

Dig a Little Deeper - Exercising professional skepticism re budget prices

It was another normal day at Mass Commuting Limited ("MCL") when Carol, the Financial Controller, walked down the hall for the annual kick-off for construction season. She had her notes with her, and a copy of last year's budget, and the previous year's costs for fixing all the pavement on MCL properties. Her job at the meetings was mostly to get the list of all the upcoming projects with the construction guys and then to price them out to make sure that they stayed on track - which they rarely did.

Every year, she had to sit through one of these meetings to hear how the Construction Manager, Greg, talked about how everything was getting more expensive all the time. How HL3 and HL8 (types of asphalt) were always going up in price, as well as gas prices, and how he would need more money this time around to make sure his roads were smooth and his people were paid properly.

He concludes this year's speech with the usual, 'take last year's budget, but add 30% to his spend'. "Any questions?" he asks. Carol pulls out her notes and raises her hand: "Actually, yes. We have seen these increases every year now, and compared to 2017, we are paying almost 2.5x the amount. Is there an end in sight to these increases? Have we considered any other measures for saving money? Like having crews do a whole region in one night, instead of the usual 'one station in one night' policy?"

Greg smirks at Carol, and just replies: "Inflation is real, and so are my costs." Carol is frustrated, but knows that no one wants to be in this meeting - and that a public debate is not going to get the answers she is looking for. She looks at her notes, and adds the 30% to the margins, knowing that these have to be approved by the Treasurer anyway at the final budget meeting coming up.

The rest of the day flies by, but on the way home, Carol listens to a podcast about cryptocurrency to take her mind off work. It's one of her favourite ways to unwind, while still learning something new. But one line from the podcast sticks out. "When you look at the trends, you can clearly see Bitcoin will outperform Dogecoin. Nothing can go up forever."

The trends... That gives Carol an idea. Rather than just look at each year, Carol decides to lay out the numbers and graph it out. She looked at trends, and noticed that the price of MCL's jobs was rising faster than the price of asphalt. A LOT faster.

Market Price per tonne of Asphalt Cement, http://www.onasphalt.org/mtopriceindex/					
	2018	2019	2020	2021	2022
January	\$588.60	\$809.80	\$709.60	\$617.25	\$917.50
February	\$588.60	\$809.80	\$709.60	\$617.25	\$917.50
March	\$657.00	\$826.40	\$767.25	\$732.00	\$1,065.45
April	\$689.50	\$850.25	\$757.00	\$749.80	\$1,156.00
May	\$713.75	\$860.00	\$729.00	\$781.50	\$1,270.00

Greg's costs per tonne of Asphalt Cement at MCL					
	2018	2019	2020	2021	2022
January	\$688.60	\$909.80	\$909.60	\$917.25	\$1,217.50
February	\$688.60	\$909.80	\$909.60	\$917.25	\$1,317.50
March	\$757.00	\$926.40	\$967.25	\$932.00	\$1,365.45
April	\$789.50	\$950.25	\$957.00	\$949.80	\$1,456.00
May	\$853.75	\$960.00	\$929.00	\$981.50	\$1,570.00

"Inflation is real", she thinks, "but these numbers can't be."

The next morning, Carol decides to go visit the Treasurer for their weekly touch-base. They go over the usual logistics of budget season, and then they start getting to some specifics. Carol raises her concerns about the cost of asphalt, and shows the Treasurer her math.

The Treasurer raises an eyebrow and asks: "what are you implying?" Carol answers: "Nothing really, just that the explanation for the rising costs cannot be the cost of asphalt, because we are outpacing it." The Treasurer responds: "I agree, that is definitely not the full story. You need to dig a little deeper."

Carol leaves the meeting feeling good that her boss listened to her, but then lost at the same time - because, with the numbers she has, and her spreadsheets, this is as deep as she can go! A few weeks go by, and aside from more snide comments from Greg, Carol is getting nowhere with her investigation. She tries to speak to the construction guys, but they are always on a job site, and none of them ever see the cost of what they are doing.

At her next meeting with the Treasurer, she asks Carol for an update, but there isn't really one. Carol feels lost, and says: "you told me to dig deeper, but I can't dig into concrete and asphalt!"

Her boss tells her to keep trying, and shows her the latest invoice for construction, and they are up 40% over the prior year. Carol knows she has to get to the bottom of it. She takes the invoice, and goes back to her office. Still feeling a bit lost, she calls her old friend, Andrew, who worked in Investigations at MCL. Andrew used to be a police officer before, but decided he wanted something a little less risky, and proved to be an amazing member of the team. She explains the numbers to him, and how the Treasurer told her to "dig deeper", but you cannot dig through asphalt.

Andrew laughs, "well of course you can't - but maybe you only need to dig through paper instead of asphalt." Carol is surprised. "What do you mean?" she asks. "Well," Andrew says, "instead of looking at the budget, why don't you look at who is approving these ridiculous costs? I mean, someone has to be signing off, right? Isn't that part of a good control framework?"

Carol looks at the invoice she took from her boss - and there are 2 sign-offs, one from Greg, and a second from Greg's supervisor, Terry. She decides to give Terry a call, and gets his voicemail, stating that he is out of the office for the rest of the summer. "That's weird, how did Terry approve this if he is away?" Carol thinks to herself.

She tells Andrew what she found and he confirms that yes, Terry is down south for the whole summer. He tells Carol that she may want to check to see how this was approved.

Carol goes and talks to her IT Manager, Jerry. She shows him the digital signature and asks how Terry can approve these invoices when he is not here? "Well," Jerry explains, "our construction guys need their time off, it's union stuff, but the work never stops, you know? So they have the ability to delegate their approvals to someone else." Carol asks: "Can you tell me who Terry delegated approvals too while he was gone?" "Of course - he delegated it to Greg, the construction manager."

Carol is very excited, and runs back to her boss explaining in detail what she has found. The Treasurer listens with wide eyes, and then shakes her head. "How did we miss this?"

Carol responds: "I guess the invoices don't come from Greg, he just approves them, so we may have thought there was little to no risk." The Treasurer nods. She calls Andrew from Investigations, and asks him what he knows about the main contractors that come to do the paving work. Andrew looked up the corporate directory, and found that the CEO of the paving company... was Greg's cousin. Now it was time to call the investigators.

"Good investigators are fact finders," Andrew told Carol right before they met with Bigger-Than-Most LLP ("BTM"), the investigative accountants who were called in. "They don't guess, they don't have agendas, they just look for the facts."

The BTM investigators explained that they needed to have proof of collusion between Greg and his cousin before any connections could be asserted. They further indicated that they needed to see how the invoices were made on the paving company's end to see if there was any intent to deceive, which would be critical if this did go to court.

In order to prove collusion, BTM and their lawyers got court orders to pull the bank records of Greg and his cousin, as well as his paving company's. "Follow the money" they said. "These guys would only be colluding if there was something in it for both of them." By analysing the bank data, they were able to see transfers between the paving company and Greg's personal account. A "referral fee" it was called. ... And also between his account and his cousin's.

In order to prove intent they had to see the books of the paving company, and MCL exercised their right to audit them as a key contractor. These did not disappoint either. The books clearly showed the regular price, and then added a "referral" mark-up payable to a "Cousin at MCL".

"So that's the game," Carol said. "They mark up the costs, and then split the profit from the invoices - and they are able to approve it because whenever Terry isn't here, Greg can just approve them on his own." "Now that is digging deep," her boss replied.

There would be a long battle ahead with BTM and the courts but the mystery of uncovering the rising costs and the true cause of the higher budgets was finally out in the open.

Questions:

1. What did Carol do well for exercising her professional skepticism in this case?
2. Why was it so important to speak to many departments in this case?

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>.