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Case Studies in (Alleged) Embezzlement and Fraudulent Accounting Practices by Company Controllers

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Introduction

This article examines three cases of embezzlement alleged to have been performed by controllers of companies. Each case reflects information obtained from the court pleadings and discovery of different civil litigation actions.[1] The discussion herein focuses on the underlying embezzlements alleged to have been committed by the respective controllers and does not discuss—other than peripherally—any issues or parties that may have been involved in the civil lawsuits (that is, any alleged negligence or professional malpractice).

This article contributes to the literature by providing both CPAs and companies themselves with specific examples of alleged embezzlement by controllers, their patterns, and similarities. In all instances, the amounts of the respective alleged embezzlements were material to the companies. Often, companies have small accounting departments with limited segregation of accounting duties, a circumstance that increases the risk of employee embezzlement. Also, the principal(s) of each of the companies discussed herein either were salesmen by origin or simply had lengthy experience with the company's primary products or services but did not have a thorough understanding of financial accounting transactions.

As is the situation with most civil litigation disputes, each of the lawsuits underlying the three cases discussed herein either was settled out of court or abandoned without going to trial. Accordingly and expressly, this study is not based on legal findings of fact made by a jury. Therefore, none of the names of any of the alleged embezzlers, business entities, or other parties that were, or may have been, involved are included herein. Furthermore, this article does not contain any identifying descriptions of the respective companies for which the alleged embezzlers worked.

The remainder of the article is organized as follows: (a) brief explanation of the embezzlement triangle—more commonly referred to as the fraud triangle—and its three causal elements; (b) list of the five research questions pertaining to the embezzlement triangle that the author discusses for each of the three cases; (c) discussion of each of the three cases; and (d) analysis of specific control measures that could be implemented or strengthened to best minimize the possibility of the embezzlements by the company controllers.

The Embezzlement Triangle

Each of the three cases discussed herein can be analyzed using the embezzlement triangle—more commonly referred to as the fraud triangle—but which has the same three elements."[2] The widely-recognized fraud triangle consists of three causal elements purportedly found in instances of fraud: (a) opportunity; (b) motive (or pressure); and (c) rationalization.

> The first and most critical [causal] element of the fraud triangle is opportunity. Many organizations unwittingly and unwisely provide their employees with a variety of opportunities to commit fraud. The most common factor is the lack of adequate controls for monitoring employee behavior…Adequate internal controls require, at the very least, that these three responsibilities [preparation of checks, signing of checks, and recording payments in the cash disbursements journal] be segregated among at least two or more

[1] Pleadings may include the Plaintiff's Complaint, Defendant's Answer, and Affirmative Defenses, as well as any counterclaims, cross-claims, third-party claims, and any answers thereto. Discovery referred to herein may include depositions, productions of documents, and/or answers to written interrogatories.
For two of the lawsuits (Case #1 and Case #3), the respective controllers were not parties to the litigation—the auditors were—and thus, the litigation involved causes of action other than those that could have been filed against the controllers (i.e., alleged negligence or professional malpractice).
[2] Huber, Wm. Dennis, "Forensic Accounting, Fraud Theory, and the End of the Fraud Triangle," *Journal of Theoretical Accounting Research*, (Mar 2017).

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> employees. Employees possessing such "incompatible responsibilities" have an easy opportunity to commit fraud. They can simply make out the checks (to themselves or to pay their own bills), sign the checks, and then hide the fraud by charging it to a variety of expense accounts. [3]

Huber argues that "embezzlement triangle" is a much more appropriate term than "fraud triangle," arguing among other things, that the fraud triangle as a model does not represent a fraud and that there are n-dimensions of a financial crime (of which fraud is merely a subset).[4] The legal elements of fraud are: (a) a misrepresentation (or omission) of a material fact; (b) the perpetrator's knowledge of the falsity of such representation (or omission); (c) justifiable reliance upon the misrepresentation by the victim; and (d) resulting damages to the victim. Further, Huber notes that the origins of the three elements of what has become known as the fraud triangle—incentive (motivation), opportunity, and rationalization—were first developed in 1953 by D. R. Cressy, a criminologist, who interviewed prisoners and identified three traits common in convicted embezzlers.[5] Accordingly, hereinafter, this article will refer to the embezzlement triangle instead of the fraud triangle.

Not all employees exploit the opportunity to commit embezzlement. Instead, the presence of the second causal element of the embezzlement triangle, motive (or pressure), separates honest employees from embezzlers. "Financial pressure can come from a variety of sources, such as (a) lifestyle, including the perceived need to maintain a high standard of living; (b) personal debt, from credit cards, gambling losses, substance abuse, or poor investments; and (c) business losses, caused by inflation, high interest rates, poor economy, or lack of demand."[6] The third causal element of the embezzlement triangle, rationalization, occurs when the fraudster psychologically justifies the commission of the fraud to himself or herself. "Common rationalizations include the following: (a) 'They owe it to me. I deserve to get paid more; (b) I'm only borrowing the money. I'll pay it back; (c) Nobody will miss it. The company can afford it; and (d) Everyone does it. I'm not hurting anyone.'" [7] Each of the alleged embezzlers discussed in this study exhibited a certain moral flexibility when dealing with their respective pressures that allowed them to rationalize or justify committing the alleged embezzlement.[8]

In each the three cases discussed herein, the alleged embezzlers had the opportunity to commit embezzlement. None of the companies employing them employed a large numbers of accounting personnel. Consequently, in all cases, there was limited separation of accounting duties. The company owners typically were not sophisticated in their knowledge of financial accounting. Often, the controller was the only person in the company with any formal or advanced accounting training. Accordingly, the controller may have had the final word in the recording of accounting transactions and/or the ability to alter transactions unbeknownst to the owners.

The alleged embezzlers also had apparent motives or pressures to commit the embezzlement(s), the second causal element of the embezzlement triangle. In two of the cases, personal financial issues resulted from significant medical expenses for family members. Other motivations for the alleged embezzlements discussed herein include: alcohol and/or drug dependency issues, marital problems, and/or a desire to live an extravagant lifestyle. In each case, it appears that pressures of these various motivations were overcome by the embezzlement triangle's third causal factor, rationalization, wherein the alleged embezzler justified his/her actions as being necessary due to his/her personal and/or financial circumstances.

At least one study in this area refers to a fraud diamond rather than a fraud triangle.[9] Wolfe and Hermanson distinguish capability as the fourth causal fraud element, identifying its elements as: position/function within the company; brains; confidence/ego; coercion skills; effective lying; and immunity to stress. Beyond acknowledging that the three alleged

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[3] Buckhoff, Thomas A. "Employee Fraud: Perpetrators and Their Motivations," *The CPA Journal* 71, Iss. 11 (Nov 2001): p. 72.
[4] Huber, "Forensic Accounting, Fraud Theory, and the End of the Fraud Triangle," pp. 29 and 37.
[5] Huber, "Forensic Accounting, Fraud Theory, and the End of the Fraud Triangle," p. 37 and Cressey, D.R., (1953). *Other people's money: A study in the social psychology of embezzlement*. Glencoe, IL: Free Press.
[6] Buckhoff, "Employee Fraud" p. 72.
[7] *Ibid*.
[8] As hereinabove set forth, each case was a civil case that was settled/dismissed prior to trial. Further for two of the cases, the controllers were not parties to the litigation. Accordingly, there is no admission of guilt in the record by the controllers and thus, the reader may be left to speculate as to the controllers' specific rationalization(s) for their alleged embezzlements.
[9] Wolfe, David T. and Dana R. Hermanson. "The Fraud Diamond: Considering the Four Elements of Fraud," *The CPA Journal* 74, Issue 12 (Dec. 2004): p. 38.

embezzlers discussed herein clearly were capable of committing their respective alleged embezzlements, this discussion is limited to the analysis of the traditional embezzlement triangle.

Research Questions

One contribution of this study is the analysis of three alleged cases of embezzlement, based on actual events, and the commonalities among them. For each of the three cases, this discussion addresses five questions:[10]

1) Who is alleged to have committed the embezzlement?
2) How is the alleged embezzlement being perpetrated?
3) What are the motives (or pressures) for committing the alleged embezzlement?
4) Are there any characteristics of the company, its management and/or organization that contribute to the alleged embezzlement?
5) How was the alleged embezzlement detected?

Case #1

By all known accounts, the alleged embezzler in Case #1 (hereinafter, "Controller 1") was intelligent, had a charismatic personality, and was well-liked and trusted by company officers. In actuality, Controller 1 had a criminal record involving fraud prior to employment with the company, which according to Controller 1, had been known by the owner(s) prior to their having hired Controller 1. The owner(s) subsequently denied having had knowledge of Controller 1's previous fraud at the time of hire. Accordingly, each of the embezzlement triangle causal factors already had existed before the alleged embezzlement of Case #1 had occurred. As controller of a relatively small company, Controller 1 appeared to have ultimate say in the majority of the accounting decisions, thereby fulfilling the first causal factor of the embezzlement triangle, opportunity. Controller 1 allegedly had drug and alcohol dependency issues. Controller 1, whose personal life was unstable, spent money extravagantly.

In Case #1, the alleged embezzlement occurred on at least two fronts. First, Controller 1 paid substantial personal expenses with company funds. These payments were accomplished both by charging personal purchases on company credit cards (especially for food and travel) and by writing company checks to vendors of Controller 1's personal purchases, while recording the transactions as company expenses.[11] For years, the company engaged a small public accounting firm to perform an audit of the financial statements. The primary independent auditor during the pertinent time period was young, relatively inexperienced, and a friend of Controller 1.

Controller 1's alleged embezzlement activities were facilitated by opening a second company bank account unbeknownst to the owner(s). From this bank account, Controller 1 hand-wrote checks, instead of printing them through the company's accounting software. It is noteworthy that Controller 1's significant other was the company's bank representative. Among the more audacious expenses that Controller 1 paid for the significant other with company funds were a birthday party at a luxury hotel and elective cosmetic surgery.

The second form of the alleged embezzlement occurred though the company's health benefits program. In response to the extraordinary costs and incomplete coverage for Controller 1's family's substantial medical expenses, Controller 1 changed the company's health benefits program to a form of a reimbursement program that ultimately reduced benefits to other employees, but enabled Controller 1 to generate checks directly to healthcare providers to ensure that Controller 1's family's medical expenses were paid by the company.

As controller, Controller 1 had the opportunity to commit the alleged embezzlement, the first causal factor of the embezzlement triangle. As hereinabove set forth, Controller 1 had numerous personal issues that likely contributed both to his motive/pressure (the second causal factor) and rationalization (the third causal factor) for the alleged embezzlement. In the end, the company's continually and substantially increasing healthcare costs over a multi-year period, coupled with complaints by other employees as to the reduction of their benefits, led the owner to investigate the problem. Upon doing

[10] Brennan, Niamh M. and Mary McGrath. "Financial Statement Fraud: Some Lessons from U.S. and European Examples," *Australian Accounting Review* 17, No. 2 (Jul 2007): p. 49.

[11] Allegedly, the company's owner(s) were aware of some or all of Controller 1's food and travel charges and considered them to be an allowable perquisite, an allegation that the owner(s) later denied.

so, the owner(s) discovered the healthcare payments, expanded the investigation of Controller 1, and discovered the second bank account and alleged credit card abuses.

Case #2

The second alleged embezzler (hereinafter, "Controller 2") worked in a controller-like capacity for a company, despite Controller 2 having neither an accounting degree nor the formal job title of controller. The company had numerous foreign vendors that naturally, were incorporated in their respective foreign nations and not in the U.S. state where Controller 2 worked. Without the knowledge or consent of the actual foreign vendors themselves, Controller 2 created and registered corporations in Controller 2's home state in the exact names of the foreign companies. Further, Controller 2 listed friend(s) and/or family member(s) as officers. After forming these shell U.S. corporations, Controller 2—again, without the knowledge or consent of the legitimate foreign vendors—opened bank accounts for each of these new U.S. corporations, again, in the exact names of the foreign vendors.

In its normal course of business, the company paid its foreign vendors through electronic wire transfers. The company's computer system contained wiring instructions with the vendor's respective bank routing and account numbers. To facilitate the alleged embezzlement, Controller 2 inserted wiring instructions that would remit payments to the illegitimate bank accounts that Controller 2 had opened in the United States under the exact same names as the actual foreign vendors. Controller 2 allegedly embezzled company funds through a combination of partial payments and duplicate payments of legitimate vendor invoices, as well as by payments of fraudulent invoices created by Controller 2. In the case of the duplicate payments, Controller 2 selected invoices of vendors that had frequently recurring charges. After the U.S. company made a payment—whether legitimate (to the actual foreign vendor) or fraudulent (to Controller 2's domestic corporation of the identical name)—Controller 2 would neglect to indicate that the invoice had been paid and then, after a period of time, would resubmit the recurring invoice for payment. Whichever entity—the legitimate or fraudulent one—had not been paid the first time, was paid the second time the same invoice was submitted for payment.

The first embezzlement triangle causal factor, opportunity, was facilitated in Case #2 by an owner who did not have sophisticated accounting knowledge and a company that was small in terms of personnel, thereby, limiting the segregation of accounting duties. Despite a modest salary, Controller 2 had a compulsion to live extravagantly and also had formed a business in a foreign country that Controller 2 hoped would become a nest egg. The business needed substantial capital to purchase property, plant, and equipment. Domestically, Controller 2 purchased a house well above Controller 2's legitimate means, as well as a boat, jet skis, jewelry, clothing, and multiple automobiles, including a luxury sports car. It may be somewhat revealing into the psyche of the embezzlers that Controller 2—similar to Controller 1—purchased elective plastic surgery for Controller 2's spouse. Controller 2 and spouse dined frequently at expensive restaurants and went on gambling excursions. It was rumored, although not confirmed in evidence, that Controller 2 also had a cocaine habit.

Controller 2's embezzlements became increasingly aggressive and ultimately led to the exposure of the embezzlement. While the owner was not sophisticated enough to discover the embezzlement as it repeatedly occurred, once the aggregate embezzlement exceeded $300,000, the obvious impact on the company's reported bottom line was too great to ignore. This, coupled with the contrast between Controller 2's compulsively lavish lifestyle and modest salary, led to the revelation of this elaborate embezzlement. Controller 2's motivations (the second embezzlement triangle causal factor) to live extravagantly and secure a retirement in abroad, as well as a certain moral flexibility, enabled Controller 2 to rationalize the embezzlement (the third embezzlement triangle causal factor). Note, during its regular course of business, the company had not retained independent accountants to perform an assurance engagement.

Case #3

Once again, the company in Case #3 was not large in terms of accounting and/or other office personnel. Accordingly, there was limited segregation of accounting duties. The owner was a salesman by nature and did not have formal accounting education. Alleged embezzler #3 (hereinafter, "Controller 3") had been an employee of the company for many years before the alleged embezzlement occurred. As controller, Controller 3 had the opportunity to commit the alleged embezzlement, thereby fulfilling the first causal element of the embezzlement triangle. Controller 3's primary motivation was the substantial medical expenses for Controller 3's multiple special-needs children. Using two methods, Controller 3 allegedly wrote roughly $500,000 worth of checks from company accounts to pay for these and other expenses. To cover the tracks and deceive the owner, Controller 3 significantly inflated both the accounts receivable and inventory balances. Controller 3 wrote company checks directly to Controller 3 with the check memorandums explaining that the checks were for repayments of a loan. No such loan(s) ever occurred. Additionally, Controller 3 wrote company checks payable to the name of same bank that both the company and Controller 3 personally used. Controller 3 endorsed a number of these checks, wrote Controller 3's account number thereon, and deposited them into Controller 3's personal accounts. When Controller 3 was questioned by a second signatory required for such checks, Controller 3 allegedly falsely claimed that the checks were for payment of taxes.

Controller 3's embezzlement was discovered after an anxiety disorder, requiring brief hospitalization and extended home rest, which kept Controller 3 out of the office for a prolonged period of time. Presumably, this illness was a physical manifestation of the stress from repeated embezzlements over several months. During Controller 3's absence from the office, the owner and an assistant repeatedly requested that Controller 3 briefly stop by the office to handle with priority issues. Controller 3 declined those requests. When the owner and an assistant visited Controller 3's home on multiple occasions during this absence, Controller 3 would only speak to them in the front yard and not invite them into the home. Later, the assistant went into Controller 3's office and retrieved unopened bank statements that contained the cancelled checks (when banks still automatically returned account holders' cancelled checks). Upon noticing the cancelled checks made payable to Controller 3 that purported to be for the repayment of a nonexistent loan, the owner began examining the bank accounts and the books. It quickly became apparent that the books were not right. Like in the previous cases, this motive (or pressure), the second embezzlement triangle causal factor, enabled Controller 3 to rationalize the alleged embezzlement, the third embezzlement triangle causal factor.

Conclusion

The Teaching Notes for each of these cases are contained in a separate document and can be obtained from the author. These cases present students, as well as accounting firms and companies themselves—particularly smaller companies—with alleged real-world embezzlement by company controllers viewed through the lens of the embezzlement triangle. The case studies examine how the alleged embezzlements were perpetrated, the motives/pressures for committing the alleged embezzlements, and importantly, the characteristics of the companies and/or their management that contributed to the alleged embezzlements. As such, these case studies are an effective way to learn embezzlement detection and prevention.

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The court pleadings and discovery from civil litigation related to Case #1.

The court pleadings and discovery from civil litigation related to Case #2.

The court pleadings and discovery from civil litigation related to Case #3.