GREEN AND BLACK VEHICLE DEALERSHIP, LLP

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This case is set in the car dealership industry environment where collusion among employees facilitates a parts inventory fraud scheme. The fraud is discovered by the car dealership company's personnel two months after receiving an unqualified (i.e. clean) audit report from their auditors. The car dealership company then hires another CPA firm to handle the fraud investigation and reporting.

The purpose of this fraud case is to give students hands-on exposure to a relatable forensic accounting situation that focuses on various aspects of the process from discovery through the issuance of a fraud report which is neither accusatory nor conclusive as to guilt. The design of the fraud case is such that it emphasizes the development of students' critical thinking, communication, and interpersonal skills.

INTRODUCTION

It was March 24, 2017, and Jana Heith, one of the partners of James and Elliott CPA Firm, LLP, had just finished a phone call. She had been speaking with Joseph Green, one of the owners of Green and Black Automobile Dealership. Joseph Green indicated in the telephone conversation that both owners were attorneys in a large law firm located in the Northeastern United States. The dealership owners purchased the dealership about six years ago and immediately hired Jack Robertson as the dealership manager to run their business. Jack had previous dealership management experience and appeared as an excellent employment choice. Henry particularly favored Jack since they had played on the same high school football team some 20 years prior.

Joseph indicated that the dealership had engaged another regional CPA firm as its auditor for the past six years. All of the audit reports to date were unqualified (i.e., clean) and the dealership financial statements indicated steadily increasing profits each year. The dealership owners were well pleased with their auditor and dealership investment until receiving news earlier in the week that a parts inventory fraud scheme may be occurring at the dealership.

Joseph indicated that an anonymously reported tip received in a letter caused Jack to suspect that possible fraudulent reporting might be occurring in the parts inventory area of the dealership. Acting upon the anonymous information, Jack selected one high dollar inventory part, the electronic control unit for small compact cars, to test for accounting accuracy. The accounting parts inventory listing (i.e., subsidiary ledger) indicated that 12 of these items should be on-hand in the inventory store room. Jack quietly made his way to the parts store room and counted 11 boxes labeled as the appropriate electronic control unit. Then Jack randomly pulled three of these boxes off the shelf to verify that the electronic control units were in fact in the boxes. What he found was disturbing. Two of the boxes contained old worn out electronic control units. These two discrepancies did not appear to be mistakes where a mechanic might have inadvertently replaced an electronic control unit on a vehicle and then put the old part back in the new box for later disposal. The two worn out units were carefully wrapped, placed in the boxes, and painstakingly sealed in a manner such that one would think the boxes had never been opened. In addition, there was one less electronic control unit (i.e., 12 – 11 boxes) in the inventory store room than the parts inventory listing indicated should be there.

Jack decided to telephone the owners before he proceeded further with any investigation. The owners, after intense deliberations, decided not to involve their current audit firm in the possible fraud investigation. Instead the owners decided to hire another CPA firm (i.e., James and Elliott CPA Firm, LLP) to conduct the forensic accounting engagement. The gut instincts of the owners were that their audit firm may have been negligent in the auditing of the parts inventory at least for the most recent fiscal year ended on January 31, 2017. The unqualified (i.e., clean) audit report for the year ended on January 31, 2017, was issued on February 28, 2017. The owners knew they currently had insufficient evidence to support the notion that an inventory fraud had occurred much less whether their audit firm had been negligent in the performance of its duties.

The accounting firm, James and Elliot CPA Firm, LLP was a medium-sized regional CPA firm. The partnership, formed in 1962, now had two locations and employed 25 working professionals. The firm primarily provided audit, tax, and consulting services. However, the firm was considering expanding its services to include forensic accounting and litigation support engagements for non-publicly traded companies.

Jana Heith was interested by the information she has gathered thus far about the possible forensic accounting engagement. She had expertise in the industry as she has been actively involved in auditing car dealerships for the past 15 years. Although she believed the engagement presents an excellent opportunity for increasing firm revenues, she knew there were risks involved in this type of engagement.

ADDITIONAL BACKGROUND INFORMATION

Green and Black Vehicle Dealership, a limited liability partnership entity, was a small to medium-sized dealership retailing new and used automobiles and was located in a city about 50 miles from the CPA firm in the southeastern region of the United States. The dealership owners, Joseph Green and Henry Black, had no plans to increase the number of partners in the partnership nor were they planning to infuse additional capital investments into the entity. There were no plans to increase the dealership new automobile franchises to include other makes than the ones they are currently retailing.

The dealership had various departments. These consisted of a new vehicle sales department, a used vehicle sales department, a service department, and a parts and accessories department. The finance and insurance departments were a part of the vehicle sales department. In addition, the dealership operated a body shop, as well as a lease and rental department. Service, parts, and body shop operations were known as back-end or fixed operations.

Each department above operated as a separate profit or cost center. For example, the parts and accessories department sold parts to the service department for cost plus a mark-up and records a profit. For the dealership as a whole, however, the gross profit recorded by the parts and accessories department was offset by the increased cost recorded in the service department. The departments entered into such internal transactions by purchasing and selling vehicles, parts, and labor.

The dealership used computer-based repair order invoicing (ROI) or electronic repair orders (ERO). The repair order was used both as documentation of the work performed and as a record of the cost and sales amounts of parts and labor. A copy that contained only the sales amount was given to the customer as an invoice for payment, and another copy containing both sales and cost amounts was given to the accounting department for posting and filing. The dealership had interfaced its repair order computer system with its computerized accounting system so the accounting records should be automatically posted when a repair transaction was completed.

THE HIRING DECISION

Jana called her team into a meeting. She wanted to make sure everyone was fully aware of the situation and the implications of what this could mean. She explained:

> *Green and Black Vehicle Dealership wants to hire our firm to investigate the suspected parts inventory fraud and have us issue a fraud report at the completion of the investigation.*
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> *If we accept this client to perform the investigation, it will be important for us to understand and communicate to the dealership owners what the fraud report should and should not contain based on the investigation. For example, the fraud report should include all findings, conclusions, recommendations, and corrective actions taken. The report should indicate all pertinent facts uncovered relative to who, what, where, when, how, and the why of the fraud. The report should further include recommendations for control improvements that will minimize the exposure to similar occurrences in the future. On the other hand, the report should not contain recommendations for disciplinary or legal action against any person suspected of fraudulent or illegal activity, even when the investigation provides tenable evidence of probable culpability or complicity.*
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> *The in-charge investigator should exercise particular care to ensure that the general tone of the fraud report is neither accusatory nor conclusive as to guilt. Even though a confession of culpability or complicity may be obtained during the*

investigation, such may not be considered valid or consequential evidence of guilt of fraud until a court of law decides. This holds true even if management has already taken disciplinary action on the basis of a confession. Fraud reports that make reference to a confession obtained during the investigation should state simply that admission of the alleged or suspected events was obtained and not that guilt was acknowledged. The investigator must pay close attention to report language as it is crucial to make certain that subjective, inflammatory, libelous, or other prejudicial connotations are not present.

Let me reiterate: To be factual, objective, unbiased, and free from distortion, fraud reports should refer to alleged activities, conduct, irregularities, and the like. Again, the activities investigated and reported should be described as alleged or purported to have occurred. When investigation findings support allegations, you may wish to use specific report language much like the following examples.

- *The investigation disclosed the existence of reasonably credible evidence to support the allegations.*
- *The investigation concludes with a rebuttal presumption that the allegations or suspicions are tenable.*
- *The investigation concludes with plausible evidence in support of the allegations.*

Joseph Green has indicated that the dealership wants to hire us to handle the fraud investigation instead of involving their regular audit firm which had performed their last six annual audits. Joseph further indicated that the dealership is not granting us permission to contact their audit firm at this time and will most likely not grant permission during the fraud investigation.

Again, the dealership owners are successful attorneys, and, as such, do not wish to alert their audit firm prematurely in the event that a negligence case against the firm might be forthcoming.

AUTOMOBILE INDUSTRY

Although there was a strong demand for new and used automobiles, dealership competition was fierce within the industry. Most dealerships made a slightly higher gross profit on used vehicles than on new ones. This trend was a direct outcome of increased demand on used vehicles as higher prices for new vehicles have made new vehicles too expensive for many people. However, due to continued low financing rates for new vehicles and other aggressive incentives offered by many automobile manufacturers, the difference between the number of new and used vehicles sold by franchised dealers was declining. The National Automobile Dealers Association (NADA) published data annually. NADA data was a comprehensive statistical analysis of the franchised new vehicle dealership industry (www.nada.org).

MANAGEMENT AND RELEVANT STAFF

Six years ago, the company experienced significant management turnover about the time Joseph Green and Henry Black purchased the dealership. Only two key positions had been filled within the last three years. Marie Flowers, a single mother raising two children on her own, was hired as controller three years ago. Martha Smith, the previous controller, resigned to move to North Carolina after her husband was transferred due to his employment. Chance Rebel, energetic and single, was hired as the parts and accessories manager two and a half years ago. He replaced Robert Bowling who retired at age 66.

Key personnel are listed below along with their educational credentials.

1. Dealership Manager – Jack Robertson - MBA
2. Controller – Marie Flowers – CPA - MPA
3. Assistant Controller – Susan Blair, CPA - MPA
4. New Vehicle Sales Manager – Justin Chambers – BSBA in Business Administration – Marketing
5. Used Vehicle Sales Manager – Carl McDaniel – High School Diploma
6. Service Department Manager – Stephen Davenport – Technical Trade School Automotive Mechanic Specialized Degree
7. Parts and Accessories Manager – Chance Rebel – BSBA in Business Administration – Management

There were usually 6 to 8 certified mechanic technicians on staff at any given time during the year. Normal turnover of 2 or 3 certified mechanic technicians generally occurred annually. There had been no turnover in this area for the last year partly due to a down turn in the economy and a higher than normal unemployment rate.

Certified Mechanic Technicians are listed below along with their seniority.

1. Senior Certified Mechanic Technician, Randy Snowden
2. Certified Mechanic Technician – John Martin
3. Certified Mechanic Technician – Byron Seal
4. Certified Mechanic Technician – Scott Harris
5. Certified Mechanic Technician – Joseph Smith
6. Certified Mechanic Technician – Aaron Yates
7. Certified Mechanic Technician – Dan Wildman

Other relevant staff not previously listed included:

1. Parts Inventory Clerk - Jim Creel
2. Part Time High School Worker that fills in for Jim Creel while he is at lunch each day from 11:30 a.m. to 12:30 p.m. – Nancy Barrett

ACCOUNTING AND CONTROL SYSTEMS

The dealership switched to a new, integrated central accounting system in late 2015. This new system maintained integrated inventory, accounts receivable, accounts payable, payroll, and general ledger software. The general ledger software interfaced with a cost accounting system so monthly budget variance reports could be generated by department profit or cost centers. In addition, the cost accounting system allowed leveling flexibility so that budget variance reports could be generated at different levels within the dealership by combining any of the individual department profit or cost centers to generate a specialized report at that particular level.

As with all accounting system transitions, glitches occurred that must be addressed. This process resulted in the assistant controller spending much more of her time in late 2015 and early 2016 reconciling information from the old system to the new system than had originally been budgeted. In addition, due to daily circumstances and heavy workloads in the early stages of the system transition, the dealership accounting staff was forced to learn the new accounting system quickly and without any formal training. Therefore, much of the learning process was by the trial and error method. As a result, various types of accounting errors occurred during the transition period. In fact, the dealership was still adapting the accounting controls to better complement the new system to prevent and detect errors as well as fraud. The controller and assistant controller had management *override authority* for the entire accounting and reporting system which was normal policy and procedure in most dealerships. System override authority was always a risk and valid concern in any company's internal control environment.

Cash

The dealership accepted no cash payments. The dealership required all customers to pay by check, money order, or electronically. The previous owners put this internal control in place after experiencing a small amount of cash missing from one of the accounts receivable cash drawers during a surprise cash count by auditors several years earlier.

Inventories

The dealership had various inventories. For example, there was new car inventory, used car inventory, rented and leased car inventory, parts inventory, and accessories inventory. Each inventory was maintained separately within the applicable profit or cost center.

CLIENT BACKGROUND CHECK

A check on the background of Green and Black Vehicle Dealership, LLP revealed that six years ago Chance Rebel, manager of the parts and accessories department, was charged with an unclassified misdemeanor for first-time possession of a small amount of marijuana. According to news reports, charges were later dropped in return for agreeing to pay a fine of $550 and performing 100 hours of community service. The background check revealed no other known legal or ethical problems with any other key employees.

CPA FIRM INDEPENDENCE ISSUES FOR ATTESTATION CLIENTS

As part of the quality control program at James and Elliott CPA Firm, LLP every six months each employee was required to file with the CPA firm an updated disclosure of their personal stock investments. This procedure related to independence regarding attestation clients.

Green and Black Vehicle Dealership, LLP is owned 100% by its two partners. Therefore, stock ownership should not create an independence issue for the firm.

LICENSURE LAWS

The CPA firm was unsure about whether state laws require the employees or the firm to have a license to conduct investigative work. Most licensing laws defined the particular activities that constitute private investigative work and affirm only licensed persons can engage in those particular activities. Although the firm believed the investigative work that the firm planned to do for this potential client should fall outside the legal definition of private investigative work, it was somewhat unclear especially since the firm has already requested background checks on individual key personnel at Green and Black Vehicle Dealership, LLP.

Further research into this topic revealed two relevant factors in determining whether an individual or firm must be licensed as a private investigator. These included whether the individual was engaged in private investigative work and how the relevant legal jurisdictions defined private investigative work or some variation such as private detective business or private investigative service.

There are 42 states and the District of Columbia that had licensing requirements for private investigators. Alabama, Alaska, Colorado, Idaho, Mississippi, South Dakota, and Wyoming do not have statewide licensing requirements and your firm and potential client were both located in one of these states. The firms' location made the original concern about licensure an irrelevant concern. It was also determined that this engagement falls outside of the particular activities that constitute private investigative services as defined by law.

FINANCIAL STATEMENTS

The morning after Jana Heith's initial conversation with Joseph Green, the firm received copies of the audited financial statements for Green and Black Vehicle Dealership, LLP for the last three years. They did not provide any interim monthly financial statements.

DISMISSAL/RESIGNATION OF EMPLOYEES

Several days later, Jack Robertson mentioned to Susan Blair, the Assistant Controller, that a fraud investigation was forthcoming. She conveyed this information to Randy Snowden, senior mechanic, and he immediately resigned from the dealership. In his exit interview with Jack Robertson, Randy admitted being part of the fraud scheme to inflate inventory. He further implicated Susan Blair had instructed him to do what he did to inflate inventory. He further indicated that by inflating inventory, the annual income was overstated which made the company appear to be more profitable than it actually was. He also mentioned that various employees' bonuses were tied to profitability. (See Exhibit 1 below.) Thus, by inflating income these employees were paid higher bonuses by the dealership than they were actually entitled to receive. This included bonuses to Susan Blair and Randy Snowden, as well as, to other employees not involved in the scheme to inflate inventory. Randy signed a voluntary written statement documenting this information.

Jack Robertson held an interview with Susan Blair where he confronted her with the allegations made by Randy Snowden. She verbally confessed to instructing Randy Snowden to inflate the parts inventory by placing worthless parts back in inventory to be counted as usable inventory with the intent to understate cost of goods sold and overstate income on the financial statements. Susan further indicated there were only two employees involved in the parts inventory scheme. Susan voluntarily signed a confession statement and her employment was terminated at the end of the interview.

Based on the foregoing information, it appears that Randy Snowden and Susan Blair were the only suspects of wrong doing in the inventory parts fraud scheme. However, Jack Robertson interviewed all of the other mechanics. Jack's opinion, after the interviews, was that the other mechanics were not involved in the inventory parts fraud scheme.

EXHIBIT 1:
Bonuses Paid Based on Earnings Attributable to Parts Inventory
The following is a list of employees and percentages of bonuses received based on the earnings in the parts inventory area.

Employee and Position	Parts Inventory Earnings Bonus %
Jack Robertson, Dealership Manager	5.0%
Marie Flowers, Controller	5.0%
Susan Blair, Assistant Controller	5.0%
Stephen Davenport, Service Department Manager	5.0%
Chance Rebel, Parts and Accessories Manager	5.0%
Jim Creel, Parts Inventory Storeroom Clerk	2.5%
Randy Snowden, Senior Certified Mechanic Technician	2.5%

HIRING A SPECIALIST/EXPERT

A specialist/expert, Neal Clark, was hired to assist in the parts inventory physical count. The parts inventory items were of a specialized nature and the specialist/expert could easily identify whether an item listed on the parts inventory listing (i.e., subsidiary ledger) was actually the item on hand. In addition, the specialist/expert could easily recognize if a parts inventory item was new and usable or if it was damaged and should not be included in the parts inventory listing (i.e., subsidiary ledger).

In making the decision to hire Neal Clark and use his work, the Investigative Team of James and Elliott CPA Firm, LLP considered and reviewed the following.

- The certification of the specialist. In this instance, the specialist was a Certified Mechanic Technician.
- The reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability and performance.

- The specialist's experience in the type of work under consideration. The specialist here had over 30 years of experience as a Certified Mechanic Technician. The Investigative Team had the responsibility of understanding the nature of the work performed by the specialist in identifying and classifying the parts inventory items.
- The specialist's identification/classification of the parts inventory items on hand should be accepted as adequate evidence in support of the parts inventory listing (i.e., subsidiary ledger) unless there is evidence to the contrary.
- The Investigative Team had sole responsibility for the Investigative Report issued and that responsibility is not reduced by the Team's use of the specialist's work in identifying/classifying parts inventory items on hand.