Detection of frauds

Harold Benington

Follow this and additional works at: https://egrove.olemiss.edu/acct_corp

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
https://egrove.olemiss.edu/acct_corp/63

This Article is brought to you for free and open access by the Accounting Archive at eGrove. It has been accepted for inclusion in Individual and Corporate Publications by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
THE DETECTION OF FRAUDS

ONE OF A SERIES OF LECTURES IN A SYSTEMATIC COURSE

HAROLD BENINGTON, A.C.A., C.P.A.

Of Ernest Reckitt & Company, Certified Public Accountants
Member of the Council of the American Institute of Accountants
Former President, Illinois Society of Certified Public Accountants

La Salle Extension University
- Chicago -
THE DETECTION OF FRAUDS

HAROLD BENINGTON, A.C.A., C.P.A.

Of Ernest Reckitt & Company, Certified Public Accountants
Member of the Council of the American Institute of Accountants
Former President, Illinois Society of Certified Public Accountants

La Salle Extension University
- Chicago -
1918
THE DETECTION OF FRAUDS

Frauds in connection with accounts are very prevalent, and their detection is one of the most important functions of the professional accountant.

During the course of over twenty years' active practice, the writer has come in contact with innumerable instances of fraud of every description, and it will be his endeavor in the succeeding paragraphs to outline the different kinds most usually encountered, how they can be detected, and what methods should be adopted to prevent them.

Frauds in connection with accounts may be, broadly speaking, divided into two classes:

(a) Those perpetrated with the object of concealing theft.
(b) Those which do not involve theft, but which are committed with the object of showing a false financial condition.

FRAUDS INVOLVING THEFT

Theft on the part of persons having the custody of cash or securities cannot, of course, be entirely prevented, but by a good system of supervision and audit its detection can be absolutely assured.

There is, however, a firmly ingrained idea among business men that a clever bookkeeper can hoodwink them no matter what precautions may be taken to prevent his doing so. This attitude is not only fatalistic but criminal. For the sake of his employees, just as much as for his own, an employer ought to place such safeguards
around the handling of his funds and of his records as will reduce to a minimum even the temptation to dishonesty; when he fails to do this, he fails in his duty to the community, and should one of his employees yield to temptation and steal from him, he himself is to a great extent morally responsible for his employee's wrongdoing.

In large commercial offices, it is possible to organize such a system of check upon the work of all employees as, in the absence of collusion between two or more of them, will bring to light irregularities within a short time after their occurrence; but in smaller offices where the cash and the books of account are handled by the same individual, fraud is, of course, more difficult of detection.

Periodical audits by professional accountants are always desirable however good in theory may be the internal system of check upon employees. The experience of the writer has been that unless supplemented by an audit by professional auditors, a business house’s own internal audit is likely to become perfunctory and slipshod. Besides this, employees are likely to become too well acquainted with one another, to rely too much on one another’s honesty, and also to be overawed too easily by their departmental heads or other business superiors on whose good will their promotion to a large extent depends.

Frauds by Receiving Cashiers

Let us assume that a cashier whose cash on hand was counted and found correct at January 1, 1916, has subsequently stolen some of his employer’s money, and by a series of typical examples of gradually increasing complexity illustrate the different ways in which he might have abstracted the money, the methods he might
DETECTION OF FRAUDS

adopt to cover up his shortage, and the ways in which
his defalcation should be discovered.

Example 1

FAILURE TO DEPOSIT IN BANK ACCOUNT

Assume that the cashier acts as receiving cashier only
and has access to no books of account other than his own
Cash Book; assume further that he has properly entered
in his Cash Book all monies received by him and has
correctly totaled his Cash Book but has deposited in the
bank less than he has received to the extent of $30,000.00
during the eleven months ending November 30, 1916.

It is obvious that in this extremely simple instance, if
his employers were to obtain a statement from their
bankers of the amounts deposited from January 1 to
November 30, the difference between their total and the
total of the Cash Book should represent cash still in the
hands of the cashier on November 30, and to the extent
that he cannot produce cash to that amount he is
"short," thus:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance on hand, January 1, 1916</td>
<td>$1,400.00</td>
</tr>
<tr>
<td>(As checked and found correct)</td>
<td></td>
</tr>
<tr>
<td>Total receipts, January 1—November 30, 1916, as per Cash Book</td>
<td>$2,400,000.00</td>
</tr>
<tr>
<td>Bank deposits, January 1—November 30, 1916, as per bank statement</td>
<td>$2,370,700.00</td>
</tr>
<tr>
<td>Cash to be accounted for by cashier</td>
<td>$30,700.00</td>
</tr>
<tr>
<td>Cash actually found to be on hand</td>
<td>$700.00</td>
</tr>
<tr>
<td>Shortage</td>
<td>$30,000.00</td>
</tr>
</tbody>
</table>
Observe that in this instance fraud can scarcely be said to have been committed. It is a simple case of theft unaccompanied by falsification of the books.

*Example 2*

**FALSIFICATION OF TOTALS**

Now suppose that the other circumstances being the same as in Example 1, the cashier had falsified the total of his Cash Book to the extent of the amount of his shortage from time to time. What would be the result?

In the first instance, comparison of the totals of his Cash Book with a bank statement would indicate no irregularity, and the cash actually found on hand would appear to be the amount to be accounted for; thus an employer who took no further steps than these to check up his receiving cashier's accounts would fail to discover the shortage.

However, since the books of account are presumably kept by double entry, the falsification of the Cash Book totals would have to be made after the posting thereof had been made to the General Ledger (if a cash account were carried in the General Ledger, or after the totals have been transferred to a “General Cash Book” if the General Cash Book balance were treated as entering into the trial balance direct), as otherwise the books of account would be out of balance to the extent of the shortage. Comparison of the Receiving Cash Book totals with the General Ledger (or General Cash Book as the case might be) would therefore disclose discrepancies which in the aggregate would equal the shortage of $30,000.00.

This illustrates the importance of an employer’s insisting on having presented to him at the close of
DETECTION OF FRAUDS

each month a reconciliation statement between the balance shown by the monthly statement furnished to him by his banker and the balance called for by his books of account in some such form as the following:

(a) Balance as per Cash Book, November 30, 1916 .......................... $93,500.00

Add:
Checks entered in Cash Book
as paid out, but which have not yet been presented at Bank:

No. 8079 ........................ $ 75.00
No. 9642 ...................... 125.00
No. 9655 ...................... 80.00
No. 9656 ...................... 20.00 300.00

$93,800.00

(b) Balance as per bank statement, November 30, 1916 ...................... 63,100.00

(c) Balance in hands of cashier, November 30, 1916 ...................... $30,700.00

At the time he examines this statement, he should satisfy himself that as regards (a) the balance does actually agree with the Cash Book and also with the Trial Balance Sheet drawn off from the General Ledger. (In the case just considered the Cash Book would have called for only $700.00 on hand, but the trial balance would have called for $30,700.00.) He should satisfy himself as regards (b) that the figures agree with the statement rendered by the bank and that such statement shows no signs of alteration or erasures. As regards (c) he should actually count the cash in the hands of the cashier or else depute the task to some reliable employee other than the cashier.
If an employer or trusted employee other than one of the cashiers or the bookkeeper goes through this procedure each month, no defalcation such as the one just considered could escape detection for more than thirty days.

**Example 3**

**FAILURE TO ENTER RECEIPTS IN CASH BOOK**

Now still assuming that the receiving cashier has access to no books of account other than his own Cash Book, suppose that he collects currency and checks from the firm’s customers from time to time aggregating in all $30,000.00, which he fails to enter in his Cash Book and uses for his own purposes.

This is the commonest form of fraud by a receiving cashier. He gets into debt and "borrows" a relatively small sum in the first instance out of his employer's money, meaning to replace the amount in a few days; he is unable to replace the amount for some time, and finding that the theft has not been noticed, he is tempted, instead of replacing the original amount abstracted, to take more. Almost invariably when such defalcations are discovered, it is found that the cashier has been gambling or speculating with the money, expecting eventually to make good his shortage out of his winnings.

Now in an instance of this kind none of the procedures previously referred to will bring the defalcation to light. The books of account will balance correctly, and the bank reconciliation statement will be in order.

If, however, the cashier entirely omits to enter in his Cash Book the collections from customers which he has misappropriated, it will not be long before one of two things happens, viz.:

(a) As statements of account would in the ordinary course of business be made out monthly and sent
DETECTION OF FRAUDS

to the firm's customers by someone other than the cashier, complaints as to the inaccuracy of such statements will begin to come in from those customers who have made payments for which they have not been given credit on the statements sent them.

(b) The firm's credit department will notice that certain customers' accounts are in arrears and begin to write them dunning letters.

In both cases, (a) and (b), inquiry will be aroused and the fraud detected.

Example 4

WITHHOLDING RECEIPTS OF ONE DATE TO MAKE GOOD SHORTAGES OF EARLIER DATES

Suppose, however, that all circumstances were the same as in Example 3, except that instead of omitting to enter amounts collected in his Cash Book, the cashier simply defers doing so until some days after the collections in question were actually made. It would be quite possible for him to conceal a considerable shortage for a long time, unless the auditing procedure, which will be explained later, is gone through at frequent intervals.

His daily bank deposits would agree with the daily totals of his Cash Book, and by reason of the very slight discrepancies in dates as between the monthly statements sent to customers and those shown by the customer's own records, suspicion would not in all probability be aroused. If, for example, a customer writes in to complain that a payment made by him on May 27 was not credited on his May statement and, on looking into the matter, the credit department finds that the amount in question is entered in the Cash Book on, say,
June 1, it would probably be assumed that some delay had occurred in the mails, and nothing further would be done about the matter.

In order to operate a fraud of this kind successfully, however, it would, of course, be necessary on June 1, the date when the cashier did finally enter as a receipt the collection that he had misappropriated, for him to deposit in the bank the like amount of cash, and he would therefore have to withhold from entry as a receipt on June 1 some other collection made that day of an equal or greater amount, otherwise he would be making good the shortage, which is the very thing that he is seldom in a position to do. Furthermore, as his shortage increases, the larger will be the number of items that he must defer entering each day, and eventually he will get to a point where it will be very difficult for him to abstract any further monies without seriously risking discovery.

Such a fraud is most easily operated where a number of the receipts are in the form of currency. It is a matter of some risk and difficulty for a cashier to obtain payment for his own purposes on a check made payable to the firm for which he works, although by means of forged indorsements it is not by any means impossible. It is also, of course, easier to work a fraud of this kind where the individual receipts are of large denominations, as it would then be necessary to manipulate only a relatively few items at any one time.

An illustration of how a fraud of this kind is operated is as follows:

On January 5 the cashier receives from customers in all, say, $6,500.00. Included in this amount is the remittance of Mr. Smith for $231.50, which is in the form of currency. The cashier properly enters in the Cash Book all the individual items received, with the exception of
DETECTION OF FRAUDS

the remittance of Mr. Smith, which he keeps for his own use, and deposits in the bank $6,268.50.

On January 9 the cashier receives from customers, say, $4,000.00. He realizes that it is now time that he should account for the remittance of Mr. Smith which he stole on January 5; so he enters it as a receipt on January 9, but withholds from entry from the receipts of January 9 an amount of $295.00 received on that day in currency from Mr. Robinson, depositing in the bank $3,936.50, the entries in his Cash Book being made up as under:

<table>
<thead>
<tr>
<th>Receipts of January 9</th>
<th>$4,000.00</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less: Robinson’s remittance</td>
<td>295.00</td>
</tr>
<tr>
<td></td>
<td>$3,705.00</td>
</tr>
<tr>
<td>Add: Smith’s remittance of January 5, not previously accounted for</td>
<td>231.50</td>
</tr>
<tr>
<td>Amount entered in Cash Book and deposited in bank</td>
<td>$3,936.50</td>
</tr>
</tbody>
</table>

Such frauds involve a continual robbing of Peter to pay Paul, but so long as the fraud is confined to currency items, it is almost impossible to detect except by accident. The moment, however, the cashier begins to appropriate checks, he lays himself open to immediate detection. To carry the foregoing example a little further, suppose that on January 15 the receipts from customers aggregate $5,000.00 but do not happen to contain any currency items, and further suppose that the cashier finds it very desirable that Mr. Robinson’s remittance should now be accounted for besides also finding himself in need of some more money. He, therefore, enters the Robinson item as received on January 15, but withholds from entry the check of Mr. Brown for $800.00.
His bank deposit for January 15 would, therefore, be $4,495.00, and the entries in his Cash Book will be arrived at as under:

Receipts of January 15 $5,000.00
Less: Brown's check 800.00

$4,200.00
Add: Robinson's remittance of January 9, not previously accounted for 295.00

$4,495.00

Now suppose that on January 20 the receipts of that day are $7,000.00 and that the cashier, fearing to withhold the Brown item from his Cash Book any longer, enters it as a receipt on that day, but to offset this withholds from entry a check received from Mr. Hoover for $600.00, a check from Mr. Green for $150.00, and currency received from Mr. Astor for $50.00. His deposit will be, of course, $7,000.00, and the amount entered in his Cash Book will be arrived at as under:

Receipts of January 20 $7,000.00
Less:
  Hoover check  $600.00
  Green check  150.00
  Astor cash  50.00 800.00

$6,200.00
Add: Brown's remittance of January 15, not previously accounted for 800.00

$7,000.00

Now though the amount of his bank deposit and the total of his Cash Book receipts on January 20 will thus be in agreement, comparison of the individual items
DETECTION OF FRAUDS

entered in the Cash Book with the individual items appearing on his bank deposit slip will reveal the fact that they are not identical, i.e., the Hoover, Green, and Astor items will form part of the bank deposit, whereas no such items will appear in the Cash Book; on the other hand, the Brown item will appear in the Cash Book, but the bank deposit slip will not show any such item as having been deposited. It is only by comparison of the details of the bank deposits with the details of the Cash Book receipts of the same day that frauds of this sort can be promptly detected. The importance of having such comparisons made at frequent intervals by an auditor or some trusted employee other than the cashier is therefore apparent, and every well-organized concern provides for this being done. It is not necessary that such comparisons be made every day, as the same moral effect on the cashier will be obtained if he knows that it will be done once or twice during the month at irregular intervals.

It is well to emphasize in this connection the extreme importance of insisting that a cashier shall deposit the whole of his receipts each day and that he shall not be allowed to make change or cash checks out of his receipts, as otherwise it becomes impossible to detect a fraud of the character outlined above by the means indicated.

Example 5

OVERSTATEMENT OF DISCOUNTS

A rather clumsy form of theft that is sometimes resorted to by a cashier consists of overstating the amount of cash discount allowed to a customer and of understating the amount of the customer’s remittance when making the Cash Book entry in regard thereto. He then deposits in the bank the amount of the remit-
tance as shown by his Cash Book and pockets the difference between that amount and the sum actually remitted by the customer.

In order to obtain any considerable sum of money in this way, it is necessary for a cashier to falsify a very large number of items, and as this would be almost certain to involve remittances made by checks, frauds of this kind can be detected by comparison of the details appearing on the bank deposit slips with the Cash Book in the manner described under Example 4.

Such frauds can, of course, also be readily detected by checking the rates of discount, and this should always be done, as quite apart from fraud, mistakes are very likely to occur in this connection.

Frauds by Paying Cashier

The examples hitherto considered (1 to 5) have all dealt with frauds on the part of receiving cashiers. Frauds by paying cashiers are, however, just as frequently encountered, and the succeeding examples will deal with some of the most usual types.

Example 6

Falsification of Totals

The simplest conceivable fraud by a paying cashier consists in overstating the footings of his Cash Book. This may be done to conceal the abstraction of currency in cases where he is allowed to handle cash or to conceal the fact that he has not entered in his Cash Book certain checks drawn by him and on which he has personally obtained payment in cases where he does not handle currency.

A fraud of this kind cannot be carried on for long if all items are posted individually from the Cash Book
to the Ledger, as in such a case the overstatement of the totals will result in throwing the General Ledger out of balance to the extent of the overstatement. Cash Books, however, often contain analysis columns into which are entered under appropriate headings the most common items of expense (e.g., salaries, traveling expenses, etc.), and the totals only of such analysis columns are posted to the Ledger. Where this is the case, both the grand total column and one of the analysis columns totals would, of course, be overstated by the defrauding cashier, and as the grand total column represents a credit to Cash Account in the General Ledger and as the analysis column total would be posted to the debit of a General Ledger account, the books would not be thrown out of balance.

Frauds of this kind can, of course, be discovered by the simple process of checking the Cash Book additions, but it must be noted that unless this is done, the mere fact that the total of the disbursements as shown by the Cash Book agrees with the total of the withdrawals from the bank as shown by the bank statement at the end of the month is no guarantee of the accuracy of the Cash Book. For example, suppose a cashier whose monthly salary is $175.00 draws his own salary check in duplicate, cashes both checks at the bank, but enters the item only once in his Cash Book overstating the total of the page on which the items appear, however, to the extent of $175.00. The result will be that the Cash Book total and the total of the bank withdrawals as per the bank statement will agree, and the fraud can be discovered only by checking the Cash Book totals or by comparing the canceled checks returned by the bank in detail with the Cash Book.

This illustrates the folly of an employer who fails to have the clerical accuracy of his cashier’s work checked over either by outside auditors or by members of his
own staff. The writer has encountered innumerable instances where money has been systematically stolen for a considerable period of time by the means just described.

Example 7

DUPICATION OF PAYMENTS

Most business houses take the precaution of requiring several responsible employees to initial as correct the invoices or other documents supporting any disbursement, and the treasurer or other official of the company who actually signs checks is required to see that this has been done before he attaches his signature to the check. He himself should also initial the invoices or otherwise mark them as having been produced to him in support of a check which he has signed, otherwise he has no guarantee that the same documents may not be produced to him over and over again and several checks thus be obtained for the same item, only one of which may be turned over to the creditor in question, the cashier forging indorsements on the others and paying them into his own bank account or that of a confederate.

If a regular and detailed audit of the concern's affairs is made, it would eventually be noticed that certain of the checks were not supported by proper vouchers, as of course there would be in existence only one genuine set of invoices, etc., to support the bona fide payment to the creditors and the bogus payments which had been misappropriated by the cashier. In the meantime, however, if the cashier has obtained possession of the canceled checks which bore his forged indorsements and has destroyed them, it would be almost impossible to convict him of fraud, however strong the circumstantial evidence might be. All that could be proved would be that the checks and the invoices in support of certain
payments were missing from the files. In such a case it is extremely hard to prove, to the satisfaction of a jury, who indorsed the lost checks and who is responsible for their disappearance.

Furthermore, unless the invoices are initialed or otherwise identified as having been paid by the party signing the check, if as is frequently the case, the cashier has the custody of or access to the files containing old invoices and vouchers, it is possible for him to take out an invoice dated, say, May 14, 1916, and by merely altering it to read May 14, 1917, to supply himself with a document which on its face would appear perfectly in order as the supporting evidence for a check and not only would deceive his employer, but in all probability would pass the scrutiny of professional auditors.

Example 8

PAY-ROLL FRAUDS

Frauds in connection with pay rolls are of very frequent occurrence. Where, as is often the case, the cashier makes up the pay roll and also pays off the men, it is easy for him to include the names of fictitious employees and misappropriate the wages credited to them. It is also not uncommon for a cashier to overstate the hours worked or the rates of pay of actual employees and to pocket the difference between the amount which appears on the pay roll as due to them and the true amount of their wages which he actually turns over to them.

It is, therefore, very important that pay rolls should be audited by comparison with time-clock cards, time-keeper's and foremen's reports, or other records independent of those kept by the paying cashier.

It must also be remembered that collusion between a cashier and foremen or other employees is more liable
to occur in connection with wages than in any other way and that it is therefore desirable occasionally to supplement the checking of one book record with another by a little practical detective work. The writer well remembers the investigation of a pay roll some years ago by his office, where it transpired that a certain "A. Bruin," who had been drawing modest but regular wages for some weeks, was, as a matter of fact, a brown bear which one of the workmen had brought home from a hunting trip and which had been adopted as a sort of mascot by the workpeople, some one of whom had devised this ingenious plan for paying for its board and transportation. Everybody seemed to know about its being on the pay roll except the proprietor of the business.

Frauds by Cashiers Handling Both Receipts and Payments

In the examples already given, the writer has assumed that the businesses concerned were of sufficient magnitude to warrant the employment of different persons to handle receipts and payments.

Many concerns, however, are for the sake of economy obliged to entrust the handling of both receipts and payments to the same individual, and where this is done, the opportunities for fraud on the part of the cashier are enormously increased. He can, of course, perpetrate any or all of the types of fraud already described and in addition many others. The following is an instance.

Example 9

Withholding Checks to Balance Short-Deposits

Suppose in any particular month a cashier draws a check in favor of one of the firm's creditors for, say, $1,200.00, enters it as paid on the payment side of his
DETECTION OF FRAUDS

Cash Book but does not mail it to the creditor, and at the same time deposits in the bank $1,200.00 less than his actual receipts for the month. What is the result? The cashier has obtained $1,200.00 for his own use, and yet the balance shown by his Cash Book will agree with the balance shown by the bank’s statement, and the accounts of both creditors and debtors in the Ledgers will appear to be in order. The fraud will, therefore, not come to light until the creditor whose check was not mailed to him complains of not having received payment, unless the canceled checks returned by the bank and the deposits recorded in the bank statement are compared in detail with the Cash Book. The importance of going through this procedure is therefore very evident, and this example once more illustrates the necessity of auditing a cashier’s transactions in considerable detail.

It may be pointed out that in many businesses where individual transactions are for large amounts and where it is customary to make payments to creditors “on account” it would be quite possible to hold back checks intended for creditors in the manner described above for several months without exciting their suspicion, particularly so if the cashier were to call upon them or write to them on his firm’s letter paper, giving some reasonable excuse for the delay.

FRAUDS BY CASHIERS WHO ALSO ACT AS BOOKKEEPERS

Many small business houses, of course, entrust the keeping of all their books to a single individual. Where this is the case, the opportunities for fraud are almost unlimited, unless very strict supervision is exercised by the proprietor or a rigorous audit is made at frequent intervals. This is especially so because his control of the bookkeeping gives him every conceivable opportunity for making any falsification of his accounts that
may be necessary to conceal his defalcations. In addition to all the types of fraud previously described, such a bookkeeper-cashier could among others perpetrate the following.

**Example 10**

**DIRECT LEDGER ENTRIES TO CONCEAL THEFT**

A bookkeeper-cashier having received a payment from Mr. Brown, a customer of the firm, keeps the money for his own use, makes no entry in regard to it in the Cash Book, but credits Mr. Brown's personal account in the Ledger and at the same time charges an expense account in the Ledger with the same amount. In this case the customer's Ledger account will be correct; the Cash Book balance will agree with that shown by the bank statement, and the books of account will be in trial balance. The only way in which the fraud could be discovered would be by checking the detailed postings to the Ledger, whereupon it would develop that both a credit and a debit for the like amount, the one affecting a personal account and the other an expense account, could not be traced to the books of original entry.

**Example 11**

**JOURNAL ENTRIES TO CONCEAL THEFT**

It is the writer's experience that employers are astonishingly careless about scrutinizing the journal entries which go through their books, and seem to think they are "just book entries" and, therefore, only of academic interest.

A bookkeeper-cashier can, however, very easily make journal entries crediting the account of persons whose remittances he has misappropriated and charging impersonal accounts such as Allowances or Returned Goods...
with similar amounts. In such cases everything will apparently be in order, and unless the proprietor or the auditor examines the journal entries in detail very carefully, the frauds will escape detection.

Example 12

Postings to Wrong Account

Again by means of posting such items as salaries, postage, rent, etc., to wrong accounts in the General Ledger it is possible for a bookkeeper-cashier to make payment of the same item more than once, misappropriating the duplicate payment for his own purposes, and yet to make it appear from a cursory scrutiny of his Ledger accounts as though everything were in order. In such cases only a careful analysis of all the impersonal Ledger accounts or the detailed checking of all postings will reveal the fraud.

Frauds by Storekeepers and Others

Having Custody of Materials

The concealment of theft of material by means of falsification of the books of account is less frequent than the case of theft of money, not because of any greater difficulty in manipulating the records in such cases, but because of the practical difficulty of removing the actual merchandise in question without detection.

In manufacturing businesses, however, where raw material of high intrinsic value is used, such as ingot tin or platinum, it is very important that materials should be issued from stores only on the authority of requisitions signed by responsible employees and that the storekeeper’s receipts and deliveries of material be checked up at frequent intervals with the purchase invoices and the signed requisitions for withdrawals.
It is also very important in such cases that a good system for recording manufacturing costs be in use so that theft on the part of those requisitioning material from stores will be indicated by the increased cost of manufacture shown by the books as a result of such theft.

Unless the precautions mentioned are taken, it is, of course, quite easy for the storekeeper to enter in his records as having been issued for manufacturing purposes material which he has stolen.

It should also be remembered that unless a good system of internal check is in use, it is always possible for the head of the purchasing department to order material in the name of his employers but cause it to be delivered elsewhere than at his employer’s place of business (e.g., such materials as coal, lumber, etc., the identity of which is easily lost). Frauds of this last-mentioned character can be detected only by careful comparison of receiving records with purchase invoices. It is important that such comparisons should be made by an employee whose regular duties are not connected with the stores department or the purchasing department.

Frauds Committed with Object of Showing False Financial Condition But Which Do Not Involve Theft

Frauds of this character are of far greater importance, of greater variety, and of graver consequence than those committed for the purpose of concealing theft. Thefts capable of being concealed by the falsification of accounts rarely involve cases of such magnitude as to ruin a business absolutely as, where really large sums of currency are involved, sooner or later the resultant shortage of working capital and the consequent inability of the concern to meet its current lia-
DETECTION OF FRAUDS

bilities, in spite of the fact that its Profit or Loss Account shows it to be making money, will lead to investigations which will bring the shortage to light.

On the other hand, falsification of accounts with the object of showing a financial condition not in accordance with the facts invariably involves very considerable sums of money, and on account of the fact that the proprietor of the business himself or at any rate someone occupying a high official position in the concern is usually responsible for the fraud, its existence will come to light only as the result of investigations set on foot by someone not actively connected with the management of the business in question.

Example 13

FALSIFICATION OF FINANCIAL STATEMENTS WITHOUT CORRESPONDING FALSIFICATION OF BOOKS OF ACCOUNT

The simplest type of fraud of this sort consists in the presentation to bankers, stockholders, investors, or others of statements which purport to show the financial condition of a business on a particular date or of its earnings for a particular period, but which do not represent the facts and are not in accordance with the books of account.

Bankers are the most frequent victims of this kind of fraud, and bitter experience has now led them almost invariably to insist that the financial statements submitted to them as a basis of the extension of credit be certified as correct by reputable public accountants.

Such frauds can, of course, be immediately detected by comparison of the statements in question with the books of account. In spite of this it is remarkable how frequently such frauds are practiced, the reason, of
course, being that they can be committed without anyone's having knowledge of them except the persons who actually commit the frauds, whereas if the books of account are "doctored" to correspond with the statements, it is quite possible that some intelligent employee will observe the fact and inform the parties about to be defrauded of what has been done. Frauds of this type have, however, only their simplicity to recommend them and have the great disadvantage from the point of view of the persons committing them that responsibility for them can be directly traced to their perpetrators with uncomfortable consequences.

Example 14

UNDESTATEMENT OR OVERSTATEMENT OF INVENTORIES

The falsification of merchandise inventory figures is one of the most favorite vehicles of fraud on the part of those wishing to show a false financial condition. The reason for its popularity is the fact that it is generally impossible from a scrutiny of the books of account or even by means of a detailed audit to determine, except inferentially, what should be the value of the merchandise on hand at any particular date. Moreover, as the character of the merchandise changes from day to day, any attempt to check up the accuracy of the values claimed on one date by comparison with the values ascertained by means of an independent appraisal at a later date involves considerable time and expense and is somewhat inconclusive in its results.

Besides this, frauds of this character can be committed in such a way as to make it almost impossible to fix responsibility of its commission. If it is assumed that it is actually the proprietor who is morally responsible for the inflation of an inventory, he can none the
less readily cause the actual clerical work involved in
the compilation of the figures to be performed by others
without their realizing that anything fraudulent is in
contemplation. An inventory usually involves the coöper­
eration of quite a number of employees, and in the
process of counting quantities, pricing them, copy­
ing drafts, and making final typed statements there is
ample opportunity for an employer to inject figures and
quantities, responsibility for the insertion of which it
will afterwards be impossible to trace.

In this connection it is well to point out that it is not
always the proprietor or the general manager of a busi­
ness who is interested in the falsification of inventory
figures. Very often departmental managers, factory
superintendents, or even foremen are partially remuner­
ated upon the basis of the earnings of the business; in
such cases the proprietor should exercise great caution
in supervising the taking of inventories, otherwise he
may find that he has paid large commissions based on
nonexistent profits in respect of a particular year to
employees who have since left his service.

Example 15

INFLATION OF ACCOUNTS RECEIVABLE

It is sometimes sought to show a better financial
condition and to improve the earnings of a particular
period by passing through the books of account a num­
ber of fictitious sales. In such cases this is generally
done at the very end of the financial year, and the sales
in question are written back early in the succeeding
financial year so that the fraudulent condition of the
books only exists for a few days or weeks at the most.

Such a fraud, if committed in connection with the
affairs of a concern of any magnitude, can hardly be
done without the knowledge of some of the employees of the concern involved and is, therefore, a very dangerous procedure; but where a smaller business is in question, it can be done with far less chance of its being discovered, owing to the more lax system of internal organization which usually exists.

Comparison of shipping records with Sales Books will disclose frauds of this kind, and professional auditors do this to the extent of making selective tests in order to satisfy themselves that no such fraud is being committed.

Example 16

CONCEALMENT OF LIABILITIES

The deliberate omission of liabilities from books of account is often a very difficult thing to detect.

Where trade liabilities are in question it should, theoretically, be possible to detect their omission by checking receiving records to ascertain that liabilities have been set up for all goods received, and here again auditors are accustomed to make selective tests along these lines. Anyone who has had extensive experience of commercial affairs will, however, realize that the task is too laborious to admit of its being performed exhaustively and that owing to the poor shape in which receiving records are generally kept, it is not an easy matter. (Perfectly innocent mistakes are frequently made by really well-organized business concerns by including in their merchandise inventory goods which have been received and taken into stock but credit for which, for one reason or another, has not at the date of such inventory been given, on the books of account, to the creditors who supply the goods.)

Where the liabilities omitted, however, represent bank
loans and where the proceeds of such loans have never been brought on to the books of account, it is almost impossible for an auditor to discover their omission. An actual example of this sort came under the notice of the writer comparatively recently: The treasurer and the manager of a large corporation engaged in the grain business borrowed a very considerable sum of money in the name of their company from bankers with whom the company did not usually have dealings. They signed the company's name to notes for the amount borrowed and paid the proceeds into a special bank account. They then proceeded to engage in speculative deals on their own account, operating them through the special bank account in question. Their speculations were unsuccessful, and they were unable to meet the notes given to the banks at maturity. The notes were renewed two or three times, but eventually the bankers insisted on payment, whereupon the whole circumstances of the transaction came to light.

These men were authorized to pledge the credit of their company and had done so in this instance. In submitting financial statements to the company's bankers, however, the liability for these notes was not disclosed; no entries appeared on the company's books in regard to them and it would, therefore, have been impossible for anyone to detect their existence by an audit of the books however searching. Frauds of this character are occasionally discovered through the parties committing them by their making interest payments connected with the suppressed liabilities out of the regular bank account of the business. Where this is so, an analysis of the Interest Account would indicate to an auditor that interest had been paid in connection with liabilities not appearing on the books. The perpetrators of such a fraud would generally, however, have the fore-
sight to meet the interest on such bank loans out of their own funds, and the auditors would therefore encounter nothing to arouse their suspicions.

Example 17

OVERSTATEMENT OF EARNINGS AND PROPRIETOR'S WITHDRAWALS

It is not by any means uncommon for the proprietor of a retail business who is contemplating selling out his business to manipulate his records so as to show an earning capacity considerably in excess of what is actually the case. One of the favorite methods adopted for accomplishing this result is to ring up on the cash register a number of fictitious sales.

Suppose the proprietor of a store rings up on the register $50.00 more than was actually received for each day during a particular week and enters these inflated totals in his Cash Book. He, of course, will have recorded earnings of $300.00 in excess of what was really taken in from customers. If he, to offset this, enters on the payment side of the Cash Book personal withdrawals of like amount, it is obvious that his books of account will on the face of things appear to be correct. That is to say, the balance shown by his bank statement will agree with that shown by his Cash Book, and an auditor comparing the register readings with the Cash Book would find them in agreement. Inasmuch as nearly all the receipts of a store are in the form of currency, the fact that the daily bank deposits did not agree with the amounts shown in the Cash Book would not excite any particular suspicion on the part of auditors, it being reasonable to suppose that the proprietor would withhold from
DETECTION OF FRAUDS

the cash receipts whatever money he needed for his own use.

The only way in which a fraud of this sort can be discovered is by comparison of the percentage which the cost of goods sold bears to the sales during the period under investigation with similar percentages for other periods and other concerns in the same line of business. Should it be found that an abnormal gross profit had apparently been earned, suspicion would, of course, be aroused. The fact that a proprietor appears to have been withdrawing for his own use more money than usual and more than should be necessary for his current expenses should always arouse suspicion on the part of an auditor.

CONCLUSION

It would, of course, be possible to give a great many more examples of how books of account can be fraudulently manipulated, but enough have been instanced to demonstrate that investors and those lending money on the strength of a financial position, as disclosed by books of account, are acting recklessly unless they insist upon an investigation of such financial condition in their behalf by competent auditors.

It has also been sought to demonstrate by means of the foregoing examples why it is necessary for proprietors and managers either to establish an efficient system of internal audit or to employ the services of professional auditors to go over such matters in their behalf at reasonably frequent intervals. In this connection it is most important that the system of accounting used be so devised as to provide the proper machinery for checking up one department against another and to fix responsibility for the transac-
tions recorded, the prices paid, etc. Unless this is so, it is impossible for proprietors to supervise their affairs adequately and useless to call in the services of professional accountants, as without such machinery it is impossible for them, in the very nature of things, to arrive at any definite conclusions.
TEST QUESTIONS

These questions are for the reader to use in testing his knowledge of the lecture. The answers should be written out fully in a notebook, but are not to be sent in.

1. With what two general classes of frauds does the accountant have to deal?

2. What does the term "internal check" mean to you? Does a good system of internal check depend in any way upon the size of a concern?

3. What form of fraud is most frequently met with in auditing the accounts of a receiving cashier? As an auditor suspecting a fraud of this character, how would you proceed to detect it?

4. In the case of a cashier who is also a bookkeeper, how would you ascertain whether he has abstracted cash and charged it to an expense account?

5. Suggest a scheme whereby the records of a storekeeper in charge of valuable raw materials may be checked up frequently and easily by the general office.

6. In checking a cashier suspected of fraud, can you see any stronger reasons for checking page totals that come near the end of the month than others?

7. For what reasons is even the most scientific system of internal check that can be devised likely to be inadequate to disclose irregularities of a fraudulent character?

8. Indicate cases of fraud which are likely to come to light in the ordinary course of business. Show how they will be disclosed.

9. Why should a treasurer always be careful to initial invoices for which he has drawn checks?

10. Suggest a system of check that will prevent padding of pay rolls with fictitious names. In the absence of sufficient internal check, how would you as an auditor ascertain if pay roll frauds were being perpetrated?
11. What advantages are gained by requiring that all cash receipts be deposited each day intact, and that all payments be made by check?

12. Why is it advisable to avoid entrusting the duties of a cashier and bookkeeper to the same individual? Can this always be done?

13. Specify some of the methods that a bookkeeper-cashier may take to conceal frauds. How would you as an auditor proceed to detect these?

14. Give reasons why frauds are sometimes committed which disclose a false condition of business. How do such frauds compare in importance with those that simply involve theft?

15. Who are usually found to be perpetrators of such frauds as mentioned in question 14?

16. In order to protect themselves, what do bankers and careful investors insist on in connection with fiscal statements?

17. Mention the chief difficulties in the way of detecting and proving fraud in connection with inventory valuation.

18. What object might a factory superintendent have in overvaluing an inventory and under what circumstances?

19. Suppose the general manager of a concern should attempt to show an improvement of earnings by entering a number of fictitious sales upon the books. How would you as an auditor detect such fraud?

20. Why is it particularly difficult to audit the earnings of a retail store? How can the proprietor of such a store inflate his sales and profits and still make his books appear correct? What circumstances will arouse your suspicions that such inflation had taken place?

21. Give a number of the best reasons that occur to you why a concern should have thorough periodic audits of its books and records by a firm of independent and trustworthy accountants.