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Starting Out - Stealing a Company's Stuff

Inventory Larceny Analysis for Budding Fraud Examiners

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May-June 2010



Starting Out

Stealing a Company's Stuff

Inventory Larceny Analysis for Budding Fraud Examiners

BY PATRICIA L. JARRACH, ESQ., CFE, CICA

May/June 2010

Not too long ago, requests for payment to a third party would have seemed highly unusual to customers. However, vendors in today's credit-tight economy commonly accept third-party checks in payment of outstanding obligations. In this case, a request to pay a third party should have raised a red flag, but it didn't.

When assets are missing, the cost can be enormous. Fraud examiners in retail or manufacturing businesses need to be particularly aware of inventory and purchasing controls. Auditors should test discrepancies, and if they find any, be prepared to investigate further. This case, presented by Patricia L. Jarrach, Esq., CFE, CICA, illustrates the necessity for every organization to review its inventory and purchasing controls regardless of the safeguards it has in place. The identification of red flags is imperative in any investigation and holds the key to detecting ongoing frauds. (The names have been changed for privacy reasons.) This case analysis will help budding fraud examiners – many who will land jobs in retail and manufacturing.

COMPANY BACKGROUND

Joe, the president of "XYZ" company, headquartered in New Jersey, faced medical issues that caused him to discontinue his routine trips to a satellite office in Texas – a manufacturing and warehouse facility. While he preferred to be hands-on, Joe took comfort in that the facility had several internal controls in place to prevent fraud and employee theft. XYZ had been in business for close to 30 years without a known incident of fraud.

The controls were many. The Texas location sent regular reports to the New Jersey headquarters. All purchases outside of the ordinary course of business had to be approved by headquarters. All time sheets and expense reports, including supporting documents, were submitted to headquarters for payment authorization. Headquarters also had to approve in writing all changes in operations at the satellite location, as well as any activities outside the ordinary course of business. All communications were documented electronically and with hard copies, both of which were sent to headquarters weekly.

Three trusted, long-term employees – Bill, Rich, and Sam – ran the satellite office. Bill was in charge of inventory and manufacturing, and Rich was the exclusive sales representative of specific XYZ products. Bill and Rich had numerous disagreements. Rich would override Bill's production schedule because of alleged customer emergencies. Often, these schedule changes delayed product deliveries to other customers, and the overrides became a central point of contention between the two managers.

ANALYTICS

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Enter Sam, who had been hired solely to coordinate the two managers' efforts and resolve their disputes when Joe wasn't on site. When our law firm began this case, Bill and Rich had been working for XYZ for almost 15 years. Sam had been there for nearly 13 years. Joe thought this division of power worked. He still received complaints for late deliveries, but they were infrequent.

THE INVESTIGATION BEGINS

Bill called Joe, who hadn't visited the Texas office for nine months, to report a discrepancy in the inventory report. Bill said product had been shipped from the Texas warehouse to a customer, but the inventory report showed the product was still at the facility. Bill asserted that he didn't know where the merchandise had been shipped.

Joe formed a special committee, which included our firm, XYZ's outside accountants, and key members from the company's headquarters. XYZ had retained our firm to help it determine the location of the missing merchandise and ascertain who was responsible for either the record error or potential theft of goods.

The committee began its investigation by contacting all the shipping companies that the Texas location used and requesting copies of XYZ's bills of lading for the previous six months. This was the first time such a request was made of XYZ's freight shippers and the first check of audit controls in the company's long history of operation.

THE ANOMALY

The bills of lading were compared to XYZ's master customer list, invoices, and shipping records submitted by the Texas office. In reviewing the shipping records, one bill of lading didn't match any of the XYZ headquarters' records. The handwriting on the bill of lading was recognized as Rich's. The recipient of the goods wasn't a company included on XYZ's master customer list, nor did it appear in XYZ's accounting records.

Joe contacted the new company that had purchased the missing merchandise and said that XYZ was conducting a routine audit and quality control review. He requested and received copies of its purchase orders. These orders matched the bill of lading, but the documents weren't in XYZ's computers, nor were they part of its business files – contrary to company policies and procedure.

Joe further inquired about the payment arrangements and method of payment for the goods. The new customer indicated that it had been instructed to make payment to a third-party company.

The team conducted Secretary of State (SOS) searches on the new company and on the third-party company. For a nominal fee, SOS searches can reveal a company's principals and where the company was formed. Even more vital to an investigation, such searches can uncover if the principals have an interest in a secondary company as a board member, a partner, or a shareholder. SOS records also identify business relations with others such as spouses, children, friends, or neighbors, who are affiliated with a secondary company. In this case, the information in the SOS search proved relevant.

But first, a big red flag appeared in the transaction with the new company – a third-party payment.

THIRD-PARTY PAYMENTS

Not too long ago, requests for payment to a third party would have seemed highly unusual to customers. Such a situation would prompt most individuals to place an inquiry to the business' home office to confirm the unusual practice. However, vendors in today's credit-tight economy commonly accept third-party checks in payment of outstanding obligations. Buyers are familiar with requests to pay a third party, and often they do so without question.

It appears that many businesses believe that payment to anyone is the top priority; controls and the payee's name are secondary or unimportant. People rarely think of (or want to think of) the broad consequences; for example, they might have paid the wrong party and someone will be calling later for payment and requesting receipts and written authorization.

In this case, a request to pay a third party should have raised a red flag with the customer, but it didn't. Thus, the request for a third-party payee wasn't confirmed through XYZ's accounting and billing departments.

A SUSPECT EMERGES

The customer willingly provided Joe with all the information about the transfer and proof of payment. The third-party payee company's name and where payment was directed didn't appear in XYZ's business records. A search of the SOS records revealed that the third-party payee company was registered in Rich's name and was located at his home address.

An exhaustive investigation matching bills of lading and product identification numbers revealed that the misappropriated merchandise was shipped to one of XYZ's largest customers, whose orders had been decreasing over the past few years. Due to the downturn in the economy, the New Jersey headquarters didn't question the decline in orders.

The investigation also revealed that Rich, who was supposed to be an exclusive product salesman for XYZ, was distributing business cards to XYZ's customers and said he was an independent broker.

We discovered a second unsuspected fraud during the investigation: Sam was supporting Rich's theft by keeping it under wraps. Sam also was defrauding the company by taking merchandise, approving known fraudulent expense reports, altering reports sent to the New Jersey headquarters, and threatening XYZ's Texas employees with termination or immigration sanctions if they revealed the scheme.

Some XYZ employees were working under valid work visas, but they didn't understand deportation rules and/or regulations. So they were successfully intimidated into hiding Sam and Rich's fraud. What

heightened the fear among employees was that Bill's cousin was deported after he tried to confront Sam about the fraud. Actually, the United States deported the cousin because he had failed to renew his visa. Yet Sam used this coincidence in timing to further his intimidation.

It's a hard lesson for most companies to acknowledge, but they need to invest in anti-fraud education to ensure open lines of communication with employees (the first lines of protection), let them know how to report suspicious activity, and fight fear and intimidation.

SAME COMMON STORY: MONITOR CONTROLS

In the end, XYZ terminated two formerly trusted managers, Rich and Sam. Criminal charges were filed against Rich for third-degree felony theft. The criminal case and associated civil actions are still pending.

This case emphasizes the importance of regularly reviewing and monitoring internal controls, including random testing, and to implement changes quickly.

THE CHALLENGE

Given the circumstances involved, what other investigative techniques and approaches could have been taken if the shipping anomaly hadn't been discovered? E-mail [Colin May](#) with your thoughts. Your comments will be published in a future installment of the Starting Out column.

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By Donna_4

Once again, where are the auditors. Companies keep cutting back, and they think Internal Auditors is a great way to cut. Companies think if they comply with the SOX testing that it is good enough. WRONG Inventory, Purchasing, Accounts Payable need to be audited continually.