ABC Co. Revenue Disappears – Quality of Indirect Audit Evidence

ABC Co. was a joint venture owned by several major oil producers. Its role was to receive the raw sulphur that was a by-product of the industry and then to market it internationally. The proceeds were then eventually routed back to the joint venturers on a complex ratio based on capital contributed and sulphur provided.

ABC Co. CEO negotiated customer contracts and arranged with certain customers in South Africa and Nigeria that invoices should be paid to a company in Bermuda (Bermco) managed by the Bank of Bermuda and (it was later revealed) owned by the ABC Co. CEO. Customers were then billed, at the full amount, on "real" invoices. The CEO made up a second set of invoices at a price about 20% below the amount of the real invoices. These reduced invoices were the ones processed by ABC Co.'s accounting system and reflected the amounts actually transferred from Bermco. The amounts customers paid to Bermco were the "real" price, which was higher than the recorded price.

To his customers, the CEO said the reason the payments were routed through Bermco was for Canadian tax and excise duty purposes. They were told that Bermco was a subsidiary of ABC Co. To his stakeholders and others in ABC Co., and to the auditors, he explained they were handled that way to enable the customers to gain tax and tariff quota advantages in their countries. Periodically, the CEO transferred the excess funds in Bermco into a personal Swiss bank account. There were also many legitimate transactions where no fraudulent overcharging occurred.

During the first year of the audit, when the auditors wanted to confirm accounts receivable they were told not to confirm directly with the customers because it could cause them very serious problems. Rather, the confirmations were to be sent to Bermco. The auditors complied with the request, and the CEO of ABC Co. caused the confirmations not to be returned. The auditors then performed alternative verification by checking back to the (falsified) invoices, which of course did not reveal any problem. In one case, the auditors pushed a little harder and the CEO caused the confirmation to be returned confirming the recorded (but false) amounts.

The auditors accepted the explanation for not sending confirmations without question and made no attempt to contact the customers in any way, or to find supporting evidence for the assertions concerning the reason for routing the billing through Bermco. Apart from the confirmation process, they made no attempt to find out anything more about Bermco. They were told the company was confidential and that no information could be released. Otherwise, their customer relationships could be damaged.

During the second year of the audit, a junior member of the audit team was assigned the task of sending out receivable confirmations but forgot the instructions and actually sent the confirms to the customers in South Africa and Nigeria. They were returned quickly pointing out that the invoice amounts outstanding and paid were more than what was reflected in the confirmation. Since this was a broad problem that affected all the figures for the accounts of these customers, the auditors realized there was a problem and launched a forensic investigation (which included the RCMP) that revealed the whole scheme.

The forensic auditors found that the biggest problem was getting information out of Bermuda regarding Bermco. The Bank of Bermuda insisted that they could reveal no information because of confidentiality requirements and that they could only reveal information to the CEO who owned the company and (they thought) ABC Co. When it was revealed that ABC Co. was owned by several multinational oil companies the bank quickly changed its mind and released the books. Then the forensic team had another tough job prying information out of the Swiss bank, but eventually succeeded, and for the same reason.

Questions:

1. What red flags should have been identified by an auditor demonstrating professional skepticism?
2. How much of a red flag is a request to not send a receivable confirmation to certain customers, and what should auditors do when faced with such a request?
3. The reasons provided that this was what the customers wanted for tax and tariff quota reasons could have been checked. How?
4. Would direct contact with customers have revealed the fraud?
5. How could auditors have discovered that the recoded sales prices were not the real prices? (HINT sulphur is a traded commodity).
6. What should the auditors have done to establish the bona fides of Bermco, and its real function? In particular, could they have discovered the true ownership of the company?
7. How important is auditor persistence in unusual circumstances?
8. It was argued by ABC Co. that although the books were fraudulently altered, the financial statements were not in fact in error because the revenue recorded was the actual amount received. How valid is this argument?

Source: Professional Skepticism Case Collection for Professional Accountants, University of Toronto Professional Accounting Centre, 2023, PAC website https://www.utm.utoronto.ca/pac/case-collections/enhancing-professional-skepticism-case-collection.