Case Study 38: Exclusive Restaurant or a Front for Illegal Gambling 295
Cynthia E. Bolt

Case Study 39: Madon Oilfield Services, Inc. 297
Christopher E. Peters

Case Study 40: Southlake Hematology/ Oncology Associates 319
Wilson A. LaGraize, Jr.

Please visit *CCHGroup.com/Resources* for any periodic updates or clarifications that may become available related to *Case Studies in Forensic Accounting and Fraud Auditing* as well as CCH's *Daily Tax Day* news, tax briefings and other items of interest.

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.

http://www.pbookshop.com

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.

http://www.pbookshop.com

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

http://www.pbookshop.com

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

http://www.pbookshop.com

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).

http://www.pbookshop.com

Exhibit 1: Deposit Slips

Bank Copy

Bank Copy

Florida Sun Bank — Deposit

Name: Miami Rehabilitation Services Date: 3/19/09
Address: 4698 Pinecrest Avenue
Miami, FL 33156

Store Number (Commercial Accounts Only): * 089-002-969
Account Number (For CAP Accounts, use 10-digit number): * 1999692829660

Items Deposited	Dollars.Cents
Currency	378.11
Coin	
Checks 1	1,014.05
2	
Sub Total	1392.16
Less Cash	0.
Total Deposit $	1,392.16

Record of Checks for Deposit — Bank Copy

	Checks	Dollars.Cents
1	8723	87.25
2	179	197.33
3	339	135.32
4	169734	359.69
5	962	32.35
6	769	99.01
7	966	103.10
Total This Side		1,014.05

Office Copy

Office Copy

Florida Sun Bank — Deposit

Name: Miami Rehabilitation Services Date: 3/19/2009
Address: 4698 Pine Crest Avenue
Miami, FL 33156

Store Number (Commercial Accounts Only): * 089-002-969
Account Number (For CAP Accounts, use 10-digit number): * 1999692829660

Items Deposited	Dollars.Cents
Currency	428.11
Coin	
Checks 1	1,109.55
2	
Sub Total	1,537.66
Less Cash	0
Total Deposit $	1537.66

Record of Checks for Deposit — Office Copy

	Checks	Dollars.Cents
1	8723	87.25
2	179	197.33
3	339	135.32
4	169734	359.69
5	962	32.35
6	322	20.00
7	1579	75.50
8	769	99.01
9	966	103.10
Total This Side		1,109.55

Exhibit 2: Deposit Reconcilement

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.

http://www.pbookshop.com

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.

http://www.pbookshop.com

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 polices 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.

http://www.pbookshop.com

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.

http://www.pbookshop.com

Paper claims are received and sorted in the mailroom, along with all other mail for all subsidiaries. Paper claims are then delivered to Acme staff members who enter the claims data into the system. Prior to final submission, the data that is entered into the system is checked and approved by the single data entry manager on duty. The manager is able to correct any errors prior to submission. After submission, the claims are processed and paid.

All claims contain confidential data, including names, social security numbers (government identification numbers), and specific health care treatments provided to patients. Bob noticed that most of the Acme adjudication and data entry personnel are actually temporary employees hired through agencies. Acme prefers to use the services of temporary agencies to allow more flexibility and to reduce hiring costs in these high-turnover positions.

Bob also noticed that the data entry personnel who support MSW shared their facility with the data entry personnel from the other private subsidiaries. In fact, some of the data entry personnel who support MSW also work on claims from other private Acme subsidiaries. The manager of the claims processing staff explained that a separate facility was not available, and that a shared facility and workload allows for more flexibility to adjust for changes needed in staffing levels.

Since employees dedicated to several different subsidiaries share the data entry area for paper claims, the manager said that no one "owns" the space. Consequently, no single manager is responsible for approving, deleting, and reviewing all physical access to the data entry area. Instead, each individual manager is responsible for initiating requests to grant and delete physical access for their own temporary and permanent employees by notifying the facilities manager. The facilities manager can only print lists of everyone with access to the facility. Therefore, the lists are never reviewed, because individual managers are only familiar with their own employees. The facilities manager did state, however, that the individual managers of any employees who were terminated promptly notified him.

As part of the audit procedures, Bob and his staff examined a sample of twenty incoming electronic claims. The claim amounts were then compared with the amounts actually processed and paid by the computer system. Bob and his staff noted that the amount claimed exceeded the amount paid by the computer system by five cents for every third claim. They further observed that several of the lead programmers for the computer system had the ability to make changes to payment amounts.

PART I

Required:

- Address the following questions as they pertain to the noted areas of concern:

Physical Security

- What concerns might Bob have about the receipt of the paper claims with the regular mail?
- Why would Bob be worried about the sharing of the facility and staff members by several Acme subsidiaries (including MSW)?
- Why would Bob be concerned that no one reviews the physical access lists for everyone who may enter the processing facility?
- Related to physical security, Bob and his staff also requested a list of recently terminated employees and a current list of employees with physical access to the data entry and/or data center facilities. Using these lists, what types of tests could the auditors conduct to ensure that physical and logical access are properly controlled?

Logical Security

- In addition to the recently terminated employee list, Bob and his staff requested information related to logical security. Using the following requested information, what types of tests could the auditors conduct to ensure that logical access is properly controlled?
  - Current list of employees with logical (system) access privileges to the claims processing system, including users and administrators.
  - List of security software parameters, such as password length/type, number of logon attempts allowed; etc.
  - Procedures to control changes to claims processing and support software, along with logs or other records, which list recent changes.

Personnel

- What unique concerns might Bob have regarding the use of temporary employees?
- Why would Bob be concerned about the activities of the "single data entry manager"? What types of controls should be implemented?
- Why would Bob be worried that the adjudication staff can resubmit claims "without further review"?
- Bob learned that a single system programmer can write, test, and approve changes to the claims processing system software. Why is this a concern?

http://www.pbookshop.com

PART II

Required:

Address the following questions as they pertain to the noted areas of concern:

Audit Techniques

- Bob and his staff purposefully embedded 20 fictitious claims, which included the same type of data as a real claim, into the claims processing program. What is the name of this auditing technique, and what is its purpose?
- Bob also discovered that audit modules had been embedded within the claims processing program. These modules flag claims that exceed a specific dollar amount for a claimed procedure and records them in a special audit log. What is the name of this auditing technique, and what is its purpose?
- Bob and his staff decided to review the amounts submitted for payment for a particular sample of claims and then compare them with the actual amounts paid to the providers. Bob noticed that the amounts paid were consistently slightly lower than the amounts submitted. Since the difference only amounted to a few cents for each claim, why would Bob be concerned about this?
- Fraudulent claims have been a frequent concern in the Medicare program, including:
  - multiple claims for medical procedures that are usually not performed on the same patient more than once within a particular time period (e.g. organ transplants).
  - claims for medical procedures that cannot be performed for a particular patient (e.g. physical therapy coma patients).
  - claims for deceased individuals.

How can Computer Audit Software (CAS) assist auditors in identifying these types of fraudulent claims?

- To determine if the five-cent discrepancy for every third claim was fraudulent, what types of procedures might be used?

IV. SUMMARY/CONCLUSIONS

This case focuses on security and control procedures and relevant audit issues of both paper and electronic systems for the third-party processing of government-insured medical claims. As computerization of accounting information systems continues to accelerate, the accounting profession is undergoing radical change as it strives to provide value in today's automated society. In addition, to comply with Sarbanes-Oxley Section 404 requirements and SAS No. 94, auditors must assess internal financial controls and IT controls. Our

first goal is to help you understand security and control issues in both manual and computerized environments.

As enterprise wide systems eliminate the traditional paper-based audit trails and environments become heavily automated, auditors are increasingly using concurrent audit techniques (Gelinas et al. 2001). Our second goal is to introduce you to the scope and objectives of the information system audit and to familiarize you with different concurrent auditing techniques.

This case provides an opportunity for you to take the perspective of an auditor for HHS in addressing the security and control and other audit and fraud-related issues in both the paper and computerized environments. The case has application in upper division information systems, auditing, fraud, and forensic accounting courses and has been useful in helping students identify and address complex issues involving fraud, auditing, and IT.

http://www.pbookshop.com

REFERENCES

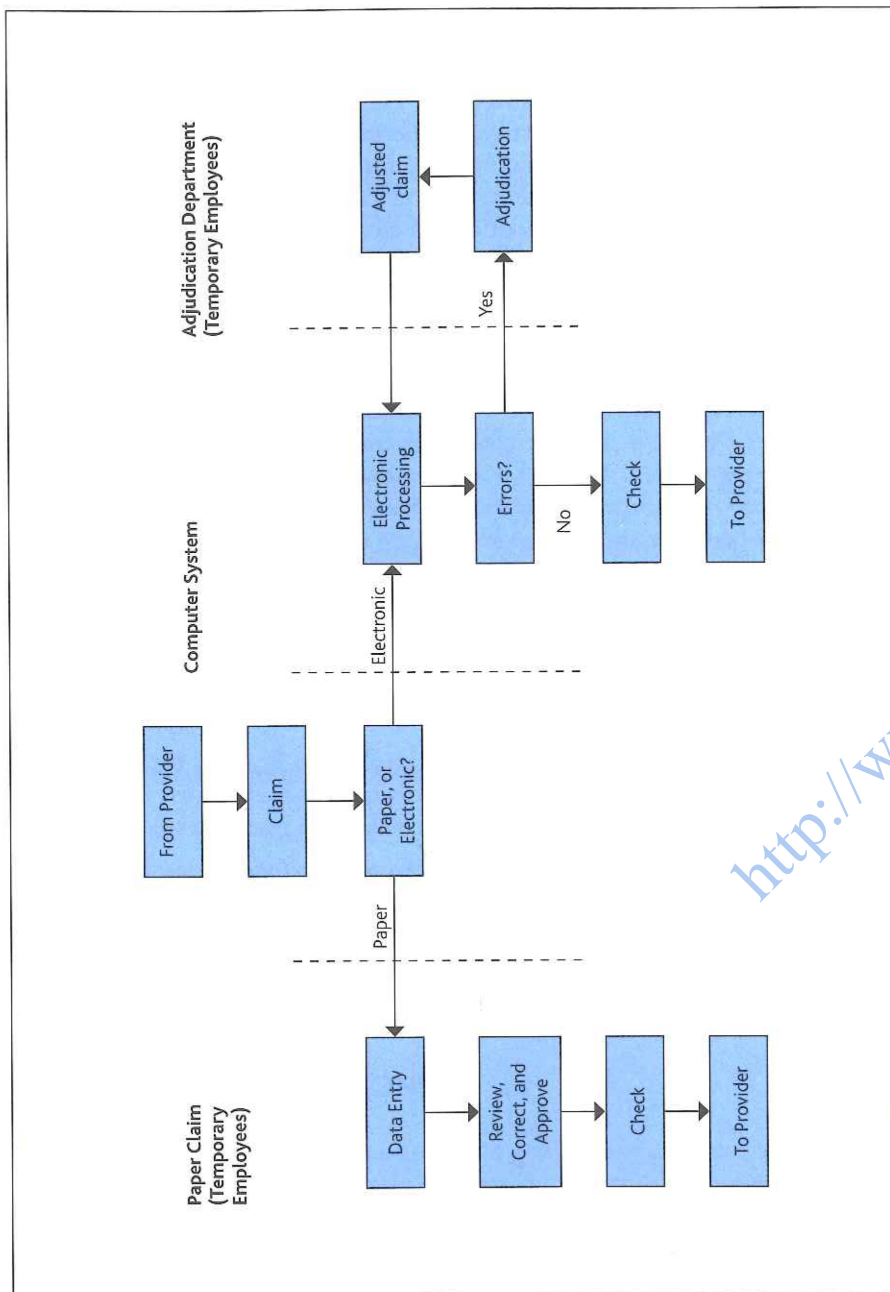
Bagranoff, N., M.G. Simkin, and C.S. Norman. 2004. *Core Concepts of Accounting Information Systems*, 9th Edition. Hoboken, NJ: John Wiley & Sons, Inc. 448.

Gelinas, U.J., Jr. W.A. Levy, and J.C. Thibodeau. 2001. Ntorood Office Supplies, Inc.: A Teaching Case to Integrate Computer-assisted Auditing Techniques into the Auditing course. *Issues in Accounting Education*: 603-637.

Hall, J. A. 2001. *Accounting Information Systems*. 3rd Edition. Mason, OH: South Western College Publishing. 133.

Romney, M. B. and Steinbart, P.J. 2005. *Accounting Information Systems*. 10th Edition. Upper Saddle River, NJ: Prentice Hall. 324.

Figure 1: MSW's Claim Processing System



CASE STUDY 11:

The Misguided Bond

Seth C. Anderson, Ph.D., CFA

Kim Capriotti, Ph.D.
Jacksonville University
Vincent Shea, Ph.D., CPA
St. John's University

http://www.pbookshop.com

LEARNING OBJECTIVES

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

- Recognize retail broker account mismanagement.
- Compare conventional bonds with put-constrained bonds.
- Learn a five-step forensic accounting process.

INTRODUCTION

This case features a 78 year-old married retiree who is seeking to improve the income from a retirement portfolio. Although the client has substantial savings, the client is not a sophisticated investor. He had previously relied on his late financial advisor who had recently passed away, but currently he relies on a financial advisor in the same retail brokerage office who "inherited" the account. The new broker advised the client's purchase of a put-constrained bond of a very risky nature of which the client was not aware. Ultimately, the client lost a substantial portion of his assets with the new speculative bond. You are provided with the client's yearly summary investment account statements, as well as excerpts from the prospectus. A dialogue format is used to present the issues, facts, and terminology of the case.

RELEVANT FACTS

Late in 2001, Ralph Martin, a former clothes salesman, sat on his patio evaluating his current retirement portfolio. Ralph, a 78 year-old retiree, had little interest in investment and had previously depended on his long-term friend

and financial advisor for investment advice. However, Fred had died almost two years earlier, and Blink Stowards, another advisor, had worked with Ralph since then. At the time of Fred's death, Ralph's $750,000 portfolio was split somewhat equally among intermediate term bonds paying income at approximately 6%, blue chip stocks yielding income of approximately 3%, and CDs paying income of approximately 5%. If it had been up to Ralph all of his money would have been in CDs because he was scared of stocks and bonds. Because of Fred's earlier guidance, the $35,000 portfolio income, along with their social security and his wife's teaching pension, allowed them to live comfortably and to lend some assistance to several college-age grandchildren.

Blink had been attentive of Ralph and had suggested several sells of "stodgy" equities such Heinz Foods, SCANA (Electric Utility), General Motors, and three natural gas utilities, in order to hopefully benefit the portfolio corpus, by investing in AT&T, Cisco, and a few other non-dividend paying telecommunications related stocks. The high-tech stocks had declined (although the old stodgy equities maintained their market values), but both Ralph and Blink were convinced that their long-term growth potential outweighed any other price risk. However, the CD component would be maturing very soon and then would need to be reinvested. Looking in his local paper's business section, Ralph saw CD rates at 2%, which would generate only $5,000 on the $250,000 principal in CDs.

Ralph mulled over the decline in income of their portfolio currently relative to the income generated earlier. He thought to himself that perhaps Blink might be able to make some suggestions which would supplement his annual income. He decided to call Blink the following Monday.

Meanwhile, in the Classroom

Susan Romano, a professor of accounting, was ending her afternoon forensic accounting class with a discussion of how to investigate the possible existence of broker account mismanagement. Earlier in the session she had discussed a generalized model for forensic accounting, which she and two other professors had earlier presented in an article.

The five-step process they used in the study entails:

I. Defining the question(s) of interest.

A forensic accountant hired as an expert must segment a broad legal question into inquiries that can be objectively measured.

II. Employing benchmarks that are commonly accepted to address the question(s).

Commonly accepted standards are selected for measuring the objective inquiries.

III. Cleaning data in a methodical fashion, which objectively allows the database to be compared to the benchmarks set forth. Data are purged of unreliable and unrepresentative observations in order to minimize the effects of data-entry error and increase the reliability of results.

IV. Comparing the data to the benchmarks.

The forensic accountant compiles observations into a format in order to compare the data set to the commonly accepted standards.

V. Providing conclusions that link question(s) to the benchmarks and then to the data. Conclusions are drawn which relate the forensic techniques employed to the questions of interest. (Waldrup et al, 2004).

Romano stated, "The two primary types of fraud usually involved in brokerage investment accounts include either "churning" (over-trading) of an account, or suitability/disclosure matters for securities in the account.

After answering a couple of questions, she continued, "In either instance, the forensic accountant needs to use the values on the client's investment account statement to determine the client's account profitability. There are two questions here. First, what calculations are required using these account values to reflect the amount of profits/losses incurred by the client? Second, are these profits/losses appropriate?"

A student queried, "Is there a formula that we should use to compute the amount of profits/losses?"

"In fact, there is a formula, and you probably are already familiar with it. Do you remember how you would compute the profit/losses on an investment account for the year?" She turned and wrote on the board the following formula:

"Total profits/losses = ending account equity value - beginning account equity value + total withdrawals - total deposits."

The Following Monday

Blink answered the first call of the day and heard Ralph Martin, with whom he hadn't spoken in several months. After a few perfunctory remarks Ralph began, "On Saturday I was looking at my portfolio and figured that my annual income now will only be about $21,000 if I renew my CDs at the 2% going rate. My stock income is significantly less than it was..."

"Yeah, that's right, but as we discussed the last time we talked, the potential growth from the telecommunications and other issues we bought probably outweighs any loss income."

"I agree. However, I'm pretty concerned about the extremely low rates on CDs now. What do you think about buying more bonds?" (See http://biz.yahoo.com/f/g/g.html for discussion of bond terminology.)

http://www.pbookshop.com

"It's good that you called at this time. Our research department has just put out a buy recommendation on some high-yield bonds that are backed by the stocks of several major companies. These bonds are short-term, only 12 months until maturity, and pay 12% annually. I haven't seen all of the details on them, but this really might be a good way to increase your total income and at the same time avoid the interest rate risk of intermediate-term and longer-term bonds."

"That certainly sounds good to me. What are the companies that back these bonds? You know that I don't like risky companies. This is all of the money that I have."

"Right off hand I remember that National Telecommunicating Data and Glorious Home Products are two of them. Both of these companies have done very well over the past five years and are certainly good companies for the long pull. Since these bonds are so short-term, I would be very comfortable for you to own them. Why don't you come down tomorrow and let me show you some information."

The Next Morning

Ralph sat across from Blink, who handed him a computer printout with statistics on three of the new "STRIDEs" offering by National Telecommunicating Data, Glorious Home Products, and Immediate Biotech. After briefly discussing the three companies, both Blink and Ralph agreed that the best company for Ralph would be National Telecommunicating Data (NTD), whose stock was trading at $20 per share. Each $1,000 unit face value of the offering had attached 50 shares of the NTD stock.

Ralph used a pencil to compute that the $250,000 currently in CDs would generate $30,000 of income, if invested in STRIDEs, which would give him a total of $46,000 on an annual basis.

"I like the increased income, but what are we going to do in a year from now when these things mature?"

"Well, our research department tells us that interest rates should go up in a year or two, and perhaps we can go back into CDs at that time. Anyway, the additional income from these high quality STRIDEs should help out over the next year."

"Yeah, that certainly will help."

Blink rose from his desk to shake hands as they concluded the meeting. "We don't yet have the prospectus for these STRIDEs available for distribution, but I'll get you one as soon as I get them." Blink had not read much about these new securities but was very attracted to selling them because of the commission. He trusted his manager's recommendation about the new STRIDEs and their safety.

"Great. You take care of it. You do what needs to be done."

Two weeks later Ralph received a thick packet of information and quickly flipped through the two documents filled with financial information. Before setting it aside, he thought, "Maybe I'll read this later, but I've never really understood this financial stuff anyway."

One Year Later

Blink stammered, "Ralph, I'm just as surprised as you. I never imagined that National Telecommunicating Data would be on the ropes now. This is unbelievable."

"Well, what about the principal amount? It was due last week and now your New York office says I've got to accept NTD stock because NTD stock price went down. I thought this was a bond where my money was safe."

Blink coughed nervously and responded, "I thought so, too!"

Over the next several days there were meetings between Ralph, Blink, and the brokerage office manager. Ralph was disgusted with the situation. They were no help.

The Lawyer

Upon the advice of his personal lawyer, Ralph met with another lawyer who specialized in complaints against brokerage offices. The lawyer carefully listened to what occurred with the STRIDEs at the brokerage office.

They agreed that the lawyer would contact a university professor of accounting who specialized in the area of forensic accounting.

Romano Gets a Call

Susan Romano entered the mailroom and noticed the pink telephone message slip awaiting her. Later that day she called Lynn Jinks, a lawyer with whom she had worked previously.

"Well, what do you have, Lynn?"

"I've got a potential client who lost a large portion of his retirement funds in something called a STRIDE, which is a new product of sorts sold by Big Brokerage Group."

"STRIDEs? What the heck are you talking about? I've never heard of STRIDEs in the financial world."

"I'm sending you all of the information on this case if you're willing to take a look at it."

The Information

Three days later Romano received a four-inch deep box containing a 321-page prospectus with an attached supplemental prospectus, year-end account statements, and numerous other papers pertaining to Martin's account. Among these papers was the opening account statement that showed the client's primary investment objectives in order as: (1) preservation of capital, (2) income, and (3) moderate growth. After reviewing the client's stated objectives, she turned to the year-end statements. The following table gives the values seen by her as reported on Martin's yearly statements for the last three years:

http://www.pbookshop.com

Statement Period
January 1, 2000 – December 31, 2000

	1/1/2000 Value	12/31/2000 Value
Bonds	$250,000	$250,000
CDs	250,000	250,000
Stocks	250,000	250,000
Total Portfolio Value	$750,000	$750,000
Income Source for the year:		
Dividends	7,500	
Bond Interest	15,000	
CD Interest	12,500	
Total Cash Disbursements for the year:		$35,000
Total Cash Received for the year:		0

Statement Period
January 1, 2001 – December 31, 2001

	1/1/2001 Value	12/31/2001 Value
Bonds	$250,000	$250,000
CDs	250,000	0
Stocks	250,000	175,000
STRIDEs	0	250,000
Total Portfolio Value	$750,000	$675,000
Income Source for the year:		
Dividends	1,000	
Bond Interest	15,000	
CD Interest	12,500	
Total Cash Disbursements for the year:		$28,500
Total Cash Received for the year:		0

http://www.pbookshop.com

Statement Period
January 1, 2002 – December 31, 2002

	1/1/2002 Value	12/31/2002 Value	
Bonds	$250,000	$265,000	
CDs	0	0	
Stocks	175,000	175,000	
STRIDEs	250,000	1,500	(NTD Stock)
Total Portfolio Value	$675,000	$4441,500	
Income Source for the year:			
Dividends	1,000		
Bond Interest	15,000		
CD Interest	0		
STRIDE Interest	12,500		
Total Cash Disbursements for the year:		$28,500	
Total Cash Received for the year:		0	

Romano looked at the summary diagram from their article that was written on the chalkboard to her left.

She thought, "It's obvious that the question of interest is the financial impact incurred relative to the benchmark of a well-managed portfolio. It was pretty clear that Martin's portfolio had experienced significant losses. As to the data, the year-end statements are all that we need. The comparison will be easy."

However, Romano will need to evaluate all related information to conclude whether or not the account had been mismanaged. Susan began reading the statement of claim, which was prepared for the arbitration between Martin and Big Brokerage and saw:

"In December of 2001 Big Brokerage, through Blink, advised Martin that he reinvest maturing CD monies in safe shorter-term investment grade bonds. Toward that end, Big Brokerage, through Blink, advised Martin that he should purchase National Telecommunicating Data bonds called STRIDEs that were tied to National Telecommunicating Data stock. Big Brokerage advised Martin that: (1) investors would receive very high, double digit returns; (2) the bonds were investment grade and backed by National Telecommunicating Data stock that could be sold to protect the principal; and (3) the bonds were safer, short-term investments. Big Brokerage represented to Martin that this was a secure investment, that Big Brokerage stood behind the investment, and there was no way to lose his principal. Big Brokerage further told Martin that if the

CASE STUDY 26:

Is the Current Use of Impression Management by Professors in the Classroom Similar to Earnings Management by Corporate Executives?

D. Larry Crumbley, Ph.D., CPA, CFF, Cr.FA, MAFF, FCPA
Kenneth J. Reichelt, Ph.D., CA, CPA (Canada)
Louisiana State University

LEARNING OBJECTIVES

http://www.pbookshop.com

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

- Determine whether an accounting technique is legal or aggressive earnings management.
- Learn about our dysfunctional accounting control system in higher education.
- Divide SET management techniques into harmful and good classroom teaching practices.
- Develop capital market, contracting, and regulatory incentives to manage earnings.

Higher education is experiencing the simultaneous phenomena of widespread use of student evaluation of teachers (SETs), student use of publisher test banks, grade inflation, course work deflation, student moral decline (resulting in widespread cheating and plagiarism), and increasing lower student motivation. SAT scores declined from 1972 until 1997, started increasing in 1998, and began another decline in 2006 to the present. Rosovsky and Hartley (2002) identified the beginning of grade inflation and the drop in SATs with the introduction of SETs.[1]

This decline in higher education is clearly explained by agency theory (e.g., Jensen and Meckling 1976),[2] a popular economic theory used by accounting researchers. Agency theory posits that because the actions of the agents (professors) are too costly to be observed by the principal (administrators, board of trustees, and legislators), agents are more likely to shirk/cheat. In higher education, professors manage the impressions of students to favorably rate their SET scores (Crumbley and Reichelt 2009), knowing that doing so is not easily observable

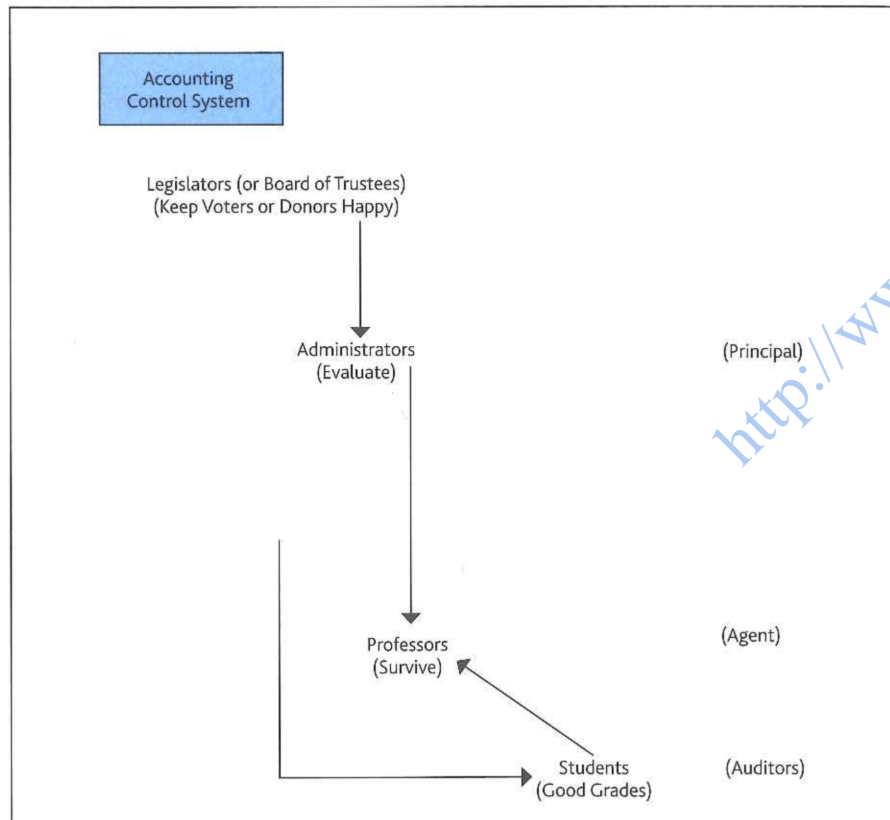
[1] Rosovsky, H., and M. Hartley. 2002. *Evaluation and the Academy: Are We Doing the Right Thing?* American Academy of Arts & Sciences. Available at: http://www.amacad.org/publications/monographs/Evaluation_and_the_Academy.pdf.

[2] Jensen, M. C., and W. H. Meckling. 1976. Theory of the Firm - Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics* 3 (4):305-360.

by their superiors or other faculty, and, in turn, it will lead to promotion, tenure, and improved compensation, all with much less effort.[3]

To elaborate, legislators for public universities and Board of Trustees in private universities tell administrators to increase retention rates and to evaluate the teaching effectiveness of university professors. Administrators then hire the inventory (students) to evaluate (e.g., audit) the professors. While using students in this manner may be an inexpensive and quick way to evaluate professors, this method does not measure learning. In fact, this dysfunctional system has actually reduced respect for professors and the higher education process. Administrators prefer higher SET scores, which lead to higher grades, higher student retention rates, and more tuition and tax revenues. As the chart in Figure 1 illustrates, professors will focus on pecuniary benefits and inflate grades and decrease their course work to survive because they are caught between a rock and a hard place.[4]

Figure 1



[3] Crumbley, D.L., and K.J. Reichelt, "Teaching Effectiveness, Impression Management, and Dysfunctional Behavior: Student Evaluation of Teaching Control Data," *Quality Assurance in Education*, Vol. 17, No. 4, 2009, p. 378.

[4] Flinn, R.E., and D.L. Crumbley, *Measure Learning Rather Than Satisfaction in Higher Education*, Sarasota, FL: AAA, 2009, Preface, xiv.

Professors today may be hired, rewarded, promoted, tenured, punished, and fired largely based on student opinions at the end of each semester about their classroom teaching.[5]

As an example of this dysfunctional system, a Dean at Louisiana State University gave the following instructions to her professors:

> Please know that your eligibility for future multiyear contracts will be contingent on satisfactory performance through a review of your annual performance reviews, instructor evaluations, and rate of student success as measured by the percentage of students receiving a D, F, or withdrawing from your course.

Apparently, this college was experiencing a reduction of incoming students, so "hard" professors and "hard" courses will now be penalized even when students drop the course. Here is more than subtle pressure on the professors to give higher grades and deflate course content.

Faculty promotion, tenure, and merit decisions typically are based on some combination of research, teaching, and service. Research normally is based on quality and quantity, while teaching effectiveness is based on peer evaluations, grade distribution, drop rates, and SET scores. The SET questionnaire is a control device used to audit professors and to measure their performance by students. As an analogy, where stakeholders rely on financial and other statistical information, they are deeply concerned with the relevance, reliability, comparability, transparency, and neutrality of the data. In fact, the rise of the accounting profession occurred primarily because of the desire for better financial reporting. Both public and private educational institutions utilize external or internal audits, but many administrators seem unconcerned with the relevance, reliability, comparability, and neutrality of the student data used to evaluate teaching. Because administrative decisions are often irreversible, positions and even careers may be at stake, data on which such decisions are made should be of proven validity.[6]

Suppose external auditors' performance was based solely on satisfied clients. Soon auditors would only be consultants, and there would be many more Enrons, WorldComs, and HealthSouths. Suppose prison guards' performance evaluations were based upon their prisoners' anonymous questionnaire evaluations? As Dr. Mike Davis often said, in education the inmates are in charge of the system, and they are clearly aware of their power over professors. This dysfunctional system in higher education causes professors to inflate grades and reduce course work content.[7]

The various pressures from administrators, legislators, peers, parents, alumni, and students upon professors are illustrated in Figure 2:[8]

[5] *Ibid.*

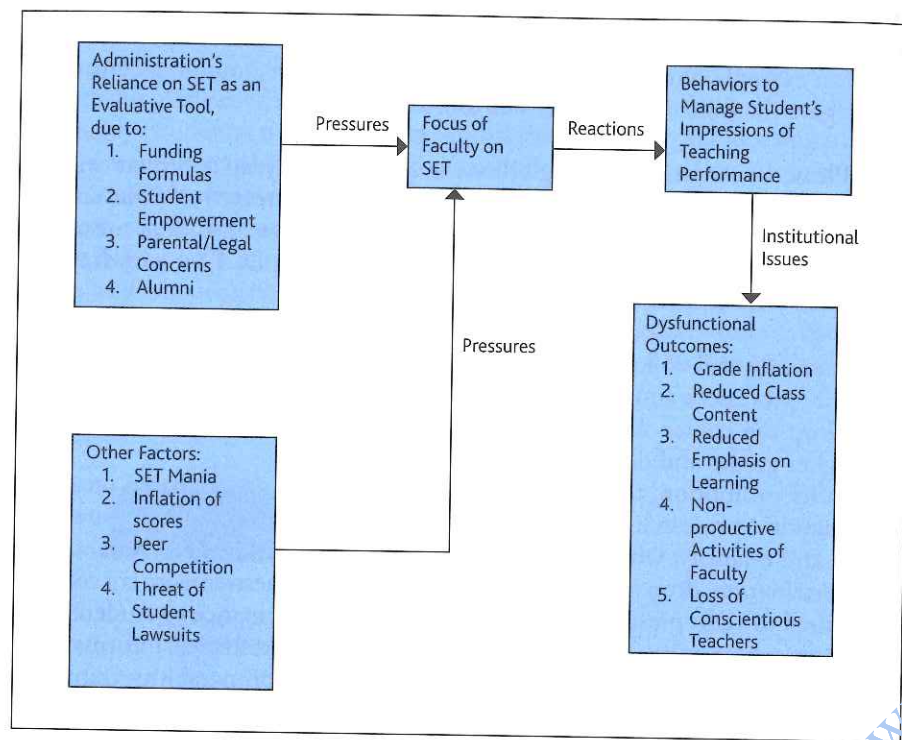
[6] Crumbley, D.L., and K.J. Reichelt *supra note 3*.

[7] Crumbley, D.L., and G.S. Smith, "The Games Professors Play in the Dysfunctional Performance Evaluation System Used in Higher Education: Brainstorming Some Recommendations," in *Measure Learning Rather Than Satisfaction in Higher Education*, Sarasota, FL: AAA, 2009, p. 45.

[8] Crumbley, D.L., and K.J. Reichelt *supra note 3*.

http://www.pbookshop.com

Figure 2



The pressures to increase their SET scores force professors to engage in impression management and dysfunctional behavior. An evaluation system based on SET scores causes professors to present themselves in a defensive manner in order to control the impressions students have of them.

Quite logically professors will try to manage their SET score, just as many executives manage their earnings. Massaging SET scores can be beneficial (or neutral) to learning or aggressive SET management (harmful to learning). But by definition one-half of all professors are below average, so many professors engage in aggressive SET management or pander pollution. Pander pollution may be defined as purposeful intervention by an instructor inside and outside the classroom with the intention of increasing SET scores, which is counterproductive to the learning process. The best approach is to give really high grades to the really poor students and induce the Santa Claus effect. Snyder and Clair found that students who received higher grades than they expected tended to give a "very positive teacher evaluation" (a happy birthday effect).[9] Worthington and Wong came to the same conclusion.[10] There is little adverse effect on a professor who inflates grades and deflates their course work.

[9] Snyder, C.R., and M. Clair. 1976. Effects of expected and obtained grades on teacher evaluation and attribution of performance. *Journal of Educational Psychology* 68 (1): 75-82.

[10] Worthington, A.G., and P.T. Wong. 1979. Effects of earned and assigned grades on student evaluations of an instructor. *Journal of Educational Psychology* 71 (6): 764-775.

Schipper defines earnings management as the "purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain."[11] Healy and Wahlen state that "earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."[12] Thus, SET management occurs when a professor grade-inflates or reduces coursework content with the intention of obtaining some financial gain, promotion, or tenure, which can have negative repercussions.

There are capital market, contracting, and regulatory incentives to manage earnings. Of course, there is both legal and aggressive earnings management. But the difference between legal earnings management and financial statement fraud can be the thickness of a prison wall. Although there have been thousands of accounting articles written about earnings management, little has been written about SET management. Further, an executive can go to prison for earnings management, but a professor is often rewarded or promoted for SET management.

http://www.pbookshop.com

W.R. Scott in his *Financial Accounting Theory* textbook outlines these "good" or legal earnings management techniques used by General Electric to "smooth earnings" from 1993 to 2007.[13]

- *Changes to the expected rate of return on pension plan assets.*
- *Sales of divisions.* Such sales generally lead to large special item gains.
- *Restructuring charges.* These are charges to current earnings to provide for expected costs of restructuring the operations of one or more of its many divisions. Apparently, GE managed the amounts and timing of these charges to offset large special item gains (e.g., sales of divisions). GE's objective was to avoid reporting higher earnings than could be sustained in future years.
- *Buying profitable businesses.* GE was constantly acquiring new subsidiary companies. If needed to prevent reporting an earnings decrease, managing the timing and identity of such acquisitions could achieve an immediate contribution to consolidated reported earnings in the year of acquisition.
- *Conservative accounting.* For example, rapid amortization of leased aircraft by GE's commercial finance division enabled large profits to be recorded when the aircraft are eventually sold. The timing of such sales can be managed by GE.
- *Allocation of purchased goodwill upon acquisition of subsidiary companies.* When GE acquires a subsidiary, it may decide, or be required, to dispose of segments of the acquired business. The flexibility under U.S. generally accepted accounting principles of allocation of the excess of amount paid for a subsidiary company over the fair value of assets acquired (i.e., purchased goodwill) enabled GE to record a gain on such dispositions, by allocating a relatively small amount of the excess amount paid to any subsidiary segments that is intended to be disposed of.

[11] Katherine Schipper. 1989. "Commentary on Earnings Management." *Accounting Horizons* 3 (4): 92.

[12] Healy, P. and J. Wahlen. 1999. "A Review of the Earnings Management Literature and Its Implications for Standard Setting." *Accounting Horizons* 13 (4): 368.

[13] W.R. Scott, *Financial Accounting Theory*, 7th Edition, Pearson: Toronto, 2015, pp. 476-477.

QUESTIONS

1. Decide whether these accounting practices would be considered aggressive earnings management by the SEC.
   a. Improper revenue recognition (e.g., bill and hold sales).
   b. Improper expense recognition.
   c. Using reserves to inflate earnings in years with falling revenues (cookie jar accounting).
   d. Shifting debt to special purposes entities.
   e. Channel stuffing.
   f. Careful timing of capital gains and losses.
   g. Use of conferencing technology to reduce travel costs.
   h. Postponement of repair and maintenance activities when faced with unexpected cash flow declines.
   i. Capitalizing marketing costs rather than expensing.
   j. Extending useful lives and inflating salvage values.
   k. Accelerating revenue from leasing equipment.
   l. Special purpose entities that are not consolidated.
2. What would have happened to university football or other sports teams if, starting in the 1960s and 1970s, coaches were hired and fired based on anonymous SET questionnaires of their players (such as professors)? What would happen if airline pilots were fired and hired based on passengers' anonymous questionnaires? What would happen if Internal Revenue Service agents were rewarded and fired by anonymous questionnaires of the taxpayers they audited?
3. If grades in universities and colleges continue to climb, what will happen to these institutions? What will employers be forced to do?
4. Faced with SET questionnaires each semester, using the classic prisoner's dilemma, what should a young professor do?
5. What are some capital market incentives to manage earnings?

http://www.pbookshop.com

6. Determine whether these steps that raise SET scores are aggressive SET management (harmful to learning), neutral, unclear, or "good" SET management (helpful to learning).[14]
   a. First and foremost, inflate your student's grades.
   b. Reduce the course material covered and drop the most difficult material first.
   c. Give easy examinations (e.g., true-false; broad, open-ended discussion questions; take-home exams; open-book exams).
   d. Join the college party environment by giving classroom parties on SET day. Sponsor student's officially approved class skipping days to, say, ball games or other events, as a means to increase student satisfaction. One Oregon professor prepares cupcakes on the day the SET questionnaires are distributed.
   e. Give financial rewards, such as establishing connections to potential employers.
   f. Spoon-feed watered-down material to the students.
   g. Give answers to exam questions beforehand. Either pass them out in class or, if the students are to work harder, put them on reserve in the library or on the Internet.
   h. Do not risk embarrassing students by calling on them in the classroom.
   i. Hand out sample exams, or take examination questions from the students' online exercises provided by the textbook publisher.
   j. Grade on a wide curve.
   k. Give SET as early as possible in the semester and then give hard final exams after SET questionnaires are given to students.
   l. Keep telling students how much they are learning and that they are intelligent.

[14] Crumbley, D.L., and G.S. Smith *supra note 7*.

m. Delete grading exams, projects, and other material. If they turn in work, give them credit. The correctness of the work is not an issue.

n. Teach during bankers' hours (9:00 – 3:00) favored by the students.

o. Give the same exams each semester, allowing the answers to spread among students and grades to increase each semester.

p. Avoid the effort of trying to teach students to think (e.g., avoid the Socratic Method).

q. Provide more free time (e.g., cancel classes on or near holidays, Mondays, and Fridays).

r. Avoid giving a cumulative final exam.

s. Do not give a final exam and dismiss the class on the last class day. Even if the final exam is administratively required, try to find methods to avoid the final exam.

t. Use simple slides so the students do not need to read the book and post the slides to the course website from which test questions will be taken.

u. Where multiple classes are taught by different instructors, always ensure that your classes have the highest grade point average.

v. Allow the students to participate in determining material coverage and the number of points assigned to difficult test questions.

w. When possible, teach classes where common exams are used; then help students pass "this bad exam" for which you are not responsible.

x. Allow students to re-take exams until they pass. It helps to put a page reference next to each question so the students can find the answer during an open-book examination.

y. Give significant above-the-curve extra or bonus credit.

7. In your opinion, is aggressive earnings management similar to harmful SET management? Explain your answer. Which is worse?

8. How does U. S. higher education rank versus the rest of the world? How can this be measured?

CASE STUDY 27:

Is the Widespread Use of Test Banks by Students Fraud?

D. Larry Crumbley, Ph.D., CPA, CFF, Cr.FA, MAFF, FCPA
Christine Cheng, Ph.D.
Louisiana State University

LEARNING OBJECTIVES

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

- Learn of the widespread availability of publisher test banks.
- Understand how use of publisher test banks is akin to fraud.
- Recognize the analogy to cheating on taxes and piracy of movies.
- Understand the negative impact of using publisher test banks and brain dumps on students and society.
- Learn how to develop a forensic technique to uncover students using publisher test banks.

http://www.pbookshop.com

INTRODUCTION

The Internet has given students widespread and anonymous access (either free or paid) to publisher test banks. Furthermore, the widespread access students have to publisher test banks is unlikely to diminish. Publishers are frustrated over legal attempts to have Internet providers cease infringing on their copyrights by publishing test banks and solution manuals or providing them for sale to students. Publishers' representatives indicate that legal victories are often met with a website being shuttered, only to have a new one pop up. In addition, the publishers' representatives indicate that their legal battles are confounded by websites hosted in overseas locations where copyright enforcement is limited. As such, it appears that students will continue to have ample opportunity to obtain publishers test banks from various Internet sources. Thus, the opportunity factor of the Fraud Triangle is clearly present.

One of the earlier examples of the mass test bank cheating occurred at the University of North Florida in 2010. A professor received 200 confessions from students using the test bank (one-third of the class).[1] Research by Ruedy *et al.*

[1] Joyner, James. "Professor Gets 200 Confessions for Cheating." *Outside the Beltway*, November 22, 2010, http://www.outsidethebeltway.com/professor-gets-200-confessions-to-cheating/.

found that as many as 68 percent of students will cheat.[2] Thus, the percentage of accounting students who use publisher test banks range from 33 percent to 68 percent.

QUESTIONS

1. Is the use of a publisher test bank by a student cheating and/or fraud? Consider the Legal.com definition of fraud as the intentional use of deceit, a trick, or some dishonest means to deprive another of his/her/its money, property, or a legal right.
2. Compare this practice to a taxpayer cheating on his or her taxes.
3. Does the use of test banks positively impact a student's in-class exam grades?
4. Is the use of test banks a victimless phenomenon?
5. Design a forensic technique to detect students' use of publisher test banks.

[2] Ruedy, N. E., C. Moore, F. Gino, and M. Schweitzer. 2013. "The Cheater's High: The Unexpected Affective Benefits of Unethical Behavior" *Journal of Personality and Social Psychology*, 105:531-548.

CASE STUDY 28:

Fighting International Fraud with the FCPA

Priscilla Burnaby, Ph.D., CPA
Bentley University
Susan Hass, MBA, CPA, CGMA
Simmons College
Brigitte W. Muehlmann, Ph.D., MST, CPA, CFM, CVA
Suffolk University

LEARNING OBJECTIVES

http://www.pbookshop.com

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

- Find financial irregularities in financial statements.
- Analyze trends in account balances.
- Perform horizontal, vertical, and trend analysis.
- Compare financial ratios to industry averages.
- Gain a better understanding of the accuracy/effort trade off.
- Analyze the statement of cash flows.

HEWLETT-PACKARD'S CURRENT PROBLEMS WITH INTERNATIONAL KICKBACKS

Andrew and Susie were on a Midwest college campus discussing current events over lunch. Susie found an article about one of the topics they were studying in law and fraud class and brought it to Andrew's attention, "Andrew I just read in the *Wall Street Journal* (Crawford, 2012) that the Hewlett-Packard (HP) criminal bribery case we studied in class last semester is finally heating up. Remember the case was about a German branch of HP bribing a Russian official. The article says that German prosecutors filed bribery, tax evasion and embezzlement charges against Hilmar Lorenz, a German and former H-P marketing executive in Russia; Ken Willett, a Germany-based American H-P manager; and Päivi Tiippana, a Finn and former manager at the company. Prosecutors also indicted Ralf Krippner, a local German politician and businessman as an accessory.

The indictment alleges that Krippner billed an H-P subsidiary for services that were never performed and helped relay the funds." Susie noted, "This case

has not yet been brought to a U.S. court. The Securities and Exchange Commission (SEC) is still investigating. If I remember correctly from articles we read (Yannet and Fuhr, 2010), the investigation began in 2007 after a German tax auditor became suspicious of payments totaling €22 million that a German HP subsidiary made to a small computer hardware firm near Leipzig from 2004 to 2006. They suspect Russian officials received €7.5 million in kickbacks for a € 35 million dollar contract to sell computer gear to Russia's Prosecutor General Office, the very office responsible to stop bribes. (Crawford, 2012)"

Susie continued, "The HP subsidiary recorded the payments as having been made for services rendered in Moscow. The investigation also identified three payment intermediaries (shell companies in multiple jurisdictions) and a Moscow-based computer supplier with foreign bank accounts as having conspired with HP to perpetrate the alleged bribery scheme. Using HP funds, the intermediaries, based in the former East Germany, allegedly paid fake invoices for equipment to the shell companies. The illicit funds then flowed through bank accounts all over the world, including the U.K., the U.S., New Zealand, the British Virgin Islands, Latvia, Lithuania, Belize, Austria, and Switzerland before making their way to Russia. (Yannet, and Fuhr, 2010)

This story is an international intrigue. The SEC has yet to file charges using the Foreign Corrupt Practices (FCPA) Act of 1977. It amazes me how long it takes to bring these people and companies to justice. And, it seems like the HP employees did not even benefit from the fraud except for getting credit for the sale.[1] I am looking forward to studying more international FCPA violations in our fraud and forensics course. It really takes a lot of information gathering and drilling down into the details to be able to bring a case like this to court. Andrew, what I don't get is that I thought all these U.S. companies have a code of conduct and policies to prohibit their employees from offering bribes to foreign officials. I thought the FCPA required that U.S. companies have accounting systems with adequate controls to prevent these fraudulent kickbacks. It has been years since the law was passed. How can this still be happening?"

STUDENT ASSIGNMENTS

Individual Assignments

Although the FCPA has been around since 1977, it is not until the last 12 years that the SEC has annually indicted multiple U.S. companies doing business in foreign countries using the FCPA. To gain an understanding of the FCPA, go to the SEC's website *http://www.sec.gov/spotlight/fcpa.shtml* and click on the FCPA (Securities and Exchange Commission, 2012b) hyperlink on the bottom left.

[1] Although the employees did not take any cash directly, the sale earned the employees commissions or bonuses, led to potential salary increases and helped fulfill expectations in order to get promoted.

http://www.pbookshop.com

Then, answer the following questions.

1. Download the document, *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (Criminal Division of the U.S. Department of Justice and the Enforcement Division of the U.S. Securities and Exchange Commission).

   a. Read Chapter 1, "Introduction," which describes the scope of the FCPA, discusses the costs of corruption, and covers the evolution of the law as well as how the SEC partners with the Department of Justice to fine companies and imprison those that break the law. It also provides an introduction to the efforts of the Commerce and State Departments to assist U.S. companies by advancing anti-corruption and good governance initiatives as well as an introduction to the international landscape.

   b. Read Chapter 2, "The FCPA: Anti-bribery Provisions," which explains the anti-bribery provisions.

   c. How can a law that was enacted more than 35 years ago still be relevant today?

2. Review the annual list of enforcement actions by calendar year for the past five years. From the SEC website, select a sample of five companies to read about in more detail. What strikes you about the companies you reviewed and their crimes?

   Go to *www.cbsnews.com/8301-18560_162-4080920.html* and view *The Price of Bananas* video. You will also find the transcript of the video at that link. Be ready to discuss the video in class.

   a. Chiquita Banana was making payments to a militant group. How does this action fall under the FCPA?

   b. What would you have done if you were faced with threats of deadly action against those that worked at the Chiquita Banana facilities under your supervision?

   c. What has been some of the fallout for Chiquita Banana?

3. Answer the questions in the FCPA Survey in the Appendix. Be ready to defend your choice based on your understanding of the FCPA and your personal beliefs.

4. To learn about codes of conduct, read the article, "Up To Code," by Paine, L., Deshpandé, R., Margolis, J., and Bettcher, K. (2005). *Harvard Business Review*, 83 (12), 122-133. Then answer the following questions:

a. Should a company have a uniform global code of conduct policy? Why or why not?

b. Should these policies be implemented globally, or at a regional, country, or local level?

c. Should companies have specific global policies regarding gifts, gratuities, payments, entertainment, conflicts of interest, and related matters? Why?

d. Who should be responsible for communicating, monitoring, and enforcing the company's policy?

Team Assignments

Based on what you have learned above by completing the individual assignment questions, work with your team to complete the following:

1. On the SEC website, select a company from the SEC FCPA enforcement actions list from the two most recent years. Click on the case on the SEC's website for additional information about the company, situation, and issues.

2. Research the company to find their Code of Conduct. After reading their Code, do you believe that management breached their duty to the company? Explain your answer.

3. Find at least three other references (e.g., documents, articles, web links) about the company's problems with the SEC.

4. Was the case you identified a civil or criminal proceeding? Explain the difference between the two types of indictments.

5. Were the parties involved fined and/or served jail time? Where are guilty parties today?

6. Write a five-page memo to the Board of Directors and create a 10-minute PowerPoint presentation to explain the fraud to the class. Include a listing of who was involved in the fraud and their home country, how the fraud was perpetrated, how that led the company to be indicted by the SEC, and subsequent conviction or fines. Also explain the financial and nonfinancial costs to the company. Include the information you found in questions 2 to 5.

http://www.pbookshop.com

Investigate the website below and the latest Corruption Perceptions Index (CPI). How should this index raise concerns about doing business in countries that have the higher corruption ratings?

http://www.transparency.org/research/cpi/overview. Note the U.S. (or your home country) ranking.

Was the company your group researched doing business in countries included in the CPI? If yes, what were the countries' scores and rankings in the latest published CPI?

CASE STUDY 29:

Consideration of Fraud in a Financial Statement Audit

Charles J. Russo, Ph.D., CPA, CVA, CMA
Amber Stone, M.S., CPA
Charles L. Martin Jr., DBA, CPA
Towson University

LEARNING OBJECTIVES

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

- Apply the Fraud Triangle.
- Understand the auditor's role in the case.
- Evaluate related party transactions.
- Understand the Sarbanes Oxley Act, Section 404.

http://www.pbookshop.com

INTRODUCTION OF KEY DECISIONS AND DECISION MAKERS

INTRODUCTION

This case is based on actual fraud and the litigation that followed the discovery of the fraud. The Securities and Exchange Commission (SEC) filed suit against Insignia, Inc. in U.S. District Court in 2011. This court case involves falsified journal entries, misappropriation of assets, securities fraud, violation of the Sarbanes-Oxley Act (SOX), and responsibilities of the independent auditor. The key decisions and key decision makers are outlined below.

KEY DECISIONS

Falsified Journal Entries

- Alan Nixon, CEO and shareholder
- Bobbie Grant, Controller and shareholder

Misappropriation of Assets

- Alan Nixon, CEO and shareholder

Securities Fraud

- Alan Nixon, CEO and shareholder
- Charles Hoover, Former CEO and shareholder
- Bobbie Grant, Controller and shareholder
- David Polk, Company Attorney and shareholder

KEY DECISION MAKERS

Alan Nixon — CEO

The CEO, Alan Nixon, was falsifying journal entries and diverting money from the company into personal accounts. The journal entries debited payroll tax liabilities on the balance sheet and credited shareholder loans. Insignia, Inc. then made payments on the shareholder loans by paying Nixon. Securities fraud was the result when the falsified financial statements were filed with the SEC. Nixon also misappropriated additional cash by directing purchasers of newly issued stock to transfer funds to accounts controlled by Nixon. The FBI website had the background information on the CEO as reported by the U.S. Attorney's Office in 2014 including the following:

1. Nixon had transferred funds to his personal bank account and other accounts under his control.
2. Nixon manipulated the financial statements by understating the amount of payroll tax liabilities.
3. Nixon overstated the amount of loans made to him by the company.
4. Nixon directed purchasers of newly issued shares to transfer funds to accounts under the CEO's control.
5. Nixon stole $6 million and spent it on himself.

The city newspaper reported that in federal court, Nixon's family and supporters presented Nixon as a man who works hard at maintaining a small farm that he leased, as well as being a good father to his 18-month old son. The SEC countered that Nixon lied, cheated, and stole from the company for over two years and that this was a side of Nixon that family members have never seen.

Charles Hoover — Former CEO

The former CEO Charles Hoover was also associated with the Insignia fraud activities. Hoover appeared to have been motivated by his need for an over-the-top upper class lifestyle. An online business newspaper had the following description of the Hoover's rather extraordinary life style that included a vacation home in the Caribbean, a large brokerage account, and other personal assets.

The Hoovers later agreed to turn over $5.5 million in assets to the SEC. The SEC asked a federal judge to appoint a receiver to sell the former CEO's assets, including the vacation home in the Caribbean, a brokerage account, a custom motorcycle, Rolex watches, and upscale jewelry.

Bobbie Grant — Controller

Based on Grant's 2012 SEC Administrative Hearing the controller, age 35, was a certified public accountant. The SEC alleged that the controller, at the direction of Alan Nixon and on her own accord, was engaged in the fraud scheme. The result was false and misleading financial statements for 2006 and 2007. The SEC Administrative Hearing cited falsified journal entries, understating expenses, understating liabilities, and providing false information to Insignia's independent auditors. As a result of this SEC Administrative Hearing, Grant was suspended from appearing or practicing before the SEC as an accountant.

David Polk — Company Attorney

Based on the company attorney's 2012 SEC Administrative Hearing, David Polk, age 50, was an experienced attorney licensed to practice in multiple states. He served the company as an attorney to assist with SEC filings and other corporate matters. The SEC alleged first that Polk drafted two post-effective amendments and a supporting legal opinion that he knew or should have known contained false statements regarding the registration of millions of shares of Insignia stock; and second that Polk sold Insignia securities without a filed registration statement. The SEC suspended him from appearing or practicing before the SEC as an attorney. He can apply for reinstatement with the SEC after two years.

Insignia Auditors — Rigby Stevens., LLP

As the independent outside auditor, Rigby Stevens, LLP certified:

1. "That it had audited Insignia's financial statements in accordance with generally accepted auditing standards;
2. That it had planned and performed its audits "to obtain reasonable assurance about whether the financial statements are free of material misstatements";
3. That, in its opinion, the company's financial statements "present fairly, in all material respects, the financial position" of Insignia in conformity with generally accepted accounting principles; and that its audits provided "a reasonable basis for (its) opinions" (Sarbanes-Oxley Act of 2002, Sec. 302).

Rigby Stevens, LLP was named as a defendant in the class action claim filed against certain of Insignia's former officers and directors, its then external auditor, Rigby Stevens, LLP, and its stock transfer agent, Stock Registration, Inc., for violations of the SEC Act of 1934.

http://www.pbookshop.com

COMPANY BACKGROUND AND FORENSIC INFORMATION

COMPANY HISTORY

Alan Nixon, CEO, and Charles Hoover, former CEO, formed Health Care Staffing, Inc. in 2001. In 2004, a shell company called Insignia, Inc. (Insignia) was formed that never earned revenue or did business. In February 2005, Health Care Staffing, Inc. and Insignia performed a reverse merger. As a result, the new entity kept the name Insignia, Inc., and Health Care Staffing, Inc. became its subsidiary. Insignia then started operating exclusively in the health care staffing industry. Insignia was a publicly traded company and therefore was subject to SEC regulations.

When Nixon joined Insignia in 2005, Insignia's annual revenue was $3.5 million. By 2006, Nixon had managed to increase the company's revenue to over $40 million. One of the ways Nixon increased revenue was through acquiring small companies. The acquisitions were financed through a combination of Insignia stock, promissory notes, and cash. According to Form 8-K, Nixon held a Bachelor of Science (1998) in Business Administration degree from a large state university, and a Master's degree (2002) and a Doctoral degree (2003) from an Internet-based university. However, it was later confirmed that Nixon did attend the large state university but did not graduate with a Bachelor of Science degree. Nixon claimed to hold masters and doctoral degrees, but this online university is a known diploma mill, offering degrees over the Internet with no substantial work to be completed. According to the class action complaint filed in Federal District Court, Nixon owned 6,000,000 shares, or 22.5% of all common stock as of April 2006. Nixon became CEO in 2006.

Charles Hoover, former CEO, held the position from 2005 to 2006 while also serving as a Board member. Hoover never attended any of the Board meetings. As the CEO of a public company, there are certain burdens and responsibilities placed on CEOs, such as reviewing and verifying certain documents and signing them before they are filed. Hoover signed many documents without even reading them, let alone reviewing for accuracy. Additionally, Hoover's lack of understanding as to how the accounting system at Insignia worked made it extremely difficult to verify anything related to Insignia's finances.

Bobbie Grant served as controller for Insignia from 2005 through 2007. In 2006, she became a licensed CPA in the jurisdiction where Insignia's central office was located. Grant made false journal entries under the direction of Alan Nixon. As a CPA, she knew that the entries she made were incorrect and misleading. Her motivations were unclear, but the 2012 SEC Administrative Hearing stated that Grant not only made false journal entries at the request of the president and CEO, but that she also made false journal entries on her own initiative. The result was Insignia filing materially false and misleading financial

http://www.pbookshop.com

statements in the company's annual and quarterly reports from 2005 through the first quarter of 2007.

The company attorney, David Polk, was not an employee of Insignia, but provided services to Insignia from April 2006 to June 2007. Polk had been practicing law for nearly ten years prior to his services for Insignia. Polk also had credentials in securities regulation and his practice centered on financial securities. He filed forms for Insignia with the SEC that were later determined to be false. Polk was fined and enjoined from further violating Sections of the Securities Act of 1933 and ordered to pay disgorgement and prejudgment interest and a civil penalty while also suspending him from appearing or practicing before the Commission as an attorney for two years.

David Polk's involvement with Insignia began when the company needed to file post-effective amendments to some of its SEC filings. They intended to use the amendments as a way to register a new issue of stock, but regulations stated that the amendments could not be used for that purpose. They also reported the number of outstanding shares at $1 million less than it actually was. Additionally, the company attorney attached a legal opinion to the filings, which stated that he performed due diligence in preparing the forms. The class action complaint alleges that he was reckless in filing the forms because he knew, or should have known based on his title and experience, that what he was doing was wrong.

Ultimately, David Polk consented to an order permanently enjoining him from violating Sections 5(a), 5(c), 17(a)(2) and 17 (a)(3) of the Securities Act of 1933 as well as requiring him to pay disgorgement and prejudgment interest of $160,000 and a $20,000 civil penalty. He also agreed to settle a related administrative proceeding by consenting to the entry of an order suspending him from appearing or practicing before the Commission as an attorney for two years.

CEO Resignation and Class Action Lawsuit

Insignia appeared to be profitable and successful until August 2007 when Nixon suddenly announced his resignation. One day after Nixon announced his resignation, Insignia's stock price dropped by nearly 48%. A few days later, Insignia announced that it would be launching an investigation into a variety of accounts and transactions that seemed unusual. The stock price kept decreasing and subsequently led Insignia to file Chapter 7 bankruptcy. The SEC then filed civil charges against Nixon, Hoover, Grant, and Polk in 2011.

The Insignia Board of Directors generally consisted of three members after the merger: Alan Nixon, CEO/chairman, and two other individuals, Michael Shaw and Frank Young. Board members Shaw and Young were appointed by Nixon in 2006. The board held no annual meetings in 2005 or 2006, and public shareholders did not elect any directors.

According to the 2010 federal bankruptcy case for Insignia, as CEO and board chairman, Nixon had general authority to execute Shaw's signature on board-related documents. Therefore, Nixon had the power to execute documents on behalf of the majority of the board (two board members out of three). Nixon

was directly involved in the fraud and served as board chairman during his entire time with Insignia. Bobbie Grant and David Polk, who were not board members, were also named as defendants. In the 2006 Proxy Statement, Shaw was discussed as having financial expertise in asset structuring, corporate structure finance, and multi-location profit centers.

A class action suit was filed in the United States District Court that alleged:

1. manipulations that enriched Nixon at the expense of the company ;
2. manipulations that artificially inflated Insignia's operating income and reported margins; and
3. manipulations that enabled Insignia to increase its borrowing, thus postponing the time when the company would run out of cash. This resulted in investors in Insignia common stock losing their investments.

The board members named as defendants in the class action suit included Nixon; Frank Young, member of the board of directors and chair of the Audit Committee; and Michael Shaw member of the board of directors and the Audit Committee. Others named in the suit included Jamie West, chief operating officer and acting CEO after the departure of Nixon; Rigby Stevens, LLP, the independent auditing firm; and Stock Registration, Inc., who failed to keep a proper accounting of the number of shares of stock issued by Insignia.

The class action complaint also noted that during 2005 and 2006, Insignia acquired six healthcare staffing companies as subsidiaries financed as follows:

- Subsidiary 1: December 2005, for $4 million cash, 300,000 shares of common stock, and assumption of $400,000 debt.
- Subsidiary 2: April 2006, for $13 million cash and 100,000 shares of common stock.
- Subsidiary 3: May 2006, for $250,000 and additional contingent payments.
- Subsidiary 4: June 2006, for $2 million cash, 700,000 shares of common stock , and additional contingent payments.
- Subsidiary 5: October 2006, for $6 million cash and 750,000 shares of common stock, with additional contingent payments to be made in stock.
- Subsidiary 6: November 2006, for $7 million cash, 200,000 shares of common stock, and assumption of $250,000 debt.

According to the class action suit, Insignia's reported revenue grew to over $40 million in 2006 from $3.5 million in 2005, and its disclosed market capitalization quintupled from $21 million on March 25, 2006, to $120 million on March 31, 2007. By the end of 2006, Insignia had over 300 corporate employees and 1,000 full time equivalent healthcare staffing professionals.

Nixon exercised immense power over the company as president of Insignia from February 2005 until his resignation in August 2007. He also served as CFO for the majority of his time as president, as well as CEO and board chairman from June 2006 until his resignation. Nixon was in complete control of Insignia

http://www.pbookshop.com

during his employment. This control allowed him to direct funds out of Insignia for his personal benefit, improperly issue Insignia stock, and make false journal entries, which led to incorrect financial statements and SEC filings. Because of his control over the company, Nixon's actions constituted the largest part of the fraud and are discussed in greater detail below. Because Insignia was under $75 million in sales, it did not need an internal control report from its external auditors per SOX regulations. However, the external auditors still had to review internal control in order to determine the appropriate audit procedures needed to support the client's financial statements when rendering their audit opinion on this publicly-held company. This issue will be explored in a discussion question involving the auditor's role.

KEY ISSUES

FALSIFIED JOURNAL ENTRIES

During his time as CEO period, Nixon personally made entries for payroll accounts into the Insignia's computer system. Nixon also had administrative access to the computers of all employees at company headquarters, giving Nixon the opportunity to alter or delete employees' documents, without their knowledge. The suit claims that the other defendants were aware that Nixon served as the only internal control at the company, and no one made any effort to determine whether his reports to the other defendants were verified independently.

Insignia payroll software correctly recorded the amount withheld from each paycheck as a liability of Insignia and the entries included a credit to a payroll tax liability account. However, the payroll tax liability was later reduced by an offsetting entry to the "Alan Nixon loan" account. The effect of this misclassifying journal entry was to eliminate the payroll taxes payable balance by reclassifying them as amounts owed to Nixon. These reclassified amounts originating as payroll liabilities, appeared in Insignia's published financial statements for the quarter ended June 30, 2006, as a related party loan of $1.5 million without further explanation. By September 30, 2006, the related party loan to Nixon was $3.5 million and was $3 million at December 31, 2006, with this reduction in loan amount in the fourth quarter due to payments to Nixon. The loans were undocumented and had no interest.

Nixon made, and directed the controller to make, a number of fraudulent journal entries to Insignia's books. Rather than debiting the proper expense account, Nixon would debit a liability account called Loan Related Party. This account represented the loan from Nixon to Insignia. Due to the false entries, Insignia's financial statements led the reader to believe that Insignia was paying

down a liability when it was actually incurring expenses by debiting a liability instead of debiting an expense. These entries made both the balance sheet and income statement appear healthier than they actually were. The pair also ran expenses through the Additional Paid-In Capital (APIC) account decreasing APIC. Although Nixon decided to book a lot of expenses to the wrong accounts, there were also expenses that were not placed on the books at all. These missing entries related mainly to the expenses of issuing stock to employees. All of the expense-related false journal entries led the annual reports to understate expenses by up to 1,500 percent during the years Nixon was in control.

When Insignia encountered a liability, such as payroll taxes, Nixon would record the liability into the Loan Related Party account rather than the correct liability account. When Insignia's external auditors, Rigby Stevens, LLP, questioned the large balance in a liability account titled Payroll Clearing, Nixon made a back-dated entry to move $1 million from the Payroll Clearing account to the Loan Related Party account. After making that entry, Nixon and the controller still signed a Management Representation Letter stating, among other things, they did not know of any fraud in the financial statements.

MISAPPROPRIATION OF ASSETS

Nixon also used false journal entries to allow him to pull money out of Insignia for himself. The entries to the Loan Related Party account that were discussed above made it appear that Insignia owed Nixon $3.1 million more than it actually did. He also pocketed $3.3 million by personally selling stock to investors and keeping the money for himself. Nixon also appeared to be selling his own stock in Insignia to a hedge fund, but he was actually issuing new stock to the hedge fund. This allowed payments from the hedge fund to be deposited to his personal bank account. In total, Nixon was able to steal $6.5 million dollars from Insignia over a period of approximately two and half years.

SECURITIES FRAUD

Form S-8 is required to be filed with the SEC to register newly issued shares of a company but no audit of an S-8 is required. When filing Form S-8, a stock issuer incorporates by reference, the audited financial statements of its Form 10K. The issuer may include the accountant's consent to use the accountant's report either directly or indirectly in the registration statement as an exhibit or via incorporation by reference to a consent filed with the Form 10K.

When Insignia issued new shares, Nixon provided false information on the forms regarding the number of shares and to whom the shares were being issued. Nixon and Hoover both signed off on these forms asserting that the information being provided was accurate, although they knew the information was incorrect. They also signed off on the quarterly and annual forms, which grossly misrepresented the number of shares outstanding.

The independent auditing firm of Rigby Stevens, LLP had accepted Nixon's verbal explanation. Rigby Stevens did not review the reclassifying journal entries in detail. If they had, they would have seen adjustments to the payroll tax liability account on the same day there were adjustments to the loan account.

Insignia paid over $2.5 million to Nixon during the first quarter of 2007. The ending balance of the loan account dropped to $1 million by March 31, 2007. There were over $4.5 million of unpaid payroll tax liability assessments from the IRS found in Nixon's office when he resigned. In the February 2008 federal bankruptcy filing, Insignia cited tax liabilities, penalties, and interest of $7 million.

IMPROPER ACCOUNTING FOR ISSUED SHARES

Insignia, Inc. December 31, 2006 annual report stated that Insignia had 45,000,000 shares outstanding. Stock Registration, Inc. was responsible for the stockholder registration list. The Stock Registration list stated that there were several million additional shares outstanding. Stock Registration, Inc. sent Nixon the correct registration list in an Excel file. Nixon edited the Excel file, and reduced the number of shares outstanding. Nixon then provided the edited list to the independent auditors. Rigby Stevens, LLP did not independently verify the number of shares outstanding by obtaining the official list from Stock Registration, Inc., as required by AU Section 326.21(a). Rigby Stevens, LLP should have obtained the official registration list and compared it with the data provided for the Insignia financial statements. Not doing so was a serious departure from generally accepted auditing standards.

The plaintiffs in the class action suit believed that the unreported shares were sold by Nixon on the open market. Under AU Section 316.85, inadequate segregation of duties should have alerted the auditor to the opportunity for the misappropriation of assets.

SOX SECTION 302 FALSE FINANCIAL STATEMENTS AND FALSE CERTIFICATIONS

There were multiple instances of securities fraud including:

1. Booking $1,000,000 in additional revenue by debiting accounts receivable and crediting revenue from a nonexistent reality television show.
2. In the first quarter 2007, inappropriately reporting income from operations from the exercise of stock warrants.
3. Increasing the debt borrowing limit with Cap Source by providing false certification of income. Insignia then borrowed close to the maximum new debt borrowing limit.
4. Filing false Form 8-K, Form 10-QSB, and Form IO-KSB with the SEC, and misleading the investing public.

http://www.pbookshop.com