the CEO and the audit committee, rather than solely to the CEO, as was the case previously.

According to press releases from Barnacle, after the accounting scandal, American Food Suppliers made substantial improvements in the company's financial systems and controls, as well as its financial organization, to strengthen financial

monitoring and reporting. They also established a new office of governance, ethics and compliance.

LESSONS LEARNED: AUDIT CONFIRMATIONS

In designing the tests to be performed during an audit, an auditor must obtain adequate assurance to address audit risk. The greater the risk of a particular financial statement assertion (e.g., the existence and amount of vendor rebates), the more evidence an auditor should gather to support the assertion. Statement on Auditing Standards (SAS) No. 67 states that, “confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions” (AICPA, 1992, SAS 67.06, AU 330). According to SAS No. 67, confirmation from an independent source is generally viewed as having greater reliability than evidence obtained solely from client personnel. Confirmation with a third party helps the auditor assess the financial statement assertions with respect to all five of management’s assertions: existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure. The auditor may design a third party confirmation to address any one or more of these assertions (AICPA, 1992). However, existence is usually the primary assertion addressed by confirmation of receivables.

Even though evidence obtained by a third party confirmation is generally viewed as being more reliable than evidence provided by the entity being audited, SAS No. 67 cautions that an auditor should maintain a healthy level of professional skepticism. The auditor should consider information from prior years’ audits and audits of similar entities. Further, an auditor has an obligation to understand the arrangements and transactions between the audit client and the third party so that the appropriate confirmation request can be designed. SAS No. 67 states that “[i]f information about the respondent’s competence, knowledge, motivation, ability, or willingness to respond, or about the respondent’s objectivity and freedom from bias with respect to the audited entity comes to the auditor’s attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary” (AICPA, 2002, SAS 67.27). The statement allows for the possibility that the party responding to the confirmation may not be completely objective or free from bias and requires the auditor to use other evidence to confirm financial statement assertions in such cases (AICPA, 1992).

Confirming accounts receivable is a generally accepted auditing procedure and is required unless the amount involved is immaterial, a confirmation would be ineffective, or if the auditor can substantially reduce the level of audit risk of the financial statement assertion through the use of other substantive and analytical tests. Accounts receivable, for the purpose of SAS No. 67 (AU 330), represent claims against customers that have arisen in the normal course of business and loans held by financial institutions (AICPA, 1992). The Statement does

not specifically address confirming a receivable that arises when a vendor owes a rebate to a reseller, a situation that differs substantially from the typical trade accounts receivable from a customer. Confirming vendor rebate receivables give rise to different risks that likely were not envisioned when the Statement was adopted in 1992.

In adopting SAS No. 67, two (of the seventeen) Board members, while assenting to the Statement, expressed a reservation that the language used in the Statement usurped the freedom of the auditor in exercising professional judgment in how best to confirm accounts receivable and that the language might also lead auditors to place undue reliance on third party confirmation when circumstances might suggest that the auditor choose a more effective test (AICPA, 1992). With the benefit of hindsight it is clear that the auditors of American Food Suppliers could have, and should have, designed a more “effective test,” one that would have helped overcome the inherent weakness that existed in this situation where parties providing the confirmation may have either been uninformed about the existence and/or amount owed to the retailer or may have had a vested interest to overstate the amount that was owed to American Food Suppliers. While some practitioner literature has made reference to biases of confirmation respondents, scant attention has been given to this particular concern regarding responses to auditor confirmations by vendors’ sales personnel.

THE AFTERMATH

- Three former purchasing executives for American Food Suppliers pleaded guilty to participating in the scheme and to conspiring with suppliers to mislead the company’s auditors. They later agreed to pay approximately \$400,000 in civil penalties.
- U.S. courts approved a \$1.3 billion global class action settlement between Barnacle and shareholders.
- The former CFO of American Food Suppliers pleaded guilty and was sentenced to eleven months of home detention and five years’ probation.
- Fifteen American Food Suppliers vendors pleaded guilty from 2003 to 2006 to criminal charges related to the fraud, admitting that they submitted false confirmations to the auditors.
- Former American Food Suppliers CEO reached an agreement with Barnacle in which he agreed to pay \$10 million but did not acknowledge liability.

QUESTIONS

- 1) What lessons can be learned from the American Food Suppliers case with regard to over reliance on third party confirmations?
- 2) What alternative substantive tests may have been available to the auditors of American Food Suppliers? How do the alternate procedures differ from typical accounts receivable confirmations when confirming vendor receivables?
- 3) What mistakes were likely made by auditors of American Food Suppliers and what responsibility does the auditor have to uncover fraud?
- 4) The FASB has reduced the wide latitude that companies once had in accounting for vendor rebates by issuing EITF Issue No. 02-16. What recommendations would you suggest to the FASB for further improving the accounting and auditing guidance in the area of vendor rebates?
- 5) Define professional skepticism. Do you think that the auditors of American Food Suppliers exercised enough professional skepticism? Why or why not?
- 6) What is the difference between a financial statement audit and a forensic audit? When would each type of audit be performed?
- 7) Who acted unethically in this case? What were the consequences?
- 8) Apparently, many people within American Food Suppliers knew of the fraud and either helped perpetuate the fraud or at a minimum did not notify the auditors or regulatory agencies. What options were available to the employees who knew about the fraud and wanted to do something about it?

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CASE STUDY 6:

Dr. Sterling's Disability Insurance Claim

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LEARNING OBJECTIVES

After completing and discussing this case, you should be able to

- Spot some red flags of fraud.
- Recognize that fraud investigations proceed in stages, with information coming in at various times.
- Develop analytical skills in a specific context.
- Focus on where funds are spent.
- Learn how to search for more information.

Dr. Albert Sterling, a fictitious surgeon, submitted a disability income claim to Guardian Professional Protection Insurance Corporation, a fictitious insurance company. Dr. Sterling is making a disability claim, stating that he cannot continue to work as a surgeon, due to debilitating depression. While the doctor and the insurance company are fictitious, several aspects of this case are real.

You assume the role of an insurance investigator who is assigned to assess the validity of the claim. The case is divided into two phases, Phase 1 and Phase 2. Phase 1 contains most of the information and questions, and requires most of the analysis. Phase 2 contains six additional sources of evidence, and allows for a more in-depth investigation about the validity of the claim. Phase 1 is effective by itself, but Phase 2 shows that a fraud investigation usually proceeds in stages, with information coming in at various times.

This case provides an opportunity to practice forensic accounting techniques in the specific context of disability insurance. You will find several “red flags of fraud” to investigate. Tracy Coenen, CPA, CFE, an insurance investigator, notes: “For insurance claims that deal with illness or injury, such as workers compensation, disability or personal injury the key to finding red flags of fraud is looking for financial information that doesn’t add up or is inconsistent with the claims submitted” (Drax, 2006).

APPLICATIONS

This case is appropriate for a forensic accounting course at the undergraduate or graduate level. We have primarily implemented this case in the advanced auditing course in our Masters of Science in Accountancy (MSA) program, which includes significant coverage of forensic accounting and fraud investigations. This case was tested and found effective in three sections of this course. We have also provided this case in independent studies in forensic accounting to both undergraduate and graduate students many times, and received positive feedback from these students.¹

FEATURES

Several features of this case may be of interest to instructors. These features include the development of analytical skills in a specific context, the focus on where funds are spent, and the search for additional information.

Use Analytical Skills in a Specific Context. This case is set in a specific context, the insurance industry, where accounts, amounts and relationships are of particular concern when viewed in the light of a disability claim. This case encourages students to develop their analytical skills, as they will identify accounts, amounts and relationships that do not make sense for a high-earning individual and his family. For example, students should notice that Dr. Sterling has taken a loan against his pension, which may seem surprising for a high-income person to do. In addition, students are provided two guidelines or “rules of thumb” commonly used in determining the validity of disability claims. When students investigate the relationship and patterns with a specific purpose in mind—determining the validity of a disability claim—they should find that Dr. Sterling has not built up his net worth as much as would be expected. Students can transfer such analytical skills to other types of fraud investigation cases, even at a corporate level.

Consider Accounts that are Not Included. Students are encouraged to consider the reasonableness of accounts that are listed. Furthermore, students are directed to consider what accounts could be missing and what the potential impact (of those missing accounts) is on the validity of the claim. For instance, the Sterlings do not report any investments in stocks, or a vacation home. High-earning families often own these types of assets. In addition, these families may have other sources of income, such as interest and dividends from investments. Under some policies, the existence of other sources of income could decrease disability insurance benefits.

Focus on Where Money is Spent. This case also requires students to take a different perspective about the funds, than do other cases based on an

¹ The university at which the authors work does not currently offer an undergraduate forensic accounting course in the regular curriculum, due to the time constraints of the other required accounting courses.

investigative technique. In a typical net worth analysis problem, students are provided some limited base year information and more detailed information for two or three years, from which they can list assets and liabilities, compute net worth, and add various expenditures (such as living costs, alimony, vacations and school tuition) to arrive at a measure of total increase in net worth. This measure is then compared to known sources of funds (such as salaries and inheritances) to arrive at unexplained sources of funds (if any). The possible presence of unexplained funds may indicate that the person is getting funds from illegal activities. The focus of this type of problem is: Where is the money coming from?

In this case, however, students should discover that the person does not seem to have a lot of assets or an extravagant lifestyle, as might be expected for a high-earning professional. Understanding where the money is being spent will help the investigator determine the validity of the claim. This case provides a completed net worth analysis (a short version, with only assets, liabilities, and net worth) and other relevant information on the person's salary and the family's lifestyle. The focus in this case is: Where is the money going?

Search for Useful Sources of Information. This case gives students a chance to consider what information would be useful in making a decision about this claim. In our experience, students tend to be unfamiliar with the types of information that are available in an investigation. This is not a surprise, as they often have limited experience with company documents, and even personal documents. So, this case encourages students to think about what type of information would be useful, and what documents would be relevant. For instance, to learn more about the family's spending, they could request bank statements, and to learn more about the value of the home, they could ask for an appraisal report.

CASE

Phase 1

This case asks you to apply your forensic accounting skills to a specialized area of forensic accounting, insurance fraud. In particular, you should consider the possibility of a fraudulent claim for long-term disability insurance. The **Background Information** provides a brief description of disability insurance. The **Disability Insurance Claim Information** gives details about the policyholder's claim and financial condition. In the **Questions for Phase 1**, you will identify and discuss issues and concerns you might have as an insurance fraud investigator.

Background Information

Disability insurance, also known as disability income insurance, provides income if a person is unable to work. This form of insurance protects the

earned income of the beneficiary (the insured policyholder). A disability policy protects income against the risk that disability will make working (and therefore earning) impossible. Such a policy is designed to pay for living expenses if the policyholder becomes unable to work due to accident or illness. There are several sources of disability insurance, including federal government social insurance programs, employer-supplied disability insurance, and state-run workers' compensation benefits. In addition, policies can be sold and issued to individuals through insurance companies, which is applicable in this case.

There are two types of disability policies: Short-Term Disability (STD) and Long-Term Disability (LTD). STD policies typically take effect after 14 days of disability and may extend for two years. LTD policies usually take effect after several weeks of disability and may provide benefits for a few years, to the time when the person can collect social security payments, or even the remaining years of the person's life.

Disability insurance policies differ in the definition of "disability." One definition views the disability as a condition that prevents the person from performing the major duties of his or her chosen occupation. So, if a person cannot perform the main duties of his or her chosen occupation, this person will receive benefits. This is the "own occupation" approach, applicable in this case. Another definition views disability as a condition that prevents the person from performing the main duties of any gainful occupation. So, if a person cannot perform the main duties of his or her chosen occupation, he or she will be expected to obtain employment in another area. Earnings from another occupation may offset the disability insurance benefits. This is the "any occupation" approach.

DISABILITY INSURANCE CLAIM INFORMATION

Guardian Professional Protection Insurance Corporation File February 10, 2010

Assume that you are a claims investigator with Guardian Professional Protection Insurance Corporation (GPPIC), a large insurance company based in Chicago. You have received a claim on the long-term disability policy for Dr. Albert Sterling. His policy is of the "own occupation" type. You are responsible for determining the validity of the claim. Here is the information that you have at this time:

1. Dr. Albert Sterling is 59 years old.
2. He is a general surgeon.
3. He is the sole owner of his medical practice. There are two offices, one in downtown Chicago and one in Lake Forest.
4. He has ten employees between the two clinics. They are nurses, office managers, medical records specialists and receptionists.

5. He has hospital privileges and does his surgery at two well-known hospitals.
6. He works around 60 hours a week performing surgery, visiting patients in the hospital, and conducting office appointments.
7. Mrs. Melissa Sterling and Dr. Sterling have been married for 35 years.
8. Mrs. Melissa Sterling has been a full-time homemaker since her marriage.
9. They have two children, Lauren and Albert Jr. (A.J.).
10. Lauren works in her father's Lake Forest office. She attended college for 2 years. She is married with one child.
11. A.J. graduated from a local university with a degree in business administration and is employed with a local market research firm.
12. Dr. Sterling reports the following salary information:

Year	Amount
2012	\$550,000
2013	575,000
2014	610,000
2015	620,000
2016	630,000

13. The combined federal and state individual income tax rate is approximately 40%.
14. Dr. Sterling states that he has been suffering from debilitating depression recently. He has filed a claim for long-term disability insurance, asserting that he cannot continue to work in his profession, as a surgeon.
15. Dr. and Mrs. Sterling's personal financial statement (Personal Statement of Net Worth/Balance Sheet) has not changed significantly since the policy was issued in December of 2012. Copies of the Personal Statements from December 31, 2012; December 31, 2013; December 31, 2014; and December 31, 2015 are in GPPIC files. The Personal Statement for December 31, 2016 is provided next.

Dr. and Mrs. Albert Sterling Personal Statement of Net Worth/Balance Sheet As of December 31, 2016	
Assets	
Cash	\$10,000
Automobile	50,000
Personal Property	60,000
Boat	100,000
Collectables	350,000
House	600,000
Pension	210,000
Interest in Professional Corporation	<u>1,200,000</u>
Total Assets	\$2,580,000
Liabilities	
Automobile Loan	\$25,000
Home Mortgage	400,000
Pension Loan	<u>15,000</u>
Total Liabilities	<u>\$440,000</u>
Net Worth =	
Total Assets – Total Liabilities	<u><u>\$2,140,000</u></u>

Under federal penalties of perjury, I do swear and affirm that the information provided above is true and correct to the best of my knowledge and belief.

Signed: Albert Sterling, M. D. Date: January 15, 2017

Note: All persons, organizations and companies in this case are fictitious. However, many aspects of the case are realistic.

QUESTIONS FOR PHASE 1

1. What type of income is Dr. Sterling hoping to replace?
2. In general, do you notice anything unusual about the Personal Statement? Consider that Dr. Sterling is 59 years old and his children are adults. He is a surgeon, and surgeons usually work a lot, and are usually high-income professionals.
3. What accounts on the Personal Statement should you investigate? Why? Please be specific as to why these accounts are of concern.
4. Consider accounts that you do not see on the Personal Statement. Please identify these accounts and discuss what concerns you would have because these accounts are not reported by the Sterlings. In other words, what accounts might you expect to see on such a Personal Statement for a high-income family?
5. Here are two guidelines usually used by claims investigators in these types of cases:
 - (1) If a person is trying to accumulate wealth, his or her home should cost at least twice as much as his or her take-home pay.
 - (2) A commonly-used formula for expected net worth is:

$$\text{Expected Net Worth} = \frac{(\text{Age} - 10 \text{ years}) \times \text{Current Yearly Pretax Household Income}}{10}$$

Please apply these guidelines to the Sterlings. Show your calculations. How do the Sterlings “measure up” here?

6. What concerns do you have about Dr. Sterling and his disability insurance claim?
7. What additional sources of information (documents, interviews, etc.) should you request or search for?