



CAMICO: War Story No 78 – Management Fraud

Subject: Management Fraud

Services: Audit

A large Florida trash collection and recycling company, TCR Enterprises, defaulted on a \$10 million loan after being audited by the accounting firm of Sondheim & Nelson (S&N). S&N called CAMICO to report a potential claim by the bank, which indeed filed a claim several months later, alleging a lack of due care in S&N's audits of TCR's financial statements. The bank also alleged damages in the amount of about \$10 million, due to it using TCR's financial statements in its approval of the loan.

The bank had investigated TCR's finances further and found that TCR had been involved in related-party transactions through one of the TCR owners, who had an undisclosed ownership interest in four vendors that did business with TCR. The bank also suspected that the TCR owner in question had been involved in a check-kiting scheme with at least two of the vendors and two other banks in order to inflate TCR's revenues and accounts receivable for collateral in the bank loan. The bank alleged the financial statements: 1) overstated revenues and accounts receivable, 2) should have disclosed the related-party transactions, and 3) should have included a going-concern disclosure.

TCR had not disclosed all of its related parties to the S&N auditors during the audit. As a result, some of the related parties were not disclosed with the financial statements, even though the auditors had received documents from undisclosed related parties that should have raised red flags. There were also red flags from TCR owners not wanting S&N to check on TCR's accounts receivable. A review of the bank's files, though, revealed that the bank also had ignored similar red flags, thereby ignoring its own procedures in approving the loan for TCR.

S&N spent a significant amount of billable hours as it prepared a defense with its attorneys. The firm and its attorneys went into a series of mediation sessions with the bank and its attorneys. The sessions were slow going and took up even more billable hours.

Meanwhile, the TCR owner with the related-part transactions was indicted on fraud charges stemming from a check-kiting scheme with one of TCR's vendors. After the bank managed to collect some collateral and about \$5 million from its financial institutions bond insurer, lowering the demand to about \$5 million, the judge in the jury trial called for a mandatory settlement conference one month prior to the trial date. More time was consumed in the settlement conference until the judge negotiated a 50-50 split of the damages.

Loss Prevention Tips

A common error is for the CPA to go along with the client on a particular issue, such as accounts receivable or the valuation of inventory or assets, which may result in a significant material misstatement. The lender then has an inaccurate view of the client's business from the financial statement, and if the business fails, the CPA is exposed to liability for the misstatement.

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Other audit red flags include inadequate disclosures, confusing explanations, and related-party transactions. The Enron debacle is a large-scale example of such problems. Pay close attention to all questionable documents, and question their purpose with a great deal of skepticism.

Client and engagement screening also become critical for CPAs in audit and review engagements. Screen or have background checks done on audit and other significant clients. CAMICO recommends Scherzer International (www.scherzer.com), which provides discounts to CAMICO policyholders requesting background investigations.

Understand which issues are critical to the third party. Don't get comfort from your belief that the financial statements are the responsibility of management. If you become aware of a problem with the statements, call CAMICO. Other tips include:

- Think in terms of a worst-case fraud scenario for the client (i.e., look for fraud).
- Make it harder for anyone to determine the mechanisms used by the auditor in detecting fraud.
- Do not be predictable in the audit procedures (e.g., don't adjust to client schedules or announce the timing, location or nature of the procedures).
- Question management and staff, including those on the loading dock; ask penetrating questions in a non-threatening, non-accusatory manner.
- Take a "big picture" approach in evaluating evidence and assessing fraud risk.

"War Stories," drawn from CAMICO claims files, illustrate some of the dangers and pitfalls in the accounting profession. All names have been changed.

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