

Too Good to be True - Professional skepticism leads to understanding performance and risk

Simple Financial Solutions (SFS) - those 3 magic words meant a world of possibilities to anyone who would not qualify for a loan or a credit card. Founded by Alex Simple, SFS started off small, renting furniture to those who could not afford to buy it outright. After a while, they noticed that most of their clients were paying in cash, and when they asked "why?", they discovered that most of their clients could not qualify for a credit card. This gave Alex a great idea. He could help them get financing by issuing his own "Simple Cards" and "Simple Loans". His customers could also use their Simple Cards/Loans to improve their credit scores and then qualify for cards and loans with their banks or credit unions. Better yet, these customers could use their newfound credit at his stores to buy more furniture or even book a vacation through his other business - Simple Vacations.

Starting off in the Toronto area, Alex soon found himself expanding all across Canada. Business was good around Toronto, but there was too much competition. Too many banks and payday lenders. Even his staff told him - "We know furniture, and we know our clients, but we don't know much about financing. Maybe we should get some people from the banks to help us grow and compete better?"

Alex listened and did try to hire some loan officers for the Toronto area. But, when he compared the margins in his Toronto stores to the smaller towns outside of the region, he found that those in the smaller towns were like gold mines. Loan officers or not, business was booming, and he simply couldn't open more stores fast enough!

One year, his accounting firm, Medium-Sized LLP, came to him and he said: "We just can't keep up! You have too many locations, and we just cannot make it out to all of them." Alex told them that the smaller towns were "practically printing money" for Simple Financial Solutions, and they were better off focusing on the Toronto area where business was slower and he needed an edge over his competitors.

The next year, Simple opened 20 more branches across Canada, as far West as Surrey, and as far East as St. John's. The partner from Medium-Sized LLP called Alex to congratulate him and then told him: "I think you should call one of the Big 4 - you've outgrown us!" Alex thanked the partner for his work and then proceeded to call Bigger-Than-Most LLP, one of the largest firms in the world and asked them to take over the audit.

Bigger-Than-Most LLP met with SFS and mapped out what the audit should look like. The largest branches were in the Toronto area and they should focus there. The partner, Sarah, tentatively agreed but she also noticed that when she added just a few smaller branches together on the East Coast, their revenues were almost at the same level as Toronto. She asked Alex and his team about this. "Isn't it great?" Alex responded. "These guys are gold mines! And almost no competitors out there!"

Sarah wasn't so sure. "When was the last time you went out to see your new offices?" she asked. "Oh, we always plan too," replied Alex, "but then we find a new market and go to open up a new one! Can you believe we will be in all 10 provinces by the third quarter this year?" Sarah responded: "While I am very happy for your success, we do need to visit a few of them to get a full scope for our audit." Alex shrugged and said: "Sure, just don't get in their way. These guys are busy making our business boom."

Sarah took the information from her meeting with Alex back to her team, and told them all to book some flights. They were going to go see these "gold mines" for themselves.

After the first-year audit, her team came back from the smaller towns rather bored. "Not much going on out there on the East Coast," one of her seniors said. "All quiet on the Western Front!" One of her managers told her. The branches were largely empty when they went to visit them. But there were signed loan and credit card agreements, and money kept being lent out to customers. No news seemed like good news to Sarah. To keep the client happy, Sarah let solving the mystery of better small town performance go "just this once", and started focusing on next year. For bringing in such a large client, she may even make a managing partner one day.

Two years later, SFS had their worst year in history. Loan default rates jumped up as high 45% in some branches and people failed to pay on time. Alex started to hide under his desk every time the phone rang. It was always bad news.

The only branches that seemed doing okay were the "lousy" Toronto ones. "It must be the recession," Alex told his team. "Those small towns just can't catch a break!"

Sarah wasn't sure anymore. She was stretched so thin on her audit clients that she phoned her friend Ray at Almost-As-Big-As-Us LLP. Ray was a Forensic Accountant, and he didn't trust anything he couldn't see with his own two eyes. Ray and Sarah spoke about Simple Financial Solutions, and Ray listened carefully. At the end, Sarah let out a huge sigh, and asked: "So, what do you think?"

Ray only asked one question: "How do three towns with a population of maybe 100,000 people outsell Toronto and Mississauga with over 3,000,000 people?" Sarah was stunned. "I mean, good news is good news," Ray continued, "but doesn't common sense tell you that it's a little too good?"

Later that year, Alex' Board of Directors was tired of the bad news and called in Ray's team of forensic accountants, who flew out to see every single branch of Simple Financial Solutions. What they found made Alex resign as the CEO of the business he started. The smaller branches, who were never visited, found out that they could issue loans to almost anyone they wanted... on paper. They could issue the loans to themselves even, and as long as they paid a bit of interest, no one ever noticed. After all, who would question all the good work they were doing to get the business booming?

Questions:

1. What did Sarah at Bigger-Than-Most LLP miss in her initial assessment of SFS? What should she have been more skeptical of after the first-year audit?
2. What tools did Ray use to prove his skepticism?

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>.