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Vision Services, Inc. Accounts Receivable Collateral Reporting Fraud

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ABSTRACT

This case is based on an actual fraud that related to a litigation support engagement that focused on an accounts receivable collateral reporting fraud (improper revenue recognition and asset overstatement) on the part of the management of a services company against its bank. The litigation support work was for the bank's legal counsel. In addition to background and historical financial results, the case study presents the motivations for the fraud, and the various techniques used to falsify the accounting records and conceal the fraudulent nature of the transactions from the bank and the company's independent auditors. Specifically, the case requires not only the investigation of accounting issues as to the proper timing of revenue recognition, but also auditing questions and fraud investigation techniques.

Keywords: Revenue recognition, collateral reporting fraud, accounts receivable fraud, litigation support engagement.

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I. INTRODUCTION OF KEY DECISIONS AND DECISION MAKER

As a result of the sudden demise of Vision Services Inc. (VSI) and the resulting loss that occurred when Second Union Bank attempted to collect on their seemingly adequate loan collateral, legal counsel for Second Union has requested your firm (Forensic Investigations, LLC) to perform an investigation of the accounting records of VSI. The bank is questioning why VSI failed when in fact the financial statements and loan collateral seemed very adequate. Your engagement scope was to determine the nature and extent of any misrepresentations in the financial information provided to Second Union and the extent of management's participation in any fraud that may have occurred which resulted in losses to the bank.

In connection with the investigation, counsel has indicated that it will be critical to their case against the former management of VSI to prove the extent of any fraud as of December 31, 2009 and December 31, 2010. This is because Jacobs signed the collateral report certifications that were sent to Second Union for 2009, Roberts signed the reports for 2010 and the officers apparently had a clerical employee sign the reports in 2011. The bank intends to use you as an "expert" witness in connection with their suit against management personnel, including Roberts and Jacobs, if the investigation concludes that they were participants in any fraudulent collateral reporting.

Legal counsel for Second Union believes that the overstatement of accounts receivable began prior to 2011, since it seemed impossible for the Company to have lost so much money in just the first few months of 2011. If it can be demonstrated that the delay in terminating the loan agreement was caused by fraud on the part of management, they believe they can make an argument that the portion of Second Union's losses caused by that delay should be recovered from management. Therefore, if fraud is uncovered at the end of either 2009 or 2010, they have requested that you calculate an estimate of the amount, if any, that the bank would have lost if the loan had been terminated at those times, compared with the amount they lost in May 2011. Legal counsel understands that various legal defenses will be asserted by legal counsel for VSI's management. However, since you are an independent accountant/analyst and not a lawyer, this is not your area of concern.

The accounting records of VSI have been obtained by Second Union's legal counsel and made available for your review in an off-site storage facility. The certified collateral reports for 2009 and 2010 are available from the Bank. Also, Second Union's counsel has obtained the working papers of M&S related to their audits of VSI. All employees of VSI are terminated and you are informed that all former VSI personnel contacted to date have declined to cooperate with the investigation. The Bank's legal counsel has told you that if a fraud claim is asserted against management, it is likely that you will be called upon to prepare a written report of yourfindings, that you will likely be subpoenaed to appear for formal deposition testimony and, if the case goes to trial, that you will be required to testify in court.

II. COMPANY BACKGROUND & FINANCIAL INFORMATION

Vision Services, Inc. ("VSI") was founded by William (Bill) Jacobs in 2001 after he was laid off from his job with a major defense contractor as a result of a 2000 reorganization to provide engineering services, temporary personnel and personnel training services for the defense contracting industry. Due to the technology-intensive nature of the defense contracting industry, there exists a constant need for well-trained technical personnel. VSI attempted to fill certain aspects of these needs by offering temporary personnel and training services ranging from general employee training to computer systems design and implementation. As with similar entities in the startup phase, VSI was minimally capitalized, as it was originally funded with only

Bill's small savings. However, with Bill's technical expertise, VSI was profitable from its formation and grew rapidly, as reported in its audited financial statements, with revenues reaching $5.4 million in 2007.

When VSI expanded in the 2000's it became necessary to obtain additional financing to fuel the growth of the business. The Company established a line of credit with a local bank with collateral for the loan consisting of a first security interest in VSI's accounts receivable. The bankers were comfortable in lending against the accounts receivable since VSI's customers were mostly large well-established companies and the credit risk on those accounts receivable was expected to be minimal. The maximum amount available on the line of credit was $600,000.

At the request of the bank, Jacobs made the commitment to have audited financial statements for VSI. He did not resist this request, as he believed that an audit by an independent CPA added credibility to VSI and its financial statements. Therefore, VSI's financial statements were audited annually for the years ended December 31, 2003 through 2010 by the accounting firm of Miller & Starr, CPAs ("M&S"). Each year M&S, following their audit, provided VSI with a signed audit report that stated that in their opinion VSI's financial statements were prepared in accordance with generally accepted accounting principles ("GAAP"). These audits were usually completed within four months of the VSI fiscal year-end (December 31).

2008

While VSI had made some efforts to diversify into other product lines prior to 2008, its primary business remained temporary personnel and personnel training services for the defense contracting industry. This market became extremely competitive in the late 2000's due to defense industry downsizing, which resulted in VSI's profit margins and market share coming under pressure. Certain of VSI's customer contracts were expiring in 2008 and Jacobs felt the Company needed to focus on selling larger engineering projects and other value-added services in order to continue its growth.

In order to provide additional financing for the larger project work, Jacobs in early 2008 contacted Second Union Bank ("Second Union"), to establish a new banking relationship with a larger bank. Bill concluded that a new banking relationship would help in the expansion plans for VSI. The introduction to the bankers was assisted by Dennis Starr of M&S, who had a good working relationship with Second Union. In May 2008, Second Union agreed to establish an asset-based line of credit for VSI for the greater of $1,000,000 or 75% of the eligible accounts receivable. To complete the agreement, VSI had to provide a first security interest in all of their business assets as collateral for loans under the line-of-credit. However, only receivables less than 90 days old would be considered by Second Union in determining the maximum advances under the line of credit. Second Union, like the prior bank, believed that if the VSI business ever failed, the only assets which would likely have remaining value would be the receivables. The Bank's security interest in other assets such as inventory, prepaids, and equipment would have little realizable value in the event of a liquidation of assets.

The loan agreement specifically required that VSI furnish Second Union audited financial statements prepared in accordance with generally accepted accounting principles. In addition, the agreement stipulated that VSI provide a collateral report consisting of an aged listing of accounts receivable within 20 days after the close of each month. These reports were also to be accompanied by a certification from an officer of VSI that the reports were complete and accurate.

2009

In 2009, Second Union became aware that VSI's financial condition had taken a turn for the worse. Upon receipt of the 2008 audited financial statements, the bank learned that revenues for 2008 had declined by approximately 7%, while gross profit margins declined and administrative expenses increased. The combination of these factors resulted in a pre-tax loss of $(279,931). This was particularly distressing to the Bank because the interim financial statements they had been shown had not reflected a problem of this magnitude.

Following receipt of the audited financial statements in April 2009, Ron Gray, Second Union's loan officer, informed Bill Jacobs that in view of the VSI's deteriorating financial condition, VSI's line of credit would be under review by Second Union's loan committee. Ron Gray notified VSI's management that the loan would not be renewed if VSI did not promptly act to eliminate its operating losses. Upon receipt of this notice from Second Union, Bill Jacobs called an executive meeting of top management and informed them that VSI would go out of business without the continuance of this loan. Heated discussion took place as to the options available to VSI.

In an effort to offset these declines in revenues and eliminate the losses, VSI's management decided to implement the following steps to reduce costs:

1. Reduction in marketing and sales costs.
2. Salary reductions.
3. Reduce administrative support, including one of the Company's two accounting personnel.

On June 2, 2009, James Roberts, VSI's Vice-President of Finance, wrote Second Union stating that VSI, with the aid of Miller & Starr, was in the process of preparing interim financial statements for May 2009, together with a forecast for the balance of 2009. The financial statements showed an improvement in results and the forecasted financial statements projected a return to profitability in 2009. Based on the forecast and the management actions, Union extended the line of credit to June 30, 2010 at the existing limit of $1.0 million, but raised the loan interest rate (from prime rate plus 1 % to prime rate plus 2%).

2010

Upon receipt of the 2009 financial statements in May 2010, the bank became convinced that VSI had made great progress on the resolution of their problems. The audited financial statements showed a significant improvement over 2008 results. Sales totaled only $5.1 million but operating profits (income before interest and taxes) were $122,764 and the Company had a modest net income. The Company's financing requirements continued to grow, however, due to an increase in accounts receivable attributed by management to administrative delays in payments on customer contracts. VSI requested an increase in their credit limit and on August 3, 2010, Ron Gray called VSI to inform Jim Roberts that Second Union was pleased with VSI's results, and the bank's loan committee authorized an extension on the line of credit, with an increase in the limit to $1,300,000.

Throughout the balance of 2010, VSI apparently continued to profitably maintain and expand their business. The 2010 audited financial statements, which Second Union received in April 2011, showed increases in revenue to almost $6.0 million, operating profits of $284,138 and net income of $92,441.

2011

On May 10, 2011, Ron Gray of Second Union became concerned about the deterioration in the aging of accounts receivable and the continual increase in VSI's accounts receivable balance, as well as the frequent overdrafts on the VSI checking account. He met with James Roberts and insisted, over Roberts' strong objection, that the Bank be allowed to contact

certain major customers of VSI regarding the substantial amounts they owed VSI. Gray felt this step was necessary to provide Second Union with comfort that the amounts shown as accounts receivable would be eventually paid.

After some discussion, Roberts admitted that many of VSI's accounts receivable (which at that time were shown on the books at approximately $1.8 million) would not prove to be collectible and that he regretted having done anything that misled the bank. He told Gray that everything he and Jacobs had done was done just to save the jobs of the VSI employees and that they had expected they would be able to work themselves out of their financial problems. Second Union immediately stopped advancing funds to VSI and VSI closed its doors, agreeing to forfeit all assets to Second Union. After collecting all valid accounts receivable and selling all other assets of VSI at auction, Second Union still incurred a loss on its loan of $950,000 at the time VSI ceased operations on 5/12/11. The VSI trade creditors received nothing.

III. COMPANY FORENSIC INFORMATION

You have obtained the audited financial statements of VSI for the years 2007 through 2010 and have prepared a summary of those financial statements, as shown on **EXHIBIT I.** You have prepared a timeline of major known events on **EXHIBIT II.** You have also obtained the M&S accounts receivable working papers, engagement memoranda and work programs and the following records from VSI files and the Bank:

VSI Financial Statements (including Notes to the financial statements)

The accounting policies note includes the following:

"Engineering Services

Revenues for engineering services are recognized upon completion of projects, which are generally of short duration. Direct costs associated with customer engineering projects in process are included in inventory at the lower of cost or realizable value."

Second Union—VSI Line of Credit Loan Agreement

Section 7.2 of the Agreement defines "eligible accounts receivable" for lending purposes:

"Accounts receivable shall represent amounts owed by customers on invoices outstanding less than 90 days and uncollected to the extent such invoices relate to services rendered or products delivered to and accepted by the customer. The determination of eligible accounts receivable for purposes of calculating available line-of-credit advances under Section 3.4 shall be made as of the last day of the month preceding the request for an advance."

VSI General Ledgers for each year

VSI Accounts Receivable/Sales Subledgers and Transaction Registers

-Accounts receivable trial balances
-Monthly sales registers
-Monthly debit/credit memo adjustment registers
-Cash receipt records
-VSI invoices
-Customer purchase orders

-Customer remittance advices

VSI Work Order Log (Documenting costs incurred by project)

VSI bank statements and deposit slips

You also have performed a preliminary review of M&S's audit working papers. Since 2009 was the seventh year that Miller & Starr had audited VSI, Miller felt comfortable with VSI's operations, management, and financial reporting procedures. In conducting the first four audits, the audit procedures included direct confirmation of accounts receivable with customers. When confirmations were sent, the auditors would include copies of the current invoices to make it as easy as possible for VSI's customers to confirm the balances. In four years of sending out confirmations, only two were ever returned that questioned the balance owed to VSI, and those differences were subsequently resolved. However, it was often difficult to get the customers to return the confirmations, with second requests and telephone follow-up often required, which created an inefficient audit process.

Starting with the fifth year's audit, M&S decided to use "alternative procedures" rather than confirmations. These procedures consisted of checking whether the accounts receivable were collected after year-end as evidence of their validity, since the best evidence of a valid receivable is actual customer payment. Where subsequent payment was not received prior to the end of the audit, the unpaid invoices were reviewed with VSI's management to determine the reasons for nonpayment, and M&S would also review the actual VSI invoice, along with any other documents available in the invoice file. In most years, the auditors were able to verify between 70-90% of the accounts receivable balance with subsequent cash receipts.

M&S performed detailed testing of the costs accumulated in inventory based on the VSI Work Order Log. However, there is no evidence that they found it necessary to examine any work order records for jobs which were fully billed prior to year-end (therefore having no inventory balance).

Investigation 2009 Information

Your preliminary investigation related to the accounts receivable balances at December 31, 2009 has revealed that as required by the loan agreement, VSI furnished to Second Union their aged accounts receivable schedule as of December 31, 2009, together with the certification signed by Bill Jacobs **(EXHIBIT III).** The M&S auditors were provided with the same detail of accounts receivable. After reviewing the details supporting the accounts receivable aging schedule for December 31, 2009, your staff has brought to your attention the following information for selected major accounts receivable balances included in VSI's financial statements. They have also brought you the related portions of the VSI work order log **(EXHIBIT IV**) for use in your review:

1. Penns Engineering Services, Inc. ("Penns")

On December 10, 2009, Penns issued purchase order No. 34A508347 to VSI for

project engineering services related to a robotic welding application in the amount of $75,000. The required completion date on the purchase order was "ASAP". On December 30, 2009, VSI's accounts receivable clerk recorded invoice No. 31290 for services rendered to Penns Engineering Services, Inc. in the amount of $75,000.

The M&S audit working papers indicated that the auditors looked at the Penns purchase order and the VSI invoice. Payment had not been received from the customer by the March 29, 2010 date of the auditors' report but management had explained that the Penns invoice approval/payment cycle was typically 120 days or more. Your staff's review has determined that on April 28, 2010, VSI issued and recorded credit memo No. 31290 to Penns for $75,000, reversing invoice No. 31290. On May 14, 2010, VSI recorded invoice No. 32150 to Penns in the amount of $75,000. On June 22, 2010, VSI received a payment from Penns of $75,000, with the remittance advice referring to "Inv. 32150-5/14/10".

2. Tempco, Inc. ("Tempco")

VSI recorded invoice No. 29934 on November 4, 2009 in the amount of $45,000 for "Development of SPC Training Module I." VSI then recorded invoice No. 31065 on December 23, 2009 in the amount of $23,000 for "Module II" development.

The M&S working papers documented that these charges agreed with the amounts for those services on Tempco purchase orders No. 3058 and 3059, each dated June 30, 2009, which specified delivery no later than January 31, 2010. M&S also had examined documentation proving that on December 21, 2009, VSI received payment for $25,000 from Tempco which VSI credited against invoice No. 29934 and that Tempco made the final payment on both invoice No. 29934 and No. 31065 with a check for $43,000 on February 3, 2010.

3. McDonald Douglas, Inc.

VSI recorded invoice No. 30489 to McDonald Douglas, Inc. in the amount of $58,995 on November 29, 2009. The M&S working papers documented that on March 22, 2010, the invoice was paid in full. However, in our review of the customer's remittance advice accompanying the payment, the customer referenced payment of invoice No. 30489 dated January 22, 2010 for $58,995.

4. Nexus Software

On November 30, 2009, VSI recorded invoice No. 30510 for programming services rendered to Nexus Software in the amount of $119,432. M&S working papers revealed that they had examined the VSI invoice and the related purchase order dated October 15, 2009, which did not specify a completion date but stated a price of $32.50 per programmer hour. No payment had been received by the end of the auditor's fieldwork, which management attributed to a cash flow problem on the part of Nexus which they expected to be resolved shortly.

Our work has revealed that on March 31, 2010, debit memo No. 30510 was issued in the amount of $2,443 to increase the amount due to $121,875. On April 12, 2010 a check for $121,875 was received from Nexus in payment of invoice No. 30510.

5. Boeing Defense Services

VSI issued and recorded invoice No. 31266 dated December 15, 2009 to Boeing Defense Services for engineering services on a classified government program in the amount of $75,411. The M&S working papers indicate that on February 14, 2010, Boeing paid $40,000 on invoice No. 31266 and paid the balance on March 30, 2010.

Investigation 2010 Information

You have obtained the aged accounts receivable trial balance VSI furnished to Second Union as of December 31, 2010, together with the certification signed by James Roberts (**EXHIBIT V**). This schedule agreed with the M&S working paper detail of accounts receivable. After reviewing the details supporting this accounts receivable aging schedule for December 31, 2010, your staff has brought to your attention the following information for selected major accounts receivable balances included in VSI's financial statements. They have also brought you the related portions of the VSI work order log (**EXHIBIT VI**) for use in your review.

Based on the date in the auditors' report of M&S, they completed their audit fieldwork on March 15, 2011:

1. Nexus Software

VSI recorded invoice No. 36998 for $69,000 on October 31, 2010, and invoice No. 37330 for $87,210 to Nexus Software dated November 31, 2010. Then on December 16, 2010 invoice No. 37330 was adjusted upward by $31,000 through an account maintenance routine available in the VSI billing software. M&S, seeing no subsequent receipt, interviewed Jacobs and Roberts regarding these transactions. Roberts indicated that all of the "paperwork" for this project was at VSI's Florida branch, but that VSI would be paid in April 2011 when Nexus' customer paid them. Jacobs pointed out that the staff auditor should know that Nexus had long been one of VSI's best customers and they always paid slow.

Because of the size of the Nexus account and since there were no records available locally in support of this account, the staff auditor decided to seek direct confirmation of the Nexus account with the customer. A faxed confirmation response was received on March 12, 2011, indicating that the account was correct, with a note stating that the invoices were scheduled for payment on April 15.

On March 29, 2011 a credit memo for $187,210 was issued to reverse invoices 36998 and 37330. The only 2011 check from Nexus Software you have located was for $15,000 received on April 11, 2011. The remittance advice on this check referenced invoice No. 38500 dated March 3, 2011.

2. CMI K\P Modules

CMI K\P Modules was billed with invoice No. 37331 on November 30, 2010 for $197,697. On February 6, 2011 VSI issued and recorded credit memo No. 37331 for $107,697. Then on March 12, 2011 an accounts receivable clerk issued another credit memo for $90,000 completely reversing the invoice transaction. Roberts informed the M&S auditor checking subsequent receipts to original Second Union checking account deposit slips dated February 4, 2011 for $106,000 and March 9, 2011 for $90,000, that he was unable to locate the original remittance advices due to their short-staffed situation, which had caused them to fall behind on filing. The difference between the $107,697 and the $106,000 was deemed immaterial.

Your investigation has revealed that the bank deposits examined by the auditor were actually for draws made against the Second Union line of credit. Dun & Bradstreet

has no record of a company by this name.

3. JLO Contracting Services

VSI issued and recorded invoice No. 37603 in the amount of $77,200 for JLO Contracting Services on December 31, 2010. The M&S auditors examined evidence of a payment from JLO Contracting Services on March 14, 2011 for $77,200. Jacobs showed the M&S auditor the actual check on the day it arrived, indicating that he knew it must be one of the items they needed to wrap up their work.

Your staff has located the JLO remittance advice, which referenced invoice No. 37603 dated February 28, 2011.

4. DCS, Inc.

VSI issued and recorded invoice No. 37588 on November 21, 2010, to DCS, Inc. for $57,339. On January 17, 2011, a credit memo for invoice No. 37588 was recorded for $30,000. On the same day a payment from DCS, Inc. was recorded in the amount of $27,339. The M&S auditor examined the evidence of the payment, and was informed that DCS did not pay the $30,000 because of an offsetting account payable in that amount that VSI owed to DCS. The M&S auditor verified the existence of the account payable by examination of the December 31, 2010 accounts payable trial balance and the invoice from DCS.

A review of the bank files revealed a collection letter from an attorney representing DCS dated June 29, 2011, threatening legal action if the bank does not release the $30,000 his client is owed.

5. Vortext, Inc.

VSI recorded invoice No. 37607, related to CAD engineering services to Vortext in the amount of $174,135 on December 31, 2010. The M&S auditors were told that no formal purchase order was received and the project manager had failed to ask for one from this new customer. However, Roberts was able to provide a copy of a Vortext Request for Quotation, the VSI Quote form which agreed with the invoice and a UPS shipping form dated December 31, 2010 addressed to Vortext.

Your staff has determined that this invoice was reversed by credit memo on March 31, 2011 and rebilled that same day on invoice No. 39521. That invoice was on the VSI accounts receivable listing at the time VSI terminated its operations. A call to the Vortext engineering manager identified in the Vortext request for quotation confirmed that Vortext had requested a quotation from VSI for the CAD services but that Vortext had given the business to another vendor because of industry rumors that VSI was in trouble.

EXHIBIT I

VISION SERVICES, INC.
BALANCE SHEETS

December 31

Assets	*2010*	*2009*	*2008*	*2007*
Current assets:				
Cash	*$1,700*	*$1,898*	*$6,455*	*$16,803*
Accounts Receivable, net	*1,744,807*	*1,023,623*	*818,513*	*934,209*
Inventory	*229,023*	*125,112*	*42,305*	*0*
Prepaid expenses	*31.958*	*17.402*	*15.605*	*14.527*
Total current assets	*2.007.448*	*1.168.035*	*882.878*	*965.539*
Property and equipment, net	*204.451*	*212.359*	*262,603*	*266,561*
Total Assets	*$2.211.939*	*$1.380.394*	*$1.145.481*	*$1.232.100*
Liabilities and Stockholders' Equity				
Current liabilities:				
Line-of-credit	*$1,273,300*	*$683,100*	*$534,800*	*$469,804*
Accounts payable — trade	*362,336*	*209,620*	*221,874*	*156,329*
Taxes accrued and withheld	*29,590*	*44,182*	*4,977*	*25,115*
Accrued expenses	*44.816*	*34.036*	*1.304*	*24.769*
Total liabilities	*1.710.042*	*970.938*	*762.955*	*676.017*
Stockholders' equity				
Common stock	*$6,003*	*$6,003*	*$6,003*	*$6,003*
Retained earnings	*495.894*	*403.453*	*376.523*	*550.080*
Total stockholders' equity	*501.897*	*409.456*	*382.526*	*556.083*
Total liabilities and stockholders' equity	*$2.211.939*	*$1.380.394*	*$1.145.481*	*$1.232.100*

EXHIBIT I (cont'd.)

VISION SERVICES, INC.
STATEMETNS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31

	2010		2009		2008		2007	
Sales	$5,962,610	100%	$5,139,795	100%	$5,050,887	100%	$5,409,655	100%
Cost of operations	4.368.487	73%	3.761.229	73%	3.802.744	75%	3.850.423	71%
Gross profit	1,594,123	27%	1,378,566	27%	1,248,143	25%	1,559,232	29%
General and administrative expenses	1.309.985	22%	1.255.802	24%	1.479.652	29%	1,345.923	25%
Income from operations	284,138	5%	122,764	2%	(231,509)	-5%	213,309	4%
Interest expense, net	(135.040)	-2%	(79.328)	-2%	(48.422)	-1%	(27.843)	-1%
Net income before provision for income taxes	149,098	3%	43,436	1%	(279,931)	-6%	185,466	3%
Provision for income taxes	(56.657)	-1%	(16.506)	0%	106.374	2%	(70.477)	-1%
Net income	$92,441	2%	$26,930	1%	$(173.557)	-3%	$114,989	2%
Analysis of Retained Earnings								
Beginning balance	$403,453		$376,523		$550,080		$435,091	
Net income (loss)	92.441		26.930		(173.557)		114.989	
Ending balance	$495,894		$403,453		$376,523		$550,080	

EXHIBIT II

Second Union v. Vision Services, Inc.
Timeline of Events
2001-2011

2001- VSI founded by Bill Jacobs

March 2004 -The accounting firm of Miller & Starr, CPAs completes their first audit of the financial statements of VSI for the year ended December 31, 2003. Relationship established with local bank and line of credit approved for $600,000.

May 2008 -Banking relationship transferred to Second Union Bank. Line of credit approved for $1,000,000.

April 2009- 2008 audited financial statements reveal a significant loss and the first sales decline in the history of VSI. Second Union informs VSI management that the lending relationship will be under review by the Bank's loan committee.

June 2009 -VSI management provide Second Union with unaudited May 2009 financial statements showing improved results and a forecast for 2009 showing a return to profitability. Second Union extends the line of credit to June 30, 2010 and increases the interest rate by 1%.

May 2010- Audited VSI financial statements for the year ended December 31 2009 confirm the improved results and return to profitability. Second Union approves extension of line of credit to June 30, 2011.

August 3, 2010- Second Union increases the line of credit to $1.3 million based on the request of VSI management.

April 2011 -Audited VSI 2010 financial statements reflect improved results and significant increases in the levels of accounts receivable, amounts outstanding on the line of credit and accounts payable.

May 10,2011 -Ron Gray becomes concerned over the accounts receivable collateral of VSI and the frequent overdrafts of VSI's bank accounts. He begins to investigate the situation and meets with VSI management.

May 12, 2011- VSI terminates operations and lays off all employees.

June 2011- VSI surrenders all assets to Second Union bank.

EXHIBIT III

VISION SERVICES, INC.
Accounts Receivable Aged Summary Trial Balance
December 31, 2009

	Days Outstanding			
	1-30 Days	***31-60 Days***	***61-90 Days***	***Over 90 Days***
Customer				
BJP Defense Technology Systems	*$23,000*			*$56,987*
Boeing, Inc.	*$75,411*			
Glorcom Industrial				*$46,544*
Harris Engineering			*$27,900*	
JLO Contracting Services	*$91,752*			
Tempco, Inc.	*$23,000*	*$20,000*		
McDonald Douglas, Inc.		*$58,995*		
Nexus Software		*$119,432*		
Penns Engineering Services, Inc.	*$75,000*			
RTS Molding, Inc.			*$16,726*	
Torrington Manufacturing &Engineering	*$119,005*			
U. S.DTS			*$89,560*	
Vortext, Inc.		*$34,128*	*$74,610*	
Other Receivables (individually under $500)	*$22,916*	*$15,983*	*$25,736*	*$6,938*
Total by Aging Category	*$430,084*	*$248,538*	*$234,532*	*$110,469*
	42%	*24%*	*23%*	*11%*
TOTAL ACCOUNTS RECEIVABLE	*$1,023,623*			

I William jacobs hereby certify that the amounts show above (except for the amounts classified as over 90 days) have been determined in accordance with the provisions of Section 7.2 of the loan agreement between Vision Services, Inc. and Second Union Bank and represent "Eligible Accounts Receivable" as defined therein.

EXHIBIT IV

Vision Services -Work Order Log Excerpts

Customer: Penns Engineering Services			
Report Date 8/31/10			
Customer P.O.		*34A508347*	*12/10/09*
Order start date			*12/20/09*
Amount Billed to Date			*$75,000*
Project status			*Complete*
	Cumulative	*Cumulative*	
Activity	*Cost to 12/31/09*	*Cost to Date 8/31/10*	*Date of Last Activity*
Employee Salaries	*$4,873.00*	*$26,875.00*	*4/28/10*
Subcontracted Services	*-*	*13,110.00*	*5/10/10*
Project & Facility Costs	*-*	*2,400.00*	*4/10/10*
Travel & Entertainment	*250.00*	*4,750.00*	*4/28/10*
Per Diem	*105.00*	*1,200.00*	*4/28/10*
Meals & Lodging	*-*	*852.00*	*4/28/10*
Shipping Charges	*-*	*350.00*	*5/10/10*
Employee Taxes & Benefits	*1,462.00*	*8,063.00*	*4/28/10*
Other Direct Expense	*1,650.00*	*2,350.00*	*5/10/10*
Costs Total	*8,340.00*	*59,950.00*	
Inventory Balance	*-0-*	*-0-*	

.

EXHIBIT IV (cont'd.)

Vision Services -Work Order Log Excerpts

	Customer:	*Tempeo, Inc.*	
Report Date 4/30/10			
Customer P.O.		*3058, 3059*	*6/30/09*
Order start date			*6/28/09*
Amount Billed to Date			*$68,000*
Project status			*Complete*
	Cumulative	*Cumulative*	
Activity	*Cost to 12/31/09*	*Cost to Date 4/30/10*	*Date of Last Activity*
Employee Salaries	*$52,956.00*	*$52,956.00*	*12/22/09*
Subcontracted Services	*6,222.00*	*6,222.00*	*8/12/09*
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	*1,543.00*	*1,543.00*	*12/22/09*
Meals & Lodging	*640.00*	*640.00*	*12/5/09*
Shipping Charges	*42.00*	*42.00*	*12/22/09*
Employee Taxes & Benefits	*15,887.00*	*15,887.00*	*12/22/09*
Other Direct Expense	*50.00*	*50.00*	*8/31/09*
Costs Total	*77,340.00*	*77,340.00*	
Inventory Balance	*-0-*	*-0-*	

EXHIBIT IV (cont'd)

Customer: McDonald Douglas, Inc.

Report Date 4/30/10			
Customer P.O.		*9993548254*	*11/1/09*
Order start date			*11/1/09*
Amount Billed to Date			*$58,995*
Project status			*Complete*
	Cumulative	*Cumulative*	
Activity	*Cost to 12/31/09*	*Cost to Date 4/30/10*	*Date of Last Activity*
Employee Salaries	*$29,654.00*	*$32,871.00*	*1/18/10*
Subcontracted Services	-	*2,350.00*	*1/15/10*
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	-	*15.00*	*1/15/10*
Meals & Lodging	-	-	
Shipping Charges	*65.00*	*89.00*	*1/22/10*
Employee Taxes & Benefits	*8,896.00*	*9,861.00*	*1/18/10*
Other Direct Expense	*4.577.00*	*4.577.00*	*12/18/09*
Costs Total	*43,192.00*	*49,793.00*	
Inventory Balance	*-0-*	*-0-*	

EXHIBIT IV (cont'd)

Customer: Nexus Software

Report Date 4/30/10			
Customer P.O.		*NX40005967*	*10/15/09*
Order start date			*10/1/09*
Amount Billed to Date			*$121,875*
Project status			*Complete*
Activity	*Cumulative Cost to 12/31/09*	*Cumulative Cost to Date 4/30/10*	*Date of Last Activity*
Employee Salaries	*$1,396.00*	*$52,333.00*	*3/12/10*
Subcontracted Services	*-*	*12,569.00*	*3/12/10*
Project & Facility Costs	*650.00*	*6,214.00*	*3/12/10*
Travel & Entertainment	*392.00*	*1,250.00*	*3/12/10*
Per Diem	*15.00*	*940.00*	*1/15/10*
Meals & Lodging	*85.00*	*3,444.00*	*3/12/10*
Shipping Charges	*-*	*19.00*	*3/12/10*
Employee Taxes & Benefits	*419.00*	*15,700.00*	*3/12/10*
Other Direct Expense	*1,005.00*	*4,577.00*	*2/12/10*
Costs Total	*3,962.00*	*97,046.00*	
Inventory Balance	*-0-*	*-0-*	

EXHIBIT IV (cont'd)

Customer: Boeing Defense Systems

Report Date 4/30/10		
Customer P.O. Order		*Classified*
Start Date Amount	*Classified*	*11/12/2009*
Billed to Date Project		*$75,411*
Status		*Complete*

Activity	***Cumulative Cost to 12/31/09***	***Cumulative Cost to Date 8/31/10***	***Date of Last Activity***
Employee Salaries	*$42,880.00*	*$42,880.00*	*12/22/09*
Subcontracted Services	-	-	
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem Meals & Lodging	-	-	
Shipping Charges Employee	-	-	
Taxes & Benefits Other	-	-	
Other Direct Expenses	*12,864.00*	*12,864.00*	*12/23/09*
Costs Total	***55,744.00***	***55,744.00***	
Inventory Balance	*-0-*	*-0-*	

EXHIBIT V

VISION SERVICES, INC.
Accounts Receivable Aged Summary Trial Balance
December 31, 2010

	Days Outstanding			
	1-30 Days	***31-60 Days***	***61-90 Days***	***Over 90 Days***
Customer				
BJP Defense Technology Systems	*$136,290*			
Boeing, Inc.		*$27,456*		
CMIK/P Modules		*197,697*		
DCS, Inc.		*57,339*		
Glorcom Industrial	*24,358*			
Harris Engineering			*$65,301*	
JLO Contracting Services	*77,200*			
McDonald Douglas, Inc.		*65,836*		
Nexus Software		*118,210*	*69,000*	
TRS Molding, Iinc.				*$29,550*
Tempco			*57,009*	
Torrington Manufacturing & Engineering	*55,630*		*93,700*	
U.S. DTS	*245,592*	*127,882*	*45,000*	*12,300*
Vortext, Inc.	*174,135*			
Other Receivables (Individually $500 or Less)	*21,578*	*19,975*	*18,739*	*5,030*
Total by Aging Category	*$734,783*	*$614,395*	*$348,749*	*$46,880*
	42%	*35%*	*20%*	*3%*
TOTAL ACCOUNTS RECEIVABLE	*$1,744,807*			

I James Roberts hereby certify that the amounts show above (except for the amounts classified as over 90 days) have been determined in accordance with the provisions of Section 7.2 of the loan agreement between Vision Services, Inc. and Second Union Bank and represent "Eligible Accounts Receivable" as defined therein.

EXHIBIT VI

Vision Services - Work Order Log Excerpts

Customer: Nexus Software

Report Date	*5/10/2011*
Customer P.O.	*NX40008301*
Order Start Date	
Amount Billed to Date	*$15,000*
Project Status	*Complete*

Activity	***Cumulative Cost to 12/31/10***	***Cumulative Cost to Date 5/10/11***	***Date of Last Activity***
Employee Salaries	-	*$4,558.00*	*3/12/2010*
Subcontracted Services	-	*3,500.00*	*3/12/2010*
Project & Facility Costs	-	*1,214.00*	*3/12/2010*
Travel & Entertainment	-	-	*11/15/2009*
Per Diem	-	-	*1/15/2010*
Meals & Lodging	-	-	*3/12/2010*
Shipping Charges	-	*50.00*	*3/12/2010*
Employee Taxes & Benefits	-	*1,367.00*	*3/12/2010*
Other Direct Expenses	-	*2,121.00*	*3/12/2010*
Costs Total	-	*12,810.00*	
Inventory Balance	*-0-*	*-0-*	

Customer:

Report Date 5/10/11

(You and your staff have been unable to locate any work order records for CMI K/P Modules)

EXHIBIT VI (cont'd.)

Vision Services—Work Order Log Excerpts

Customer: JLO Contracting Services

Report Date 5/10/11

Customer P.O.		*J23X94X6382*	*10/23/10*
Order start date			*1 1/1/10*
Amount Billed to Date			*$77,200*
Project status			*Complete*
	Cumulative	*Cumulative*	
Activity	*Cost to 12/31/10*	*Cost to Date 5/10/11*	*Date of Last Activity*
Employee Salaries	*$15,266.00*	*$24,699.00*	*2/26/11*
Subcontracted Services	*9,211.00*	*15,730.00*	*2/26/11*
Project & Facility Costs	*1,259.00*	*3,407.00*	*2/26/11*
Travel & Entertainment	*580.00*	*1,192.00*	*2/26/11*
Per Diem	*-*	*58.00*	*2/26/11*
Meals & Lodging	*1,820.00*	*3,293.00*	*2/26/11*
Shipping Charges	*-*	*160.00*	*2/26/11*
Employee Taxes & Benefits	*4,580.00*	*7,410.00*	*2/26/11*
Other Direct Expense	*1,200.00*	*1,200.00*	*2/26/11*
Costs Total	*33,917.00*	*57,149.00*	
Inventory Balance	*-0-*	*-0-*	

Exhibit VI (cont'd)

Customer: DCS, Inc.

Report Date 5/10/11

Customer P.O.		*3721*	*9/15/10*
Order start date			*9/12/10*
Amount Billed to Date			*$57,339*
Project status			*Complete*
	Cumulative	*Cumulative*	
Activity	*Cost to 12/31/09*	*Cost to Date 8/31/10*	*Date of Last Activity*
Employee Salaries	*$12,900.00*	*$12,900.00*	*11/20/10*
Subcontracted Services	*1,533.00*	*1,533.00*	*10/30/10*
Project & Facility Costs	*1,816.00*	*1,816.00*	*11/20/10*
Travel & Entertainment	-	-	
Per Diem	-	-	
Meals & Lodging	-	-	
Shipping Charges	-	-	
Employee Taxes & Benefits	*3,870.00*	*3,870.00*	*11/20/10*
Other Direct Expense	*92.00*	*92.00*	*11/5/10*
Costs Total	*20,211.00*	*20,211.00*	
Inventory Balance	*-0-*	*-0-*	

Exhibit VI (cont'd)

Customer: Vortex, Inc.

Report Date 5/10/11
Customer P.O.
Order start date *8/25/10*
Amount Billed to Date *$ 174,135*
Project status *Complete*

Activity	***Cumulative Cost to 12/31/10***	***Cumulative Cost to Date 5/10/11***	***Date of Last Activity***
Employee Salaries	-	-	
Subcontracted Services	-	-	
Project & Facility Costs	-	-	
Travel & Entertainment	-	-	
Per Diem	-	-	
Meals & Lodging	-	-	
Shipping Charges	-	-	
Employee Taxes & Benefits	-	-	
Other Direct Expense	-	-	
Costs Total	-	-	
Inventory Balance	*-0-*	*-0-*	

IV. INDUSTRY INFORMATION

Bill Jacobs worked for 22 years with Northrup Grumman that provides various products and services to the U.S. Government. As a defense contractor, Northrup not only provides defense products related to the Department of Defense's E-4B and E-6B national command aircraft and the B-52H bomber, but also provides technical support and training to the government. Northrup's business with the U.S. government accounted for approximately 77% of their annual sales.

Since the government carefully provides due diligence in selecting product and service contractors, any accounts receivable related to contact work including subcontractors are considered very reliable for payment and thus an aging of accounts receivable is usually not a big concern although there are certain customers that tend to slow pay.

As the civilian and military demand cycle dropped for certain programs Bill, who was considered a technical expert in defense contract training services, was laid off by Northrup resulting from a major corporate reorganization.

V. FINAL THOUGHTS RELATED TO KEY DECISIONS & DECISION MAKER

At the request of Second Union Bank, you have been engaged to determine any losses incurred by the bank and to determine the existence of any possible fraud on the part of Vision Services. In discussion with your staff, you concluded that the issues for this investigation can be categorized into three major focus areas:

- Accounting issues
- Litigation/Investigation/Fraud issues
- Auditing issues related to the work by the independent auditor

Your task is to identify the specific issues related to the above stated focus areas.

Other Documents Reviewed

Your review of the Accounts Receivable Debit/Credit Memo Adjustment registers for 2010 and 2011 indicates that in the typical month several hundred thousand dollars of credit memos were processed, as well as significant amounts of debit memos. Your review of the VSI general ledger for December 2010 revealed that the net sales VSI recorded for the month were approximately $502,000.

The M&S working papers for 2009 and 2010 contained management representation letters signed by Bill Jacobs and James Roberts which included all appropriate representations regarding compliance with GAAP.

Your testing of the VSI work order records has found that the cost accumulation data in the VSI work order logs is complete and accurate.

VI. APPENDIX

General Background on Collateral Reporting Fraud

This section provides an overview as to general background information relating to a collateral reporting fraud.

An asset-based borrowing arrangement, as highlighted in this case, is one in which the amount made available for loans to a company is based on the assets which the company can offer as collateral. Usually the available amount is computed as a percentage of assets, with the more liquid assets such as current accounts receivable, providing the best collateral and therefore being assigned a higher percentage. Asset-based borrowing arrangements with banks and other financial institutions are one of the most common sources of corporate financing, and certainly they are the most prevalent form of working capital financing for smaller closely held

companies.

In spite of the fact that most large banks have internal collateral audit departments and also require their loan clients to have annual audits, it would be a rare bank which has not been victimized by a management fraud involving overstatement of collateral. The fraud techniques utilized by management in these cases vary in level of creativity, but almost always follow the same pattern. For a desperate and unethical management team of a financially struggling company, the practice of recognizing revenue early (before the earning process is complete and risks of ownership have transferred to the customer) is very tempting, both in its simplicity and its ability to satisfy their financial needs. The additional revenue improves operating results, providing bankers and others with false comfort that the company is doing well, while the additional accounts receivable which are recognized provide access to additional cash from loans against the accounts receivable collateral.

The case of Vision Services, Inc. is a typical example of collateral reporting fraud in the following ways:

1. The fraud was perpetuated over a long period of time (over two years), growing larger as time passed.

2. The fraud started with early recognition of revenue on legitimate customer orders, then graduated to the recognition of revenue for totally fictitious customer orders.

3. Management was very adept at providing explanations that would address the concerns of the bank and the auditors.

4. With the benefit of hindsight, it is possible to identify a number of ways in which the fraud could have been detected much earlier than it was.

The early or fictitious recognition of revenue is as simple as initiating an invoicing transaction in the accounting system. Where goods are actually to be delivered to the customer in the near future, sometimes the invoice is sent to the customer. More often, particularly in the extreme cases, invoices are created internally but not sent to the customer until the goods and services are delivered. Sometimes the same invoices are then mailed, but often the invoices are replaced with properly dated invoices.

In a severe case of fraud, where revenue is being recognized months in advance or for totally fictitious transactions, management's problem usually arises when the fraudulent invoices reach an age where they are no longer eligible to be used as collateral (often after 90 days). Invoices which are never paid must be somehow removed from the system and replaced with new accounts receivable which management can use as loan collateral. Common methods of accomplishing this include reversing the old invoices with credit memos or other accounting adjustments and the more complicated technique of misapplying actual cash receipts to those invoices rather than the actual invoices being paid by the customer.

TEACHING NOTES

CASE SYNOPSIS

This case study presents a litigation support engagement based upon an accounts receivable collateral reporting fraud (improper revenue recognition and asset overstatement) on the part of the management of a services company against its bank. The facts of the case were drawn from an actual fraud situation where litigation support work for a bank's legal counsel was requested, although the identities of all involved parties have been changed. In addition to background information and historical financial results, the case study presents the motivations for the fraud, and the various techniques used to falsify the accounting records and conceal the fraudulent nature of the transactions from the bank and the company's independent auditors.

This case emphasizes the issue that the U. S. Securities & Exchange Commission has reported that approximately 60-65% of their enforcement actions address some form of revenue recognition concern. This case also highlights a value added service of litigation support that an accounting firm can offer to clients beyond the normal audit, tax and consulting type services. The investigative techniques used by the accountant in performing litigation services are also emphasized.

TEACHING OBJECTIVES

The case objectives are to provide critical thinking and analysis in a potential fraud investigation. Specifically the case requires students to consider not only accounting issues as to the proper timing of revenue recognition, but also investigation techniques in a fraud investigation. However, in the investigation, the students need be aware of the misconduct by the independent auditor.

APPROPRIATE COURSE(S) FOR THE CASE

The case is well suited for a forensic accounting/fraud examination and/or an auditing course. The first segment of the case could also be utilized in the first intermediate accounting course in conjunction with the coverage of accounts receivable and revenue recognition. The facts present the scenario of an accounts receivable collateral reporting fraud and focuses on the role of the student/accountant as an expert providing litigation services to a client. With adequate pre-class preparation by students reading the case in detail, the in-class case discussion time should range between one to 1 ½ hours. For a one-hour limitation, the instructor should scope out beforehand the specific questions to be discussed in class.

The case would also work well for those faculty members that utilize group discussion and role-playing among students. The various student groups could represent VSI's management, Second Union Bank or the litigation consultant. Each group could defend their respective actions and concerns.

DISCUSSION QUESTIONS & ANSWERS

Accounting Issues

1. Per Generally Accepted Accounting Principles (GAAP), when should revenue be recognized? Also, how are accounts receivable to be valued and reported?

2. Are the stated revenue recognition policies of VSI on engineering services, as stated in the footnotes, appropriate and in accordance with GAAP?

3. For the accounts receivable balances specifically discussed above, what is your opinion as to amount, if any, of the overstatement of accounts receivable:

   a. As of December 31, 2009?
   b. As of December 31,2010?

4. With the exception of accounts receivable, are there any other balance sheet accounts that you believe should be appropriately adjusted based on your findings?

   a. As of December 31, 2009?
   b. As of December 31, 2010?

5. What would have been the impact of the adjustments you have proposed on the pre-tax income of VSI:

   a. For the year ended December 31, 2009?
   b. For the year ended December 31, 2010?

Litigation Consulting Engagement Issues

1. What, if any, evidence have you identified that would indicate knowledge of any financial statement and collateral reporting fraud on the part of Jacobs and Roberts?

2. What were the apparent motives of management to commit a fraud in this situation?

3. Compute your best estimate of the damages that Second Union incurred as a result of delaying termination of the loan agreement with VSI until May 12, 2011, versus the result if they had terminated the agreement on:

   a. December 31, 2009
   b. December 31,2010

(For purposes of this "damages analysis" calculation you may assume that the net liquidation value of all assets other than cash and accounts receivable is zero and that the bank would have had a first priority claim on the cash and the proceeds of accounts receivable.)

Auditing Issues

The Bank's legal counsel is also concerned that the loss on the VSI account followed so closely the completion of the apparently problem-free 2010 audit of M&S. They expect that management may use that clean audit opinion as a defense at trial. Accordingly, legal

counsel has also asked you to determine whether the fraud, if any, would have been detected by the proper application of Generally Accepted Auditing Standards (GAAS) and how any fraud was concealed from the auditors.

1. Distinguish between an error and fraud. Would management's actions in this case be considered an error or fraud? What is the auditor's responsibility for discovering errors and/or fraud?

2. What are some of the risk factors (red flags) that are apparent in the case?

3. Do you believe that the audit approaches employed by M&S were in accordance with GAAS? Why or why not?

4. What additional evidential matter could have been acquired by M&S (based on your knowledge of VSI's customers and accounting records)?

5. Based only on your analytical review of the VSI financial statements and accounts receivable trial balances as of December 31, 2009 and 2010, was information available which should have alerted the auditors to the potential of fraud and financial statement misstatement?

6. Was it appropriate for M&S to accept a fax confirmation from Nexus Software as audit evidence in the confirmation process? What special concerns are there for the auditor in accepting faxes as audit evidence?

7. Was M&S justified in their reliance on management representations? Why or why not?

Answers:

Accounting Issues

1. According to the FASB Concept Statement, Statement of Financial Accounting Concepts No. 5 (ASC 605-10-25-1), revenue is generally recognized when a) realized or realizable and b) earned. The Concept Statement states that revenues are realized when (goods or services); merchandise,or other assets are exchanged for cash or claims to cash. Revenues are considered earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. This concept is a key issue as to the proper recording of selected revenue transactions of VSI.

2. The stated revenue recognition policies disclosed in the footnotes to the VSI financial statements for engineering services appears to represent a reasonable application of the "realizable" and "earned" concepts of the FASB Concept Statement.

Some students may suggest that the percentage-of-completion method of accounting, as discussed in Accounting Research Bulletin No.45 (ASC 605-35-15), could be appropriate for VSI defense-related contracts. This is an excellent question, since large defense systems contractors do often use percentage-of-completion accounting. However, in this case we believe that percentage-of-completion accounting is not appropriate since a) the contracts tend to be of short duration, b) the contracts are not generally construction type and c) there is no evidence of reliable "estimate-to-complete" information with which to perform that type of accounting. Regardless of this issue, however, it is clear from the terms of Section 7.2 of the loan agreement between VSI and Second Union bank that the bank is using a completed contract definition of "realizable and earned" for purposes of determining eligible collateral.

3.a. The overstatement of accounts receivable as of December 31, 2009 is determined as follows:

Customer	Accounts Receivable Overstatement	Discussion
Penns	$75,000	Project was not complete at 12/31/09 per the work order log.
Tempco	0	The work was completed in 2009. Partial payment does not influence the proper timing of revenue recognition.
McDonald Douglas, Inc.	58,995	Project was not complete at 12/31/09 per the work order log.
Nexus Software	119,432	Per the work order log, this project had barely been started at 12/31/09.
Boeing Defense	0	The work was completed in 2009.
Total Known Overstatement	$253,427	

3.b. The overstatement of accounts receivable as of December 31, 2010 is determined as follows:

Customer	Accounts Receivable Overstatement	Discussion
Nexus Software	$187,210	An example of a fictitious transaction in the account of an actual customer.
CMI K/P Modules	197,697	Fictitious customer.
JLO Contracting	77,200	Advance recognition of revenue on an actual customer order.
DCS, Inc.	30,000	Inflating the amount of an otherwise valid receivable.
Vortext	174,135	Fictitious order from a potential customer.
Total Known Overstatement	$666,242	

4. In some cases where the accounts receivable and revenue were recorded early, there actually were legitimate direct costs incurred which were appropriately inventoried under the VSI accounting policy for inventories. If the improperly recorded revenue and accounts receivable are reversed by adjustment, it is also appropriate to adjust the related inventory balances.

4.0 December 31, 2009		*4.b. December 31, 2010*	
	2009 Inventory		*2010 Inventory*
Customer	*Understatement*	*Customer*	*Understatement*
Penns	*$8,340*	*JLO Contracting*	*$33,917*
McDonald Douglas, Inc.	*43,192*		
Nexus Software	*3,962*	*Total Understatement*	*$33,917*
Total Understatement	*$55,494*		

5. The impact of the corrections of accounts receivable and inventories and the related sales and cost of sales accounts would result in the reduction of pre-tax income for the years 2009 and 2010, as follows:

	VSI's Income Before Provision for Income Taxes-2009	VSI's Income Before Provision for Income Taxes-2010
Per Vision's audited financial statements	$43,436	$149,098
Less: Improperly recorded revenue -current year accounts receivable	(253,427)	(666,242)
Add: Improperly expenses inventory-current year	55,494	33,917
Add: Revenue recorded in 2009-Earned or reversed in 2010	N/A	253,427
Less: Current year cost of sales expensed in 2009	N/A	(55,494)
Corrected Vision's financial statements	($154,497)	($285,294)

Litigation Consulting Engagement Issues

1. Experience indicates that while financial irregularities involving personal gain such as embezzlement can be initiated by all levels of employees, significant revenue recognition and collateral reporting frauds in closely-held companies are generally perpetuated with the direct involvement of top company management.

   VSI was a small company, with a small number of significant customers. Jacobs and Roberts were the hands-on management of the company. They were both involved in the collateral reporting to the bank and were also both involved in dealing with the auditors. It is not credible that an accountant in their employment would take it upon themselves to falsify the books while they themselves were unaware of the true financial situation.

   The best empirical evidence of the direct involvement of Jacobs and Roberts in the fraud that we have at this time is the documentation of the M&S auditors of the blatant misrepresentations made by Jacobs and Roberts in response to direct questions regarding fraudulent transactions and the ultimate Roberts admission that he knew the receivables would not be collectible. Other types of documentation evidencing knowledge of the fraud would often be available in cases of this type, including possible testimony from the accounting staff of the company and documents evidencing management's approval of transactions or forgery of documents.

2. The continued survival of VSI was dependent on access to bank financing. In April 2009, Second Union Bank had made it very clear to management that the line of credit would not be renewed if losses continued. Early recognition of revenue was used to conceal losses, presumably with the idea that the company would become profitable again. In reality the situation continued to deteriorate. The extra accounts receivable also provided collateral for additional loan advances which the company used to pay operating expenses and fund its losses.

   The personal gain of Jacobs and Roberts appears to have been in the form of continued

employment and the opportunity to retain the value of their stockholders interests in VSI.

3. The following is an analysis of the position of Second Union Bank if they had terminated the VSI loan agreement as of December 31, 2009 or 2010 versus the $950,000 loss they incurred upon termination on May 12, 2011:

	With 12/31/09 Termination and Asset Liquidation	With 12/31/10 Termination and Asset Liquidation
VSI Cash Balance	$1,898	$ 1,700
VSI Accounts Receivable Balance	1,023,623	1,744,807
Less: Pre-billings and fictitious accounts receivable	(253,427)	(666.242)
VSI Net Collectible Accounts Receivable	770,196	1.078.565
Total Cash and Accounts Receivable Available for Collection	772,094	1,080,265
Second Union Loan Balance	683,100	1.273.000
Estimated Loss to Bank (a)	N/A	$193,035
Actual Loss With 5/12/11 Liquidation	$950,000	$950,000
Difference—Potential Measure of Damages	$950,000	$756,965

(a) While information is not included in the case, additional factors which might enter into a determination of the Bank's losses and damages claim are interest on the losses to the date of trial and costs incurred in connection with the liquidation of the company's assets.

Auditing Issues

1. Statement on Auditing Standards No.99, "Consideration of Fraud in a Financial Statement Audit", states that the primary factor that distinguishes fraud from an error is intent. An error is an unintentional misstatement whereas fraud is intentional distortion of the facts. The misstatement perpetrated by VSI's management was intentional and therefore considered financial statement fraud. SAS No.99 also presents the following fundamental concept that addresses an auditor's responsibility for discovering errors and fraud:

   "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud". (AU 316.01)
   The auditor is required to "assess the identified risks after taking into account an evaluation of the entity's programs and controls". (AU 316:43-45)

2. In a discussion of the risk factors present, the following facts should be reviewed. First, external pressures such as the pressure from Second Union to turn things around are often the starting point for manipulation of financial statements. Second, the

Company was cash poor (as evidenced by low cash balances and frequent overdrafts) and advances on the line of credit were at the maximum levels in 2009 and 2010 (75 % of accounts receivable less than 90 days). Additional cash could be readily generated only by creating additional accounts receivable. Third, accounts receivable were by far the most significant asset of the company and were increasing disproportionate to revenues. Fourth, there were the business risks related to industry downsizing and increased competition. Fifth, VSI had restructured and downsized their accounting department to one person, elevating the risks associated with a lack of internal controls and the possibility of a management override of controls.

Such risk factors as listed above should have raised concerns for the auditor that there was a higher than normal risk that accounts receivable would be materially misstated. Such risk factors should be evaluated as to their impact on the financial statements and the implications on the procedures employed in the audit.

3. M&S began using alternative procedures rather than confirmation of accounts receivable beginning with their fifth audit of the financial statements of VSI. According to SAS No.67, The Confirmation Process, the confirmation of accounts receivable is a generally accepted auditing procedure. SAS No.67 states that there is a presumption that the auditor will request the confirmation of accounts receivable during an audit unless: 1) the accounts receivable are immaterial, 2) the use of confirmations would be ineffective as an audit procedure, or 3) the auditor's combined assessment of inherent and control risk is low, and other audit procedures are sufficient to reduce the audit risk to an acceptable level. However, the standard further states that in many situations, both confirmation of accounts receivable and other substantive tests of detail are necessary to reduce audit risk to an acceptable level.

   Additionally, the audit staff of M&S assigned too much evidentiary value to subsequent payments against accounts receivable. The subsequent receipt of payment on an invoice is evidence that the receivable was valid when paid. However, receipt of payment does not necessarily provide evidence that the receivable was a valid asset as of the audit date. Even more important was the fact that M&S staff simply looked at VSI's created invoices in support of accounts receivable for which subsequent payment was not received. This procedure provides virtually no evidentiary value, particularly given the obvious lack of controls in the VSI accounting system.

4. Even without confirming accounts receivable, M&S could have requested shipping documents for any billing related to a tangible product or the work order cost records for services work. M&S could also have reviewed the credit memo registers, where reversals of pre-billed and fictitious invoices were often recorded.

5. Given the industry in which VSI operates, the aging of accounts receivable was not alarmingly poor. However, there were significant increases in the total accounts receivable balance in both 2009 and 2010. By 2010, the evidence of the fraud was so evident that it was hard to miss. This was a company with reported average monthly sales of less than $500,000. Actual reported sales for the month of December 2010 were $502,000 (see case facts). In spite of this, the 1-30 Days accounts receivable balance at December 31, 2010was $734,783, a situation which seems impossible. This situation was caused by the churning of accounts receivable with credit memos

and the reversal of previously recorded invoices in December substantially offsetting new invoices recorded in that month.

6. Fax confirmations are becoming more prevalent in today's audit files. Although accepted as audit evidence, they do pose certain audit problems. This issue of fax confirmations was addressed by the AICPA in their Audit Risk Alerts. The alerts inform auditors that although faxes can serve as audit evidence, certain corroborating audit procedures should be conducted. One concern is the fact that fax machines can be preprogrammed with an incorrect transmitting number and name. This results in no other information about the source of the fax. This fax therefore could be a falsified document. The AICPA suggests that for a fax to be an acceptable document for audit evidence, audit procedures should be performed which would verify the origin of the fax. One procedure is to have a fax machine that pulls the information rather than simply receive the information. This pull facility provides definite proof as to the origin of the fax.
7. Formal and informal inquiries of management and receipt of management representation letters are standard audit processes. The problem arises when the auditor places total reliance on management's representations in place of stronger forms of evidentiary matter. The risks associated with placing reliance on management representations are elevated when management is under pressure to achieve certain financial results.

EPILOGUE

Forensic Investigations LLC provided a report to Second Union Bank as to the accounting issues discovered which addressed the losses incurred by the bank if the loan was terminated at 12/31/09, 12/31/10 or at 5/12/2011. This report and the litigation/investigation procedures were presented in court in the role of an expert witness. The auditing issues identified in the investigation were provided to the AICPA for any disciplinary measures they might take against the independent auditing firm. Bill Jacobs was convicted of accounts receivable reporting fraud and had to pay restitution and a court fine, as well as serve two years in prison.