

# CHAPTER 1

## Keep On Trucking

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Jenny Baker was viewed by her associates as a brilliant CFO. She was known for her ability to predict the outcome of future uncertainties with startling accuracy. She was also known to be very demanding, even intimidating at times. Many of her staff had experienced one of her famous outbursts; consequently, they didn't always feel comfortable asking her many questions. She had started her career as a staff auditor for one of the Big Four accounting firms, where she specialized in the transportation industry and was well regarded for her understanding of the nuances of sometimes complex financial transactions.

Using her experience as a launching pad, Jenny had taken a job in regulatory accounting for a regional trucking firm and had moved quickly through the ranks to become the CFO. Not content with a regional firm, she had made several strategic career moves that finally landed her a job as vice president of finance at a national transportation company. During her tenure there, Jenny had gained the confidence of those around her, including the CEO and many of the directors on the company's board.

While pursuing her career, Jenny had also found time to marry and have two children; she even had three grandkids. When she wasn't working, she loved to spend time with her grandchildren; she would even plan her vacations as family events so that she could include them. She was in her mid-fifties, had a nice home, a country-club membership and was no longer driven to advance in her career. She was satisfied with where she was in life. Her long-term plan was to retire early and enjoy all of the things she had worked so hard to earn.

### Atkins Trucking

Atkins Trucking Company had been founded in the late 1930s as the economy began to recover somewhat from the Great Depression. The company

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began as a local trucking firm in a major metropolitan area in the north-east. The founder, Daniel Atkins, had prided himself on delivering high-quality service and always pleasing the customer. Over the years, the company had acquired a reputation for integrity.

After World War II, the transportation industry really began to grow and Atkins Trucking expanded from a local operation to a regional firm and eventually became a national player in the field of transportation. As a result of the expanded transportation market and to recognize new service lines, the company had changed its name to Atkins Transportation Services. Because of family influence, however, the company remained closely held. The only public financing of company activities came from the debt markets. The company made regular use of commercial paper and occasionally issued bonds for long-term capital investments. Atkins Transportation employed 3,500 people concentrated at corporate headquarters, as well as in strategic transportation hubs located throughout the United States.

### Always Learning

I was the internal audit director for Atkins Transportation Services. My department consisted of six employees, one of whom was designated as a special projects auditor. One of the things we liked to do was proactively look for fraud. We often undertook data mining to look for improper expenditures or unusual vendor relationships. Sarah Harrington, the special projects auditor, routinely brainstormed with me about new approaches for finding fraud. One day we received a brochure describing a forensic accounting class focusing on financial statement analysis. Since neither of us had taken such a class before, we signed up for it. It turned out to be a wise investment.

Forensic financial statement analysis typically includes techniques involving horizontal and vertical relationships among the basic financial statements — the balance sheet, the income statement, and the statement of cash flows. I remember the instructor specifically telling us to focus on “time-sensitive interdependencies” to identify possible manipulation. In other words, look at what happens over time, not just the current year or the previous year. He also said the most important indicator of earnings manipulation is the correlation of reported earnings with reported cash flows from operations. After completing the class, we had lots of new tools at our disposal to look for fraud.

Armed with this information, I downloaded ten years of company financial data into a spreadsheet and began the process of selectively graphing the relationships we had been taught in class. This was a tedious process, but it began to reveal some unusual patterns. For the early years on the graph, the reported earnings did correlate well with the cash flows from operations; however, the most recent five years showed a remarkable

divergence in correlation. Moreover, an analysis of the allowance for doubtful accounts showed entirely unexpected results. For example, during a period of strong revenue growth, the allowance had increased dramatically. According to what I had heard, the company was doing a great job at collecting accounts receivable. What I was seeing painted a different picture.

This was all new territory to me. We weren't quite sure what to do next. However, I remember thinking, "This is exciting . . . this stuff really works!" Almost every day, I would call in Sarah or one of the other auditors to show them what I had found. "Look at this," I said. "Do you understand why this is happening?" No one had any explanations.

As I continued my analysis, Sarah began to download journal entries from the company's accounting system. She organized the entries and looked into some of the accounts that didn't make sense. One day Sarah came into my office and said, "I found some journal entries with the notation 'Jenny's entry' as the explanation for the transaction." I asked, "Is there any other information about the purpose of the entry?" "No, that's all there is," she said.

Sensing that we had found something significant, we began to discuss what to do. Soon a consensus emerged that we should talk to our external audit firm. They were already onsite with only six more weeks until the annual report was completed. We scheduled a meeting and showed the engagement partner and the auditor in charge our financial statement analysis. Then we talked about the transactions we had found with the unusual notations. They seemed interested in our work, but their initial response was, "We need to finish the engagement . . . our opinion is due by the 30th of next month." This didn't sound promising, but they said they'd get back to me.

After a few days, I received an e-mail from the engagement partner saying they were not going to pursue the issue this year. They had looked at their work papers and they were satisfied with the explanations they had received from management. However, they suggested that we look more closely at the issues. I thought, "Great . . . what do we do now?"

### **Management by Intimidation**

"Why can't the controller explain these entries?" I asked. Sarah and I had just come from a meeting with the company controller and the director of accounts receivable. Rather than take a more direct approach in our investigation, we had decided to initiate an audit of accounts receivable. That way, we could gather more information and not raise too much concern.

Our meeting had started off well, but soon became uncomfortable when we asked about some of the entries that had been made to the allowance for doubtful accounts. We showed the controller, Stewart Wood, some of the journal vouchers with the notation "Jenny's entry" and asked if he could explain them. He responded, "If you want to understand those

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entries, you'll have to go and talk to Jenny." "Why is that?" I said, "Don't you know the reason for these entries?" At that point, Stewart became defensive and said, "Those entries are communicated to me by management; you'll need to talk to them."

Not wanting to concede so easily, I changed tactics and said, "These entries are affecting our bottom line, Stewart. Some of them increase the bottom line and some of them decrease it. What do you think management is trying to do here?" Stewart was unwilling to respond, so Jack, the director of accounts receivable, intervened and said, "I've worked in this industry for a long time and this kind of thing is not unusual. Management is just trying to smooth out the peaks and the valleys. This is fairly common; you shouldn't be too concerned about it."

Next we turned our attention to some of the bad debt accounts related to the allowance for doubtful accounts. Jenny was very exacting in her demands for information, so the controller had set up several accounts to keep track of bad debts by service line. There was a bad debt account for short-haul service, one for long-haul service and one for international service. There was even an account called "Bad debt — NA." I showed this to Stewart and asked him what "NA" meant. He responded, "It means 'not assigned.'" "What do you mean by that?" I said. Stewart explained, "This account is not assigned to any of our service lines; management uses this account to make occasional adjustments to bad debt expense." "Is this part of your normal monthly process?" I asked. "No," Stewart replied. "Management decides when we make entries to this account."

I asked Stewart to explain the methodology for determining the amounts to book to the NA account. He said he didn't know the methodology. I then asked to see the substantiation for some of the entries. He said he didn't have any. I asked him who approved the entries to this account and he told me that no one approved them. "These entries are made at Jenny's direction," he said. "No one needs to approve them."

This was astounding to me. There were absolutely no controls over some very material accounting entries. How could the external auditors have missed this? I knew from prior audits that the monthly process for estimating bad debts was well substantiated and that all entries were required to be approved. We had apparently stumbled into a dark closet and we soon discovered that no one appreciated us trying to shine some light in there.

Before proceeding further though, Sarah and I decided to dig into the accounting records some more. We downloaded all the entries made by Stewart over the past five years and then performed text searches looking specifically for the words "Jenny's entry" in the description field. We learned that Jenny concentrated her unusual activities in two areas: accounts receivable and regulatory reserves. We already knew what was happening in accounts receivable so we began to focus on the regulatory reserves.

Regulatory reserves were contingent liabilities established for settling accounts with various taxing authorities. In the transportation industry, licensing fees and taxes were subject to audit and sometimes the taxing authorities would make adjustments to what the company had already paid. The reserve accounts were established to estimate potential audit adjustments.

Next, I charted the balance in the reserve accounts over ten years to see what was there. Not surprisingly, I saw the same unusual pattern of increasing and decreasing balances that seemed unrelated to underlying business conditions. "Those must be some of the peaks and valleys," I thought.

Sarah scheduled a meeting with the director of regulatory accounting to see if he could help explain the regulatory reserve transactions. Soon after scheduling the meeting, Sarah received an e-mail from the director explaining that he was headed away on vacation and he would like to delay the meeting until after he returned. That seemed strange; he knew about his vacation when he scheduled the meeting. Why did he want to delay it? Soon we learned that Jenny had ordered him not to meet with us until he returned.

The next morning, I received a call from the CEO, Todd Martin. He wanted me to know that he had received a call from Jenny Baker. She had complained that I was being unprofessional in dealing with her staff. She said that I had told her staff that she was manipulating the accounting records. I told Todd that all we had done was ask questions about some accounting entries that didn't make sense. We didn't know what was happening and the only way to find out was to ask questions. Todd replied, "Just be aware that Jenny isn't happy about what you're doing. Watch your step."

Later that day I received an e-mail from Jenny telling me that she wanted to know the scope and objectives of our audit. She said her people were busy doing their work and didn't have time for all of the questions we were asking. I replied that we had sent a memo to the director of accounts receivable announcing the audit and that she had been copied. I also explained to her that once we began collecting information, we had found some entries that didn't make sense. I stated, "As auditors, we have the responsibility and the authority to follow the trail wherever it leads." I copied the CEO on my response. Jenny didn't reply.

After the director of regulatory accounting returned from his vacation, we succeeded in scheduling a meeting. Sarah met with him and got the same story we had already heard. The director kept track of all of the known regulatory liabilities, but Jenny directed him to create reserves for unknown liabilities. The director couldn't explain the methodology for estimating these reserves. The amounts were determined by Jenny based on her years of experience in the transportation industry. He had no reason, nor desire, to question Jenny about the reserves. If we wanted to know more about them, then we'd have to ask Jenny.

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After talking it over with Sarah, we decided to go directly to Jenny for answers. We scheduled a meeting for the following Monday. When we arrived, we noticed several of her high-ranking staff members arriving in the conference room as well. We had expected to be meeting with Jenny alone. Perhaps this was an intimidation tactic — Jenny was famous for intimidating her own employees. Now it was our turn. I leaned over to Sarah and whispered, “Looks like this is going to be a big meeting.”

Once the meeting got started, we proceeded to explain our concerns about the accounting entries we had found. We reported that internal controls over certain transactions were nonexistent and asked Jenny if she could explain what was happening. Her response was unusual. Rather than discuss the specific transactions, she began by talking about the complexity of the transportation industry. She talked about all of the regulatory and economic uncertainty and how it affected financial reporting. She then reviewed all of the experience that she and her staff had and said they were more than qualified to account for all of that uncertainty by including reserves in the company’s financial statements. We, conversely, didn’t have the same experience that she had; we were not experts in the industry. I admitted to her that we didn’t have the same experience that she had, but we could understand the accounting if someone explained it to us.

Although she didn’t say it, her message to us was that we had to rely on her experience rather than normal accounting rules. That’s where I turned my attention next. Prior to the meeting, I had brushed up on internal controls over accounting estimates as well as the rules for recording contingent liabilities. I asked her, “So, you’re telling me that with all of the uncertainty in the transportation industry, it’s hard to estimate things like bad debts and tax liabilities?” “Yes,” she replied. “It’s almost impossible to estimate things like bad debts or regulatory reserves. We look at our financial statements each month and if the numbers don’t look right, we make adjustments as needed based on our experience. We try to reflect the underlying business.”

I informed her that according to FASB No. 5, *Accounting for Contingencies*, contingent liabilities may be recorded only if it is probable that an asset has been impaired or a liability has been incurred. Moreover, any contingency must be capable of reasonable estimation. If those criteria aren’t met, then the proper accounting treatment is to disclose the contingency rather than to record it. She then stated firmly, “Our financial statements have been audited by our external auditors and they had no problems with any of the entries.” I told her that we planned to talk to the external auditors, but any further information she could provide might be helpful. After some additional comments by Jenny, the meeting concluded.

Before contacting the auditors, however, I told Sarah that we needed more information. “Let’s dig through the accounting records and see what we can find,” I said, so Sarah headed over to the accounting department to

begin looking at the suspicious journal vouchers and making copies of any supporting documentation. When she got back, we began to review the vouchers. After looking at a number of documents, Sarah suddenly exclaimed, "Look at this!" She handed me a voucher with a copy of an e-mail from Jenny attached to it. It was written to the controller instructing him not to report some extra income the company had received that quarter. It stated, "Don't book this as income. Put it in the reserve accounts." That was all we needed to make our case. I immediately called the CEO's office to schedule a meeting.

### **Dreading the News**

The CEO was out of town, so our meeting had to wait until the following Friday. The delay allowed us plenty of time to put together a solid presentation. We had examples of journal entries with no support and no approval; we had graphs showing the ups and downs in the allowance for doubtful accounts, as well as the regulatory reserves. We had a graph showing the reported bottom line and what it would have been without "Jenny's entries." And to top it all off, we had Jenny's e-mail ordering the controller not to report income.

All of this painted a clear picture of improper earnings management, the goal of which is to smooth reported earnings. Jenny accomplished this by increasing contingency accounts like the allowance for doubtful accounts and other reserves when business was good and decreasing the accounts when business was bad. Within generally accepted accounting principles, management has the ability to influence reported earnings, but only within reasonable limits. Jenny was clearly out of bounds.

When I arrived at the CEO's office on Friday, he was anticipating me like someone anticipates a trip to the dentist. He knew it needed to happen, but he wasn't looking forward to it. Once I showed him our presentation, he asked, "Why is Jenny doing this? I don't understand it. Atkins Transportation already has a strong financial position." "I think it's the debt rating," I replied. "Bondholders and ratings agencies like to see stable earnings. Greater earnings volatility means greater risk; greater risk means higher interest rates. Stability lowers our debt costs."

The CEO leaned back in his chair, thought for a few minutes, and said with a sense of resignation, "I need to call the chairman of the board; why don't you go call our audit firm and get them over here." I agreed and left the room. I wasn't happy about any of this, but it was my job. Atkins Transportation Services had built an excellent reputation. This kind of behavior could permanently damage that reputation. These practices needed to be stopped.

During the next few days, there was a flurry of activity. I had meetings with the audit committee, a meeting with the chairman of the board and a

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meeting with our audit firm. The audit firm formulated a plan to restate earnings; we hired consultants to help with the process, and my staff was enlisted to provide assistance. Our legal counsel began the process of contacting the SEC and our debt underwriters to inform them of the situation and what we planned to do about it. No one knew what the repercussions would be, but we believed we were doing the right thing to protect our reputation.

Rather than being fired, Jenny was given the option to retire. She gladly accepted the opportunity to “spend more time with her family.” I believe it was the right outcome. Jenny’s departure would allow her to spend time with her grandkids, and she would no longer be under the pressure she felt to achieve a certain level of financial performance. I was certain her employees would be relieved.

### Lessons Learned

When Sarah and I first considered taking a forensic accounting course, we had high hopes, but we weren’t sure how valuable the material would be. After all, we had already been to quite a few auditing courses in our careers and studied published resources as well. What we learned, however, was a different approach to investigation. Forensic accountants must be very thorough because their reports typically end up in court where they will be attacked by the opposing side.

Preparing for this type of encounter requires a highly disciplined approach to an investigation. For example, the auditor must acquire a very strong knowledge of the company’s financial statements. This can be achieved only by reading the statements thoroughly and analyzing the numbers using horizontal and vertical techniques that include graphical depictions. The minimum suggested analytical horizon is the previous five years, but in this case we needed to go back ten years to see the unusual relationships that existed. If we had not taken the time to do this, we would not have uncovered the improper activities. The forensic accounting course gave us the tools we needed to be successful.

We also realized the importance of corporate culture. Jenny was known for intimidating her employees and that environment allowed the accounting scheme to sprout and grow without opposition or detection. After a while, everyone considered the unusual entries to be a part of the normal routine. No one questioned why the entries were being made. The culture made it possible for the scheme to take place.

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Although it seems like an elementary concept, we also saw the importance of basic internal controls. If controls such as requiring substantiation for every entry and requiring approval for every entry had been followed, then it would have been far more difficult for someone to start and perpetuate the kind of activities we found during our audit.

We also found that we needed a thorough grasp of basic accounting rules. For example, we had to review the definition of a *liability* and we also had to understand accounting for contingencies. We found it was most helpful to go back and read the original accounting statements from the Financial Accounting Standards Board. Textbooks were helpful, but the original pronouncements included discussions that were right on point and helped us make our case. In fact, those resources were indispensable in overcoming opposing viewpoints.

Then there was the issue of becoming discouraged. When undertaking this type of audit, it is possible that feathers will be ruffled or careers will be threatened. Sarah and I found it helpful to read about similar situations as described in educational materials from the Association of Certified Fraud Examiners. These books and videos confirmed for us that we were finding real problems, not misunderstandings. We also found encouragement by reading books like *Extraordinary Circumstances* by Cynthia Cooper, who recounted what happened to her while investigating the WorldCom scandal. We knew if she could fight through to the end, we could do it also. It made the obstacles easier to overcome because we knew what was coming and could prepare for it in advance. These resources made a big impact on our audit.

## Recommendations to Prevent Future Occurrences

### *Pay Attention to Significant Transactions*

Auditors, both internal and external, sometimes get in the habit of focusing on routine accounting transactions while ignoring non-routine transactions. This is true because most accounting transactions are routine in nature. They happen on a regular basis and are well understood. Nonroutine transactions, however, have a much higher risk because they fall outside the normal accounting process.

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More audit effort should be expended to identify nonroutine transactions and determine the purpose of those entries. Moreover, nonroutine accounting entries should be evaluated throughout the reporting period, not simply the entries made near the end of the year. Manipulation of accounting records can occur at any time.

### ***Apply Controls to All Transactions***

Internal controls do not work if they are not applied to all transactions. There should be no special class of transactions that are controlled differently than others. The same principle applies to transactions originated by higher levels of management; the same controls should apply regardless of who requests an entry. Controlling 99% of the accounting entries is insufficient. That remaining 1% is more than enough to misstate financial results.

### ***Increase Board Involvement***

Sarbanes-Oxley requires that qualified financial experts serve on the boards of publicly traded firms; however, not all companies are publicly traded. Therefore, it is important for those firms to compensate in some way if there is no qualified financial expert on the board. One way is to hire a board consultant whose job it is to interact with company financial executives, understand what they are doing and advise the board on matters of significance related to financial reporting. Regardless of the type of firm, financial reporting should be a priority for all board members, and audit committees should be very engaged in the financial reporting process.

### ***Don't Tolerate Abusive or Defiant Behavior***

There is often a tendency at the higher levels of an organization to tolerate behavior that is otherwise unacceptable. There are many reasons for this, but regardless of the reasons, there should be an understanding that deviations from behavioral standards promote an environment where other standards also may be violated. Behavioral issues involving high-ranking financial personnel should not be viewed in isolation but should be considered a weakness in the control environment that can have a real impact on financial reporting. Boards and CEOs need to evaluate this risk and auditors need to consider it in planning their audits.

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### *Improve Auditor Awareness and Training*

An auditor is only as good as the tools at his or her disposal. Training is an essential ingredient for success. There is always new fraud research being conducted, new audit techniques being developed and new fraud schemes being hatched. Auditors must remain current with these new developments if they wish to remain effective. Without adequate training, auditors might overlook issues that have the potential to cause serious harm to the public, to employees and to company reputations. Training is always a wise investment.

### **About the Author**

**Ralph Wilson, CFE, CPA**, is a graduate of Liberty University and the University of Virginia. He has approximately 25 years of professional audit and compliance experience in a number of industries, including financial services, education, healthcare, not-for-profit and governmental. Mr. Wilson also teaches graduate auditing and fraud examination courses.

