THE PROBLEMS THAT ALLOW FRAUD TO OCCUR

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Introduction

The median amount of time it takes for fraud to be detected is about 18 months worldwide[1]. This means that from the time the fraud is initiated to the time an auditor or certified fraud examiner discovers it a year and a half passes. Since every publically traded company must undergo an audit at least once every 12 months, this means that the average fraud scheme lasts at least 6 months even after the company had been audited.

Additionally, the median amount of loss caused by each fraud case was $145,000 USD[1]. So if the median amount of fraud per every six months was calculated, it would come out to about $48,000 for every six months that the fraud went undetected. The six months of the fraud going undetected, according to research done by the Association of Certified Fraud Examiners, will cost an average company an extra $48,000 in losses. This information, however, is not even completely accurate. Usually a perpetrator of fraud starts his theft with small amounts, and as he grows more comfortable, the amounts stolen slowly start to increase to larger and larger sums. Using this knowledge it is very common in most fraud cases for the last six months of a fraud operation to be the most costly to a company. So while the average would suggest that the perpetrator was making off with $48,000 every six months, it is possible

[1] (Association of Certified Fraud Examiners)

that perpetrator only stole $48,000 in the whole first year, and then in the ensuing 12 months made off with the other $96,000.

Of all the fraud cases included in the “Report to the Nations on Occupational Fraud and Abuse” that was published by the ACFE in 2014, only 17.1% of fraud cases were discovered by an audit, whether it was internal or external. According to the study, in 2014 the most effective way to discover fraud was through tips from fellow employees in the company. Tips managed to help discover 42.2% of the frauds in the survey, which is more than twice as much as the certified and trained auditors were able to discover. While it is especially difficult for external auditors to discover fraud, there are many instances in which the auditors did not perform their duties properly and overlooked some glaring red flags that could have helped discover the fraud well before it was actually discovered. An internal auditor that works with a company all year long should be able to identify fraud within a company better than an employee that is not trained at all to detect such things. A lack of thoroughness and a lack of identification of red flags by auditors can cost companies suffering from fraud thousands, if not millions, of dollars every year.

Crazy Eddie

Crazy Eddie was an electronics company that was able to get away with management fraud for about sixteen years. The store was not always known as Crazy Eddie though, and it was not always owned solely by criminal mastermind Eddie Antar. In 1969 Eddie Antar, Sam Antar (Eddie’s father), and Ronnie Gindi (Eddie’s first cousin) all opened an electronics store, and they all owned an equal one-third share. From 1969 to 1971 the store retained the name Sights and Sounds and then in 1971, when Sights and Sounds went bankrupt, Eddie Antar took advantage of the poor financial situation and purchased Ronnie Gindi's one-third share. After buying Ronnie's shares, Eddie Antar now owned two-thirds of the store and looking for a fresh start, he decided to rename the store Crazy Eddie in 1971. From 1971 to 1987 Sam Antar, Eddie Antar and the rest of their family were guilty of skimming cash from their sales, paying their employees off the books, falsifying their financial records to reduce taxable income, money laundering, and falsifying inventory on hand[2]. These illegal acts took place while Crazy Eddie was both a privately owned company, from 1979 to 1984, and while it was a publically traded company from 1984 to 1987. The standards of auditing are very different for privately held companies and publically traded companies. For example, privately owned companies are not required to disclose any of their financial information to the public; unlike public companies which are required to release audited financial statements every year. Another key difference is the necessity to comply with GAAP standards. Publically owned companies must provide audited financial statements that are in compliance with GAAP standards, as this is required by the Security and Exchange Commission (SEC). Privately owned companies may be subject to GAAP as well, however, since their financial statements are not issued to the public, they are not always required to have audited statements in compliance with GAAP[3].

From the beginning of their business together, Sam and Eddie Antar disregarded the fair trade laws set by the US government. The fair trade laws were first enacted in

[2] Sam Antar from WhiteCollarFraud.com
[3] William Shaftoe

1931 by the US government to benefit manufacturers by setting a fixed price that all products could be sold at[4]. This made it very difficult for small companies to differentiate themselves from other small companies and large corporate ones because they all had to sell the same products at the same price. This lack of differentiation was one of the main driving forces that pushed Sights and Sounds into bankruptcy in 1971. So when Eddie Antar took over the company and renamed it Crazy Eddie, he decided to disregard the fair trade laws and sell his products at a lower price anyway. Manufacturers found out about this underselling of their products and retaliated against Crazy Eddie by refusing to sell their products to the company. This forced Eddie Antar to purchase his merchandise from other retailers, as well as from overseas. Of course it was illegal to violate the fair trade laws that every other company had to abide by and it was also illegal to sell products from manufacturers against their will. This violation of rules should have been a warning sign to the SEC and future auditors. It is no coincidence that Crazy Eddie was obtaining their merchandise to sell illegally in 1971, and then in 1984 they were leading one of the biggest inventory frauds in US history. It is interesting to see how Crazy Eddie began their company with illegal activity involving inventory and that it took auditors and professionally trained fraud examiners fifteen years to realize that Crazy Eddie was a company based on fraud.

Aside from the lack of adhering to the fair trade laws, Crazy Eddie had several glaring red flags that should have been noticed by auditors long before they actually were detected. The red flags that were separate from the financial statements included the fact that the entire Crazy Eddie company only depended on three suppliers, despite

[4] White Collar Fraud

its enormous size when it went public, the fact that all employees that had high positions in the company were family members that were not qualified to hold the positions that they held, and the fact that employees insisted on counting the inventory during audits every time[5].

At the time Crazy Eddie went public in 1984, they had 43 stores opened in the New York Metropolitan area; at this time, however, they only had three suppliers listed on their records[6]. This would mean that for every one supplier they had, approximately 14 stores were being supported. Since Crazy Eddie was reporting such high revenues, it can be assumed that they were selling large amount of inventory. This makes it very unlikely that just three suppliers were able to support all of these sales. This should have been a red flag to auditors to investigate Crazy Eddie's inventory closer as well as to verify that the suppliers that were providing Crazy Eddie with their merchandise were legitimate. This was a red flag that should have been observable from Crazy Eddie's Initial Public Offering (IPO), which took place in 1984.

Every high ranking employee in the Crazy Eddie Company had some sort of relation to Eddie Antar. None of his employees were independent from one another, or from Eddie, and most of them were not even qualified for the executive positions that they held[7]. The most troubling family member that was working for him, however, was his cousin Sam Antar. Eddie Antar paid for his cousin to attend college and study accounting, and then only two years after graduating he made him the Chief Financial Officer of Crazy Eddie. Even though Sam Antar had studied accounting in college, he

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[5] -White Collar Fraud
[6] Ted Sherman ; The long and wild Crazy Eddie investor fraud case nears the end
[7] Michael Knapp; Contemporary Auditing

was still vastly unprepared and inexperienced to become a CFO of a company that was preparing to go public and was making millions of dollars in revenue every year. Aside from the fact that Sam Antar was an unqualified CFO, he was also working at Penn & Horowitz, Crazy Eddie's auditing firm. Sam Antar had complete control over the audits of Crazy Eddie that were performed during the years 1981 to 1984. Since auditing standards forbids that an individual works for both a company and its auditing firm, Eddie Antar was paying Sam Antar off the books so that he did not have to list him as an employee. Despite the fact that both Sam and Eddie have the same last name, Penn & Horowitz should have collected enough information about Sam Antar to know that he was related to Eddie Antar and that he had at last worked there in the past. If Penn & Horowitz had collected this information they would have seen that there was no way that Sam Antar could remain independent in his work and deliver a clean audit report. Had Penn & Horowitz realized this, Sam Antar may not have been able to manipulate the financial reports for Crazy Eddie in the early 1980's and the fraud may have been discovered before the company ever went public in 1984.

Crazy Eddie reported inventory that was vastly overstated, and it was not discovered by auditors until 1987. The red flag that was present here would have never been present if auditors performed their jobs correctly. The Crazy Eddie employees were always so anxious to count their own inventory for auditors and insisted that the auditor in attendance just believe their numbers as true. It is standard procedure during an audit for the auditor to count inventory themselves and to only have the employees present their data, not have the employees count it themselves. For the auditor to not only allow the employees to count their own inventory, but to then issue them a clean audit report was a lack of competence and independence from the auditors. The auditor should have identified the persistence by Crazy Eddie employees to be so helpful as a red flag and instead of accepting the help, the auditor should have delved deeper to try and discover the reason for their helpfulness.

There were many red flags that should have been identified and investigated by the auditor deeper. However, the three red flags previously mentioned involving the business operations were not the only glaring problems within Crazy Eddie. With all publically traded companies, the financial statements are analyzed intensely by auditors every year to make sure the statements are in compliance with GAAP, to make sure they are free of material misstatements, and to check if there are any abnormal trends that could indicate fraud. Crazy Eddie had several things that were wrong with their financial statements that could have and should have been identified by auditors. The red flags that were evident on their financial statements were the actual percent changes in inventory from one year to the next with regards to the percent changes to sales, the amount that accounts payable was understated, the vast changes in Days-Sales-Inventory from one year to the next, and the vast change in the accounts payable to inventory ratio[8]. During the years that Crazy Eddie was a publically traded company that was being audited every year, there were vast overstatements and some very abnormal trends within the financial statements that should have been identified by a trained auditor.

In the year 1985, the second year that Crazy Eddie was a public company, it should have been obvious that something was wrong with the inventory reporting in the

[8] Sam Antar, whitecollarfraud.com

financial statements. In 1984, Crazy Eddie reported an increase of net sales of 22% and an increase of merchandise inventories of 14%[9]. While this percent change is not a red flag because it is a very possible situation, it is what happens the year after that should have alerted auditors. In 1985 Crazy Eddie reported an increase of net sales of about 57% and an increase of merchandise inventories by an incredible 126%[10]. While it is already uncommon for inventory to increase faster in sales, an increase in inventory that is two and a half times higher than the increase in sales should have really alerted auditors to a problem. A simple horizontal analysis of the reported inventories and sales for the two years could have showcased this abnormality, but the auditors failed to notice and the rather obvious discrepancies continued for several more years before falling apart in 1987. In 1986 Crazy Eddie reported an increase of net sales of about 34% from the previous year, and an increase in merchandise inventory of about 82%. Once again Crazy Eddie reported their inventory to not only increase faster than their sales, but the percent change was two and a half times larger than the increase in sales. In 1987 before Eddie Antar sold his shares and fled the country, it was estimated that he was able to inflate his consolidated inventories by a staggering $22.5 to $28 million dollars[11]. If auditors had caught the blatant inventory fraud in 1984 then the tens of millions of dollars in fraud in later years would have never have happened.

About six months after Crazy Eddie first went public, Eddie Antar knew that to maintain his upward trend in stock price he would have to start manipulating the

[9] Horizontal analysis of Crazy Eddie Financial statements
[10] Horizontal Analysis of Crazy Eddie Financial Statements
[11] White Collar Fraud

financial statements[12]. By understating accounts payable and overstating inventory Eddie Antar was able to substantially increase reported profits for each year. In 1986 Eddie Antar understated accounts payable by about \$3 to \$4 million. Then in 1987, before selling all of his shares and fleeing, Eddie Antar underestimated accounts payable by a staggering \$26 to \$29 million dollars to increase profits[13]. Eddie Antar managed to keep the accounts payable to inventory ratio pretty steady from 1984 through 1986, helping it maintain an average around the 85% range. Then in 1987, when Eddie was planning to sell out and eventually flee, the profit was made to look as high as possible so Eddie could boost stock prices and really cash in[14]. For the year 1987, Eddie Antar reported a decrease of accounts payable of about \$1,700, which brought it down to about \$50,000. Meanwhile in this same year, Eddie Antar reported an increase in inventories of about \$50,000, which brought it up to about \$109,000. An auditor should have right away noticed a discrepancy in the fact that inventories went up and accounts payable somehow went down. In the year 1987 the accounts payable to inventory ratio went from 86.4% to 45.9%, nearly getting cut in half[13]. Eddie Antar was still working at Crazy Eddie for most of 1987, and did not flee to Israel until February of 1990. Auditors should have recognized these trends long before 1987 and he should have never been able to leave the country at all.

As with the accounts payable to inventory ratio, Eddie Antar was able to keep the Days-Sales-Inventory ratio relatively steady and consistent for a few years before it too got out of control. For the years 1984 and 1985 Crazy Eddie had the same exact Days-

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[12] Michael Knapp, Contemporary Auditing 9th Edition
[13] Sam Antar, The Crazy Eddie Fraud
[14] Sam Antar, White Collar Fraud

Sales-Inventory ratio of 69.2 days. Then in 1986 it jumped up 11 days to 80.9 days, and then it jumped again in 1987 up to 112.9 days[13]. The Days-Sales-Inventory ratio is calculated by dividing the average inventory by the cost of goods sold, and then multiplying that number by the number of days in the period. From 1985 to 1986, Eddie Antar reported that the costs of goods sold went up about 52%, and that inventories went up over 126%[15]. This drastic jump in inventories is what had caused the Days-Sales-Inventory ratio to go up over 15% in just one year. Then in 1987, Crazy Eddie reported an increase of about 40% for cost of goods sold from the previous year, and also reported an increase of about 82% in inventories from the previous year. Once again Eddie Antar had his inventories increase at a rate that was twice as fast as his costs of goods sold, and this caused the Days-Sales-Inventory ratio to once again jump an astounding 28% in one year[14]. These very large and very uncharacteristic changes should have also alerted auditors to either a misstatement in inventories or the costs of goods sold. It took the auditors until the end of 1987 to realize what had been done, and at this point tens of millions of dollars had already been stolen by Eddie Antar and his family.

The Crazy Eddie fraud was one of the biggest fraud schemes of the 1980's. This particular fraud began to come to an end in 1987, which was about fifteen years before the Sarbanes-Oxley law was put in place. The SOX act is the reason that the Public Company Accounting Oversight Board (PCAOB) was formed, and the reason that auditors are held to stricter auditing standards today as well[16]. The PCAOB was created

[15] Horizontal analysis of Crazy Eddie Financial Statements
[16] White Collar Fraud

as a part of the Sarbanes-Oxley act in 2002, and it was tasked with overseeing the audits of public companies to make sure that everything is being done correctly.

The Sarbanes-Oxley Act

Congress passed the Sarbanes-Oxley act in 2002 to protect investors from the possibility of fraud from publically traded companies. The SOX act enacted strict reforms to the auditing process that were aimed to improve financial disclosures and prevent fraud. There were eleven titles and sixty-eight section within these titles that were included in the Sarbanes-Oxley act that were put in to address the many problems wrong with the audit process. The titles and their significance are as follows: Title I which outlined the creation and duties of the PCAOB, Title II which outlines the auditor independence standards, Title III which outlines corporate responsibility and the duties of the CEO and CFO within publically traded companies, Title IV which outlines the enhanced reporting of financial figures by publically traded companies as well as the requirements of increased internal controls to ensure accuracy, Title V which outlines the analysis of conflict of interests, Title VI which outlines the SEC's authority to censure security officials from their practice, Title VII which requires the SEC to conduct studies on publically traded companies transactions and to report their findings, Title VIII which outlines the corporate accountability for fraud and the punishments they face, Title IX which increased the criminal penalties associated with white-collar crimes, Title X which requires that the CEO sign the company tax return, and Title XI which further outlines corporate accountability and the criminal offenses that follow corporate fraud[17]. These eleven titles are an overview of what the Sarbanes-Oxley Act enacted and what their goal was with these reforms. The Crazy Eddie fraud took place before this act was ever enabled, however, even after the creation of the SOX act, fraud is still possible. There have been several large frauds that have taken place since 2002 that have carried on much longer than they should have mainly due to an auditors lack of professionalism.

MF Global

One of the prominent frauds that took place after the creation of the Sarbanes-Oxley act is the one that was committed by the company MF Global. MF Global was a very large brokerage firm that had $41 million in assets before going bankrupt[18]. Like with the Crazy Eddie fraud, auditors as well as accountants missed red flags that would have alerted them to a fraud long before it was actually discovered. On October 31, 2011 MF Global filed for bankruptcy, and at this time their Chairman and Chief Executive Officer was Jon Corzine. Corzine was formerly the Chairman of Goldman Sachs as well as a former Senator and then Governor. It is believed that he was able to steal about $1.6 billion in customer assets before MF Global had to file for bankruptcy in 2011. Jon Corzine was appointed CEO in March of 2010, so his theft of customer assets lasted about nineteen months in total.

There were many people at fault for the fraud that Jon Corzine was able to carry out. Of course Corzine was at fault for perpetrating the theft; however, there are also

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[17] The Sarbanes Oxley Act
[18] Forbes.com

accountants and auditors that are under scrutiny for not noticing that something was wrong before the company had to file for bankruptcy. Some of the red flags that should have went noticed include the sudden change in procedure by MF Global to return customer funds, as well as the unauthorized transferring of large sums of cash by the treasurer[19].

In the last few months leading up to the bankruptcy of MF Global, the company decided to change their policy on customer refunds suddenly and unexpectedly. Before the change, the company would always wire the funds owed back to their customers, then out of nowhere MF Global began to write checks to their customers instead. This was done so that the company would have time to transfer the customers assets to other accounts first, and then when the customers went to cash their checks they all bounced[19]. This sudden and unexpected change in a policy that had been in place for a long time should have been a red flag to auditors that something was amiss. Also the bouncing of checks to their customers also should have alerted auditors that something was wrong with MF Global's financials and they should have investigated it further before the company had to declare bankruptcy.

Edith O'Brien was the treasurer of MF Global in the months leading up to their bankruptcy. She is the person responsible for all the transfers of customer funds to overseas accounts and to banks to pay off debts owed by MF Global[20]. She was authorized to perform these transfers by Jon Corzine, however as treasurer it is still her duty to realize the proper actions with the funds and so she is being labeled as co-

[19] Daniel Collins, Futuresmag.com
[20] Bob Adelmann, The New American

conspirator and is being held liable in the fraud. The auditors of MF Global should have detected that the funds being used by the company were being used illegally because the company was clearly in no state to be paying off such large loans. This lack of skepticism by the auditors and their failure to detect the fraud cost thousands of people their life savings.

The auditing company for MF Global was PricewaterhouseCoopers, one of the big four accounting companies. PwC is not facing any criminal charges for their involvement and aiding of the fraud, however, they are under a lot of scrutiny for their failure to detect the fraud. PricewaterhouseCoopers was the auditor of MF Global for several years before the fraud began to take place and for this reason they should have realized a change in procedure and transactions even faster. Instead they failed to notice any fraud at all and eventually MF Global went bankrupt. Then on March 29. 2014, nearly two years after MF Global went bankrupt, they filed a lawsuit against PwC for their poor advising regarding European sovereign debt. MF Global claimed that if PwC had accounted properly for MF Global's European sovereign debt, then the company would not have invested so heavily in them and therefore they would not have suffered the massive losses in 2011[21]. The lawsuit filed was for $1 billion in losses; however, on April 20, 2015 PricewaterhouseCoopers settled the lawsuit with a $65 million settlement for MF Global[22]. PricewaterhouseCoopers poor advising and auditing not only cost the investors of MF Global millions of dollars, but it also cost them $65 million and their reputation.

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[21] Bloomberg Business
[22] Accounting Today

Conclusion

The Crazy Eddie and the MF Global frauds are ones that could have been largely prevented. The auditors had ample chances to detect that something was amiss with the businesses that Eddie Antar and Jon Corzine was running. Of course the first 13 years of Crazy Eddie's existence was as a private company, however, it still took auditors four years of auditing and reviewing to discover that vast amount of fraud that was taking place. It is also true that most fraud that involves public companies go on way longer than they should and the blame is on the auditor for not doing their jobs correctly.

In the beginning of this report, the statistics involving fraud world-wide for public companies. These reports included the average amount of time before fraud is detected, which is eighteen months. This is one of the most important figures because it means that, on average, a publically traded company will be audited and the fraud will still not go detected for another half year. Now the average amount of money stolen during fraud is $145,000, however, in many cases it is much more and this extra six months of going undetected costs stockholders and investors millions of dollars. The first year that Crazy Eddie was public, Eddie Antar stole a fraction of what he stole in every subsequent year. In the following three years that Eddie Antar falsified his financial statements and successfully deceived auditors, he stole over $100 million, of which only about half was collected. In the first six months of 1987, the year Eddie Antar sold out, Crazy Eddie overstated their inventory by about $25 million. The same goes for the MF Global fraud as well, and it is ironic how the MF Global fraud lasted just about eighteen months too. Jon Corzine was only CEO for a short time and although his fraud lasted most of his tenure, the largest amount stolen was in the last six months. If auditors had discovered the fraud even just six months before MF Global went bankrupt then potentially over $1 billion could have been saved. Six months can make a huge difference, and auditors would be able to detect a much larger percent of fraud if they did their jobs efficiently and effectively.

Of course the job of an external auditor is difficult, as they are going into a company that they do not know and are still expected to detect an abnormality that is actively being hidden by either management or an employee. However, in the Crazy Eddie fraud there were around half dozen red flags that should have definitely been detected by auditors long before they actually were. Once again of course not every fraud case has as many glaring red flags as the Crazy Eddie one, but a majority of fraud cases do have at least one or two red flags that could be detected by auditors had they done their job thoroughly and correctly. It is too often that auditors fail to do their job correctly and their mistakes often cost many stockholders their life savings.

Eddie Antar was the main perpetrator of the Crazy Eddie fraud and he is the reason that the fraud was as big as it was, but the blame as to why it went on so long is on the auditors. Today auditors are held to much higher standards, but even now the average time that fraud goes undetected is eighteen months. Unless auditors face stricter punishment for missing obvious red flags there will be little change in the near future as well. The Crazy Eddie fraud was one of the biggest frauds of the 20th century in America, and the MF Global fraud was one of the biggest frauds to take place after the creation of the Sarbanes-Oxley Act. Even though most of it could have been prevented, it was a true learning experience for not only everyone involved, but for future auditors nationwide.

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