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Soft Cues and Hard Evidence: What to Look for When Things Look Too Good

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Research has shown that forensic accountants and auditors must possess certain skills and abilities that avoid routine behavior in audits. This requirement means that an accountant must have the abilities to notice the unusual, to use unstructured problem-solving skills and critical thinking, to perform audits with flexibility, to have the composure to calmly continue the investigation, and to understand the legalities required to successfully bring a case to justice (DiGabriele, 2008). No longer can auditors wear blinders by continuing routine audits without noticing the unusual behaviors that lead to discovering malfeasance (DiGabriele, 2011). Auditing education has centered on the professional rules of conduct, specific audit techniques, planning the engagement, and studying internal controls.

Although the concept of internal controls dates back 30,000 years to the tally stick (Apostolou and Crumbley, 2008), some are reluctant to understand how internal controls must be tested and evaluated to be relevant. Instead of following prescribed procedures year after year, all auditors must be aware of small cues that warn of potential problems in financial operations and reporting (Terrell, Terrell, and Herron, 2011). Forensic accounting requires a departure from the normal procedures and the recognition that small cues might hide major problems because fraudsters are very clever. Rezaee, Crumbley, and Elmore (2004) found that educators believed cases and textbooks were the most effective means of teaching forensic accounting.

The case of the Gravois Bank and Trust is based on a series of actual frauds perpetrated over a period of six decades. Two examiners uncovered the fraudulent behavior during an otherwise typical training assignment involving an experienced Commissioned Bank Examiner (CBE) and a trainee bank examiner. Their discovery process developed from the application of certain audit practices and procedures, and their judicious attention to details. Only the names of parties involved, and the geographic locations have been changed to protect the identities of many innocent parties. The actual facts of the case remain true but have been summarized in some areas. Due to the complexity of the crimes and the long timeline of events, however, facts about the individuals are included that were not brought out in the trial but were discovered by the examiners during the course of their two-year investigation. Readers might think that this case study is too long, but instances of fraud are rarely singular events. Rather, each fraud seems to be woven into a story of its own. Learning to suspect, detect, and decipher those stories is a large part of fraud examinations.

The case study is presented in two parts. The first part is the bank history where you are introduced to the bank examiners and learn the background of the bank's development along with its descent into the various frauds. Part two focuses on the process of fraud discovery and evidence gathering by the examiners. Footnoted hints also are provided that highlight important insights into the auditing process.

In early 1994, Eddie Coello and Lynne Kristopher drove along at daybreak on a bleak winter morning, on their way from the Federal Reserve Bank (FRB) of Minneapolis to inspect a small bank in Gravois, Minnesota. Lynne, a recent Ivy-League college graduate, was smart, articulate, and motivated—intending to rise through the Federal Reserve's ranks as quickly as possible. She planned to transfer to the Board of Governors within three years as a Commissioned Examiner, although commissioning usually took longer. Unknown to her trainer, she requested him because he was reputed to be thorough and had been commissioned in less than three years, and she wanted to know how he did it.

Eddie Coello, her trainer, came from a tough, inner-city neighborhood where he had observed many criminal acts and actors, from petty crime to occasional felonies. Statistically, he should never have graduated from high school or his second-tier state university. Grateful for his good fortune to survive his upbringing and receive the opportunity to work for the Federal Reserve, however, he never stopped pushing himself to work harder and smarter than others.

As they drove, Lynne peppered Eddie with questions about the job—the institutional profile, management structure and governance, financials, strategic plans, prior examination data (especially the confidential sections not disclosed to the public), history, correspondence files, and so forth. He was visibly surprised at so many questions from a trainee. "It's a training assignment of a very small bank," he said. "Don't expect too much at first. We probably won't find much. If you like, as boring as it'll likely be, we'll make sure you have the full examination experience. But you'll have to do a lot more work." Lynne readily agreed stating, "work has never been an issue with me. I graduated Magna Cum Laude in three and one-half years with a double major in accounting and finance." "Not bad," thought Coello and, "not the usual trainee at all."

During the four-and-a-half-hour drive, they spent most of the time discussing every possible matter of the assigned job, plus audit strategies, pre-planning, and such. After the first hour, Eddie suggested, "When I was in your seat, I kept a journal on me or used a small recorder all the time. The most experienced people won't be around you forever. Learn everything you can from them, about anything and everything, but make sure it's not just conversation that you may not remember later on."[1]

Q1: What are the similarities and differences between the work of bank examiners, internal auditors, and external auditors?

The Gravois Bank and Trust (GBandT) occupied the most prominent building along Main Street in the southeastern Minnesota town of Gravois and was chartered in early 1929. Despite its unpromising opening year, the bank survived the Great Depression largely because it was too new to have very many loans on its books to default. By chance, its only competition was an already established bank with a robust loan portfolio, which soon became insolvent following the great crash and was closed. Without competition, GBandT grew with the town for quite a long time. Still, when environmental laws began to make local coal mining unprofitable, and the prices of agricultural products fell, young people started to leave Gravois – taking their deposits and loan needs with them. The town grew older, literally and figuratively, and eventually the number of pensioners outnumbered working adults by almost two-to-one. Similarly, GBandT grew old with the town.[2]

GBandT was a family-controlled and operated institution. Founding President Jessie Smith was an upstanding citizen and banker who employed his two sons at the bank from the very beginning. His elder son enlisted in the army during World War II, earning two purple hearts and a bronze star before being killed in battle a few months before the war's end. Heartbroken, Jessie gradually lost all interest in the bank. Alternatively, his surviving son, Wesley, preferred to remain state-side during the war, where the opportunities for social and monetary advancement increased proportionately as the supply of young patriotic men dwindled. Wesley increasingly assumed more of the managerial duties of running the bank from his grieving father, eventually taking over the bank's management before Jessie's death in the late 1940s.

However, unlike his conservative and staid father's business practices, Wesley had more of a gambler's mentality. He often chose to risk loans to marginally solvent borrowers, for example, especially when potential profit margins for the bank were high. With his gambling spirit, he also looked for new business opportunities only loosely linked, if at all, to banking. He believed that business (like anything else in life) was a game like any other, where the only real objective was to win. The prize to be won, of course, was money which, especially in a small town, led to power.

Wesley had a talent for understanding and manipulating rules, so bookkeeping and regulatory guidelines placed no real constraints on his business strategies. He became a master at off-book banking and would often engage in non-documented handshake deals, using cash transactions and money orders whenever possible to avoid anyone tracing his activities. His off-book banking may involve receipting, but not recording, a large customer deposit, then making an equity or debt investment in a business that he, or someone close to him, owned. Worse, the deposit customer may have been unaware that his deposit was not legally booked.

Other times, Wesley would locate a business opportunity and have others listed as the owner of record while borrowing money from the bank. A variation on this theme was to have family or friends borrow more money than needed for their legitimate business interests, and let Wesley use the excess funds for his own purposes, so long as he committed to paying back both principal and interest on the funds he used. Sometimes, in fact, unrelated borrowers did not even know that their official loan balances were more than they intended to borrow, because Wesley would simply add an amount to their requests

[1] Hint: Trainees should recognize that the responsibility for learning is theirs—and that trainers are assigned only to assist their learning.
[2] Hint: Adverse structural economic changes should alert fraud examiners and auditors to the potential for increased pressure to commit fraud.

for his own use. This sort of sophistication required not only a double set of accounting records but also rigged documentation records.

Wesley subscribed to the view that the smartest cat in the jungle should be allowed to live life on its own terms. Any game playing was a necessary part of life because he was limited in his self-dealing under regulatory rules and guidelines for banks. In a sense, he thought, it was the regulators' fault he had to go to such lengths to conceal his business dealings! Besides, he rationalized that he would repay the loans from the profits of the new businesses, so no one was really harmed in the deal.

Wesley also would create "handshake employment opportunities" to repay personal debts or pay for personal acquisitions by hiring creditors' friends or relatives at GBandT. The bank, therefore, paid his bills – but, since the payment scheme was couched in terms of an operating expense for the bank, the after-tax cost was lower than it would have been to him personally. The actual amount of work done by those temporary employees, moreover, was a negotiable arrangement. When asked if he was worried about being found out or charged with misdeeds, he would reportedly respond, "Let 'em prove it. There's not much of an audit trail to follow."

Proof of any wrongdoing would, indeed, be difficult to discover. Not only was there an inordinate number of cash or near-cash transactions, but the bank's part-time internal auditor was a relative, as was the bank's chief accountant. The head teller, Vice President in charge of lending, branch manager, and even the janitor were also relatives. Every other employee working for the bank, in fact, was either a friend or a close relative of Wesley's friends and business associates. Although this practice was inconsistent with good internal controls, it was a small bank, and local people believed Wesley was just trying to lend a helping hand to many of the townsfolk. Whenever auditors or other outsiders discovered accounting errors, Wesley could always blame his poorly educated, elderly cashier, Miss Hansen. Yet, Wesley explained, he couldn't bear to fire or retire her. After all, where else could she find a job, after all?

People seemed to feel compassion for "poor ol' Wesley," trying to succeed in small-town banking while employing so many people who were unlikely to find work elsewhere. Not surprisingly, his sympathetic persona, coupled with a reputation for resourcefulness in financing most business proposals brought to him, cast him in the role of local hero. The few who did not understand his reluctance to make necessary changes, or who refused to accept his excuses for improprieties, eventually left him alone after he sincerely promised to make necessary reforms. At least, he'd vow to do his best while operating in such a small town.[3]

GBandT's loan portfolio grew rapidly during Wesley's reign, although his managerial practices sometimes bothered more conservative bank examiners or auditors. But with a few relatively simple tactics, Wesley was always able to handle them. His favorites included providing them with snacks and beverages throughout the day, 'slow walking' necessary documentation, and arranging special discounts for "government workers" or "Wesley's friends" at the local diner. Wesley learned early on that well-fed people are more content and less likely to complain – seriously, anyway. Also, he knew that people cannot really work when they are eating or waiting. Most auditors and examiners have a limited time schedule, after all, so wasting their time by having them wait (even on legitimate documentation) meant less time for possibly more controversial matters. Ingratiating himself with them was also effective because, as he said, "Folks will give you the benefit of doubt if they like you, and folks especially don't like to criticize people they like."

Q 2: What is social engineering? In what ways did Wesley exhibit social engineering?

Although Wesley was a shrewd businessperson, he sometimes gambled on questionable loans or investments and lost. Even his public persona could not mitigate those problems. Early in his tenure at the bank, he lost a large amount when a commercial real estate project failed and could only be sold for a fraction of what he had loaned on it. Coincidentally, that was when he decided to marry Mary Lynne Hudson; daughter of the wealthy and locally prominent physician, George Hudson. Dr. Hudson became a shareholder of GBandT shortly thereafter, buying approximately 25 percent of the bank's stock, and probably saving it from insolvency.

[3] Hint: Poor internal controls (especially ongoing), nepotism, frequent cash or near-cash transactions, and excessive CEO influence in day-to-day operations should alert fraud examiners and auditors to the potential for individual and/or collusive fraud (Rezaee and Crumbley, 2007; DiGabrielle, 2009).

To Wesley, marriage was like business; largely another game to be played. So, his feelings for Mary Lynne certainly did not prevent him from living life on his own terms. He made frequent, though dubious, business trips to Minneapolis and Chicago before and after marriage, for example, where he enjoyed a decadent life. Notably, neither bank examiners nor auditors ever seriously questioned the reasons a small-town Minnesota banker needed to visit those cities for legitimate business purposes. To Wesley, their reserve amounted to implied approval of his costs.[4]

Wesley thought he had the best of everything, except for an heir to his empire, but the couple had only one child – a daughter, Francis Ellen (Ellie). Ellie grew up away from her father's personal or business affairs, but she heard enough whispers and rumors to suspect that he was less than a conservative businessman. Still, she tried to be obedient to her parents' wishes—even in the selection of suitors. Ellie had dated two or three young men whom Wesley did not like because they lacked what Wesley called "street smarts." One fellow, though, who had shown an interest in Ellie while he was working as summer help in the bank was more to Wesley's liking.

James J. Johnson, or J.J., grew up in Gravois. He was an especially athletic, if academically challenged, student. As a very personable local sports celebrity, though, he could choose to work at any of the local businesses during his summers but selected GBandT; at least partially due to Ellie Smith. Ellie represented a lifestyle that J.J. could only dream about; money, prestige, and social opportunities. J.J.'s family was poor since his father had died when J.J. was only twelve, and J.J. always yearned for a father figure to mentor and advise him. He thought that Ellie had the kind of father a guy could only wish for; a smart, self-made man of wealth, whom everyone seemed to like, and nobody dared to cross.

Wesley and J.J. hit it off immediately. Ellie was initially reluctant to date J.J. but her father's persistent praise of the young man, and his popularity, led to their marriage eighteen months after high school graduation. To her, it was an agreeable-enough pairing. To him, it was the chance of a lifetime.

At the bank, J.J. started at the bottom, working up through the various bank positions. J.J. seemed to thrive at the bank, and he was eventually promoted to commercial loan officer and then Vice President of the bank. He reached VP in about ten years, and it was a well-deserved promotion. Moreover, the townsfolk loved seeing the rise of J.J. Johnson, and they loved Wesley even more for making J.J. "work for a living."

J.J. thoroughly enjoyed working in the bank, and especially with Wesley. Of course, J.J.'s work titles were only meant to be a formality to appease onlookers and bank examiners, because J.J. was always paid more than enough to support him and Ellie quite comfortably. But J.J. sincerely liked to move through various departments on his way up the ladder and learn as much as possible from Wesley about each of those areas. J.J. may not have been an honor student in high school, but he was a clever and intelligent man. Wesley also was pleased to have someone to teach all that he had learned throughout his banking career.

Wesley treated J.J. like the son he never had and reveled in J.J.'s success at improving on, or even expanding, Wesley's own schemes. J.J. learned everything about how Wesley handled his business, including an occasional business trip to Minneapolis or Chicago. The two were apparently cut from the same block and became inseparable until Wesley's death in the early 1960s, only two years before Mary Lynne's untimely passing away.

J.J. and Ellie had three healthy children – James Jr. ("Jr."), Sandra ("Sandi"), and Albert. J.J. proved to be a doting father, especially protective of Sandi. Alternatively, he set about training his sons in the family business – passing on the tactics he had learned from Wesley, as well as his own ideas. He also let them test their own business skills by setting up small, undisclosed companies that were usually funded either directly or indirectly by GBandT, much as he and Wesley had done. At the appropriate time, too, J.J. also began taking his sons along on his dubious 'business' trips. It may have been during one of those trips in the mid-1980s when J.J. discovered that Jr. lived an alternative lifestyle. Fearing the shame to which he might be subjected more than anything else, J.J. banished his son from his presence for many years. While the local folks seemed to understand and even sympathize with J.J., Ellie could neither understand nor tolerate J.J.'s actions.

During the ensuing disagreements, Ellie told J.J. that, if he insisted Jr. leave their home, she would do likewise. J.J. responded that he no longer needed her, and even told her the true nature of his business trips. In fact, so far as he was concerned, she was no longer welcome in his home, his life, or his bank. Reportedly, years earlier J.J. had convinced her

[4] Hint: Frequent, and even infrequent but apparently unnecessary, business expenses are often symptomatic of fraudulent activities.

that he was viewed as a “kept man” in the local community, and it would be better for the family business if Ellie transferred her ownership of the bank to him. It seemed a small matter to her at the time, and now it was too late.

Still, Ellie promptly moved out of their home but, in defiance, kept her seat on GBandT’s board of directors. During a board meeting several months later, however, their feud came to a head when Ellie announced she was leaving J.J. for another board member, Clinton Ferris, M.D. Dr. Ferris had acquired Dr. Hudson’s holdings in the bank about three years earlier.[5]

When Ellie filed for divorce, J.J. initially refused to agree to alimony payments. After reminding J.J. of her knowledge about his off-book banking schemes, however, he agreed to payments – but on his own terms. Ellie relocated to California and found work in another bank as an administrative assistant. Yet she officially retained her seat on the board of GBandT and received $6,500 in tax deductible “director’s fees” for each monthly board meeting – whether she attended or not. GBandT also reimbursed Ellie for her travel and other expenses when she flew back to Minnesota to attend the meetings, which she did when they coincided with one of her children’s birthdays or a major holiday.

J.J. skirted the issue of payments to Ellie in two ways when dealing with bank examiners or auditors. First, he formed a shell bank holding company (BHC) to purchase the bank as its sole asset. Then he then moved the payments to Ellie from the bank to its new parent company, which was examined and audited much less frequently than was the bank, and by a different group of regulators. Legally, then, the payments to Ellie were not bank expenses, per se, and could not be questioned by bank examiners or auditors. Only BHC inspectors could question the payments, and their visits were relatively rare (for a ‘shell’ holding company). J.J.’s other stratagem was to argue with the BHC examiners that, given her long tenure at the bank, Ellie provided an important and necessary knowledge base of the local market.

Small, shell holding companies were generally considered only marginally important to regulators and, following the SandL and farm debt crises, received scant attention unless there was reason to believe that serious abuse was occurring. Consequently, J.J. jousted with regulators over the payments to Ellie essentially through the mail. He successfully convinced the examiners that the payments were legitimate and/or relatively insignificant. Emboldened by this success, however, J.J. considered moving other operations “upstream” to the books of the BHC, such as payments or activities that bank regulators could not and would not overlook at the bank.

J.J., like Wesley, had funneled bank funding into many business ventures on his own behalf, but for the most part, he failed to report them to banking regulators. These included every sort of small-town business including restaurants, shops, kiosks, used car dealerships, furniture stores, handmade brooms, antique shops, and the like. Normally the business was in someone else’s name so it could not be connected to J.J. Required reporting of personal business interests is a regulation aimed at preventing bankers from self-dealing. Otherwise, bank owners could effectively loan their own business interests (i.e., themselves) a multiple of their supposed investment in the bank. Then, on a net basis, they would have contributed nothing at all to the bank’s capital – or may even have a net-negative investment in the bank on an effective basis.

J.J.’s method of operation was secretly funding his own business interests. He was reasonably successful in financing those ventures, so his next logical step was to finance fictitious businesses. Concealment was relatively easy since audit sampling techniques were known to him, and small loans were scarcely reviewed by auditors or bank examiners.

Early on in the 1990s, J.J. became increasingly interested in health and pseudo-health businesses – especially tanning and toning equipment. These businesses were not counted among a bank’s prime borrowers, because they were usually only marginally sound, due to high overhead and equipment costs along with a low fee structure. After visiting a few trade fairs to examine the equipment, though, J.J. began to hatch his greatest scheme.

J.J. learned that some tanning salons diversified their risks and income streams by expanding into toning equipment to help (mostly) convalescent people strengthen their bodies. To J.J., the idea of bringing additional market segments into these small salons seemed almost perfect. After all, diversification could lead to larger operating margins, maybe even enough to properly service their debt loads. For smaller operations, though, financing would continue to be a problem. J.J. considered

[5] Hint: Unprofessional public behavior of personnel, especially by executives should alert fraud examiners and auditors to potentially increased pressures that may eventually contribute to committing fraud.

carving out a market niche for GBandT by financing tanning and toning salons throughout the north-central U.S. The local economy had been stagnant for several years, after all, and J.J.'s idea was a relatively novel way for the bank to grow.[6]

Using the bank holding company as his vehicle, J.J. decided to blitz the midwestern market for GBandT to offer business financing for tanning and toning salons – through either direct loans or lease financing. He developed a team that worked national trade shows to entice attendees to enjoy the benefits of owning their own businesses – largely financed, of course, by GBandT. Easy financing for the borrowers meant that the terms were especially favorable to the bank. Simultaneously, J.J. personally set up a "consulting" arm of the operation to advise new business owners on beginning and/or running their own small businesses and started to franchise his own business model to those who were reluctant to fly solo. His largest contrivance, however, was to set up a manufacturing business to produce the equipment he would eventually finance.

In summary, J.J. would control an ostensibly independent manufacturer of toning equipment and then, in turn, provide loan funding to borrowers wanting to purchase that equipment. If purchasing the equipment entailed too much risk for some salon owners, as it did for many, he would set up a leasing company funded by GBandT that would purchase the equipment and lease it to the salon owners. He would also reap consultants' fees for helping establish many of the businesses. Finally, he would covertly own a few of the franchised operations himself.

Truly, the scheme was magnificent: J.J. would benefit indirectly through the bank's formal loan and lease financing and directly through the manufacture and sale of equipment, consulting and franchise fees, and franchise ownership. As usual, most of his direct benefits would be based on undocumented hand-shake transactions so no one, especially the banking regulators and auditors, would be the wiser. Being cautious, he secretly borrowed money to fund a few of his own franchised salons from other banks, using fraudulent financial data to obtain the personal loans.

J.J. estimated that there was a very low probability that things could go wrong with his scheme. Even if the loans and leases went bad, he could space the write-offs so that the bank's bad-debt allowances merely offset what otherwise would have been paid in income taxes. Plus, repossessing the toning equipment from failed operations would allow the bank to recycle equipment through other salon owners and franchisees, recovering their losses through resale.

Q 3: What is the computation for determining taxable income for a bank?

Bank examiners disliked the loan and lease operation from the start, but since it was initially profitable for the small-town bank they decided to "wait-and-see." By the time the default rates for the loans and leases began to escalate, J.J. forestalled their criticisms by preemptively abandoning the business and humbly admitting that "maybe I made a mistake." GBandT had to realize some substantial losses, of course, but behind the scenes J.J. managed the write-offs so that they merely whittled away at the bank's annual tax bills without it effectively costing the bank very much on a net-after-tax basis. Meanwhile, he continued to benefit from his direct business ventures.

The regulators were appeased by J.J.'s repentance and promise of reforms, including his willingness to recognize the substantial losses without regulatory pressure and his offer to step down as CEO. It appeared that J.J. was doing all he could to remedy the situation. As it seemed unlikely that anyone would deliberately jeopardize their biggest investment – the bank![7]

However, J.J.'s repentant nature and promised reforms were all part of a well-conceived contingency plan. Even his offer to step down as CEO was contrived because he had already planned to officially pass the reigns of management to either the bank's Vice President in Charge of Lending, his first cousin, or to the Executive Vice President in Charge of Operations, his second cousin. Meanwhile, he would retain his position as CEO of the bank's holding company. In reality, no decision would ever be made at the bank without J.J.'s prior approval.

Q4: Why would shareholders (like J.J.) wish to "borrow" their own equity?

J.J. realized that he was having problems when his hand-shake business partnerships began to disintegrate. He had set up a manufacturing company in New Jersey, where he found two unscrupulous fellows with whom he felt he could do

[6] Hint: Material changes in either the mix or rate of change in balance sheet and/or income statement accounts should warrant investigation. Immaterial differences, however, should be examined when other indicators of misconduct are present.

[7] Hint: Nominal acts or promises that result in little or no real or effective change should alert examiners and auditors to increase the scrutiny of accounts and transactions.

undocumented business. Things went well as long as orders for the low-grade-but-high-priced equipment escalated. However, as the equipment orders eventually slowed, there was not much money left over after J.J. paid himself. Before too long, J.J.'s partners unilaterally dissolved the partnership and pressed J.J. for more money. J.J. had little fear of his business partners turning him in, though, because each partner had dirty hands of his own – and would be reluctant to speak to any law enforcement agency.

A more direct threat was another undocumented business associate whom J.J. had hired to manage (i.e., ostensibly own) J.J.'s franchised salons. Jerry Long was J.J.'s life-long friend and agreed to own (in name only) and manage (in fact) certain businesses. After several months, however, Jerry and J.J. had a falling out and, thereafter, Jerry began treating the businesses as if they actually were his – taking money from the cash registers, hiring his own friends and relatives, occasionally firing J.J.'s hires, and generally becoming an expensive nuisance. Yet little could be done because Jerry technically owned the business.

Finally, J.J.'s own sentimentality contributed to his eventual downfall. His eldest son, James Jr., had lived away from home ever since J.J. had thrown him out several years before. Through his ex-wife Ellie, J.J. learned that Jr. had contracted a potentially terminal disease and needed health insurance to prolong his life. J.J. not only invited his son back into his life, but he concocted yet another business that would allow him to provide group health insurance coverage and good salaries to both Jr. and his partner.

J.J. set up Jr. and his partner in a credit analysis business to 'independently' provide credit analysis for the tanning and toning equipment leasing operations. Since neither had any prior experience in that profession, GBandT staff secretly provided them both with free training before hiring the company to provide credit analysis services for the bank. The credit analysis business was informally owned by J.J., but officially registered in Jr.'s partner's name. Long-term contractual payments to the (ostensibly) independent credit company were shifted to the BHC. Those payments continued for another two years – even after J.J. essentially shut the loan/leasing operation down to mitigate bank examiners' prior concerns.

By the time the loan and lease operation had run its course, J.J. had made a very large sum of money and was even thinking of retirement. In total, J.J. and some of his associates had engaged in hundreds of frauds and instances of insider abuse of banking operations, including:

- loan fraud (one fraud for each borrower and lessee, one for each fictitious business loan, and one for each of J.J.'s personal loans to finance his own undisclosed salons);
- financial statement fraud (on average one fraud for each case of loan fraud, plus one count for each bank and bank holding company financial statement submitted to regulatory authorities);
- failure to report insider loans, either direct or indirect;
- failure to report executive business interests;
- deliberately concealing material facts, deceiving and lying to Federal banking authorities;
- tax fraud—both at the personal and business levels.

J.J. had relied on collusion, cash (or near-cash) transactions, and undocumented business arrangements to carry out his schemes. Even experienced bank examiners and auditors would find it difficult to overcome those tactics. J.J. had also successfully relied on a keen understanding of materiality levels and, importantly, auditing procedures and practices of bank examiners and auditors. He was especially aware of their reluctance to talk to one another, to venture off-site to compare notes with others, or to physically check the value and veracity of collateral. Furthermore, he usually divided large frauds into very small, related frauds and criminal acts that generally remained under the radar of bank examiners and auditors.

The discovery of fraud began to unfold because Eddie and Lynne returned to a principles-based examination, which set materiality levels extremely low. Ordinarily auditors and examiners would not revert to low levels of materiality without some solid evidence of criminal wrongdoing – except in the case of a training exercise. Additionally, Eddie believed in assessing non-financial evidence and evaluating the veracity of collateral values. J.J. had fortified himself against the risks from standard examiner and auditor investigations. However, his fraudulent escapades ended as the result of an innocuous training exercise.[8]

The examiners arrived in Gravois a little before noon and after checking into their rooms at the Gravois Inn and having a light lunch, found their way to the bank by one o'clock. "The first thing I like to do," Eddie instructed, "is to meet with the CEO and talk about the bank. You should discreetly take notes while I talk, but don't be shy about joining in with your own questions." [9]

The examiners found the GBandT bank management team to be very friendly and more than willing to discuss the affairs of either the bank or its BHC. The intent was to make an outsider feel welcome in J.J.'s little world. J.J. was a very likable person, known for his hospitality, like Wesley before him. Consequently, much of the bank's colorful history was widely known and relayed to the examiners. In that atmosphere, it was unusual that J.J.'s replacement at the bank, CEO (and J.J.'s second cousin) Gary Smith, seemed hesitant to meet alone with bank examiners. Gary attended introductory and initial meetings, although always with other bank officers in attendance, during which examiners verified off-site financial analysis and generally discussed strategies, plans, market opportunities, and impediments. However, at subsequent meetings, J.J. was always present and was obviously the dominant bank representative, answering questions and speaking on behalf of the company, although officially he had voluntarily stepped down from bank management more than a year prior.

Meetings with the bank's supervisory staff would usually suffice when examiners were looking for abnormalities under normal circumstances, but this particular bank audit was a training assignment. Consequently, the training process warranted that the trainee had at least some exposure to CEO meetings – if only to discuss general strategies, business plans, and rationale for prior decisions. Meeting with the CEO alone was the first point of departure from prior, ordinarily routine, work at GBandT. It soon became clear to the examiners that the bank staff was actively *preventing* Gary from meeting alone with them. This action was the first inkling Eddie had that something was amiss – and one of a growing list of inconsistencies between financial and non-financial data.

If Gary was, indeed, CEO of the bank, why didn't he have some vision of where the bank was heading? And why didn't he want to share that vision with the examiners? Ordinarily, CEO's talk behind closed-doors with regulatory and external auditors about business plans and the like – if only to get an informed outside opinion, or at least use them as sounding-boards. Additionally, he did not seem to have an adequate explanation of how the bank became involved with the credit analysis company, nor the relationship between their financial analysis and eventual credit losses sustained by the bank. Overall, he did not act like the CEO – neither in his actions, body language, demeanor, knowledge, or apparent confidence. That is, unless the conversation turned to his farming interests or his family. During those times, he seemed much more relaxed, lively, and sincere – both physically and verbally. [10]

Q 5: How could examiners or auditors have tested the suspicion that bank staff were actively preventing Gary Smith from meeting alone with them?

Q 6: Why would bank staff want to prevent such a private meeting and what were the possible concerns of the staff?

Q 7: Since Gary attended initial meetings, was it even necessary to meet privately with him?

Q 8: Why were examiners suspicious of Gary? What were they possibly suspicious of? Would this episode likely make them suspicious about other matters?

The bank's credit portfolio (including leases) was increasing by about three and one-half percent per year, in a town predominantly populated by retirees. This latter point was observed by examiners while walking around town after lunch

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[8] Hint: Dramatically lowering materiality levels may disrupt and/or reveal small-unit frauds. Auditors should always use random variations in materiality levels from year to year (Terrell, Terrell and Herron 2011). Non-financial evidence should always be assessed vis-à-vis financial evidence, and vice-versa. The veracity of collateral documentation and estimated values should be assessed at least on a sampled basis.

[9] Hint: Try to ensure that more than one examiner/auditor is always privy to all interviews, and that any notetaking is done discreetly.

[10] Hint: Contrary to popular notion, a substantial part of auditors' and forensic accountants' work involves interviewing and otherwise communicating with the auditees' staff (DiGabriele, 2008). Consequently, examiners or auditors should be trained in, or familiar with, kinesic interviewing tactics. Body language is an important non-financial form of evidence that may lead to better analysis of financial evidence.

and discussing local demographics. Coello verified his observation by chatting with the manager of the local grocery store, where the examiners stopped to purchase an after-lunch snack. The manager disclosed that about two-thirds of his customers were Social Security recipients. A check of county demographic records substantiated his estimation. The discussion and subsequent verification left examiners wondering why relatively significant loan growth would emanate from a bank in such a community, in which one would guess that incurring debt would be limited. Consequently, they determined to scrutinize the bank's loan portfolio more carefully. [11]

Q 9: What evidence would lead a person to think of Gravois' population as "older"? Is a loan growth of 3 percent per year consistent with a large retirement community? Why or why not?

Q 10: How would non-financial clues about the bank management and the community create suspicion in auditors/examiners?

Q 11: What other questions about the loan portfolio might emerge from learning more about the community?

Items written off against the loan and lease loss reserves negated about two-thirds of taxable earnings, so the effect also reduced income taxes to near zero. Most credits were either small consumer loans or relatively small commercial loans for local businesses – including car dealerships, small shops, grocers, and appliance stores. The main exception was the tanning and toning loans and leases which were all out-of-town customers. Regardless of loan purpose, J.J. boasted that (except for the one glaring mistake), his loans were generally above reproach. Judging from the low average of past-due balances within the portfolio, he seemed to be telling the truth. Still, there were a large number of loans that, on balance, resulted in a loan/deposit (accounts receivable/customer deposits) ratio of about 72 percent. Again, that seemed relatively high in a town dominated by retirees. But since asset quality was good (except for the tanning/toning loans and leases), not much notice had been (historically) taken of the portfolio.

Physically checking collateral is not a customary part of audits/examinations. Business loans are primarily based on borrowers' cash flow, and collateral tends to be regarded as no more than a tertiary source of repayment. To warrant physical checking of collateral, the collateral and/or circumstances would generally have to be somewhat unique (for example, expensive or giving reason for suspicion of fraud). Thus, collateral reviews usually entail little more than a documentation review to ensure that banks hold legally binding liens with a sufficient (bank-determined) market value estimate.

The training focus of this examination, however, seemed to warrant physically checking collateral, especially collateral related to the tanning and toning equipment. One of the junior bank officers escorted examiners to a small warehouse where repossessed equipment was stored. The equipment was literally piled in the building as though it was not something of value. Indeed, it appeared to be very inexpensively made. The examiners guessed (and later verified) that cost of construction would be no more than \$300–\$800 per unit, compared to the bank's retail valuation estimate of \$3,000–\$8,000. [12]

Inquiries about the manufacturer, after an unusual delay, showed that the equipment had been built in a facility in New Jersey. Further inquiries, through public records, indicated that the manufacturer no longer existed. In an unusual, but not inappropriate tactic, Coello then called the two principals and learned that one had been imprisoned for a violent crime, and the other indicated that he planned to "disappear" – and so should be left alone. The list of anomalies continued to grow.

Q 12: What are the usual audit/examination procedures for reviewing bank loans? How could these procedures be modified to investigate examiners' growing suspicion that something was somewhat unusual at GBandT?

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[11] Hint: Understanding an audit/examination client should include an understanding of the business' geographic, historical, economic, and cultural circumstances. Friendly discussions with local people should avoid confidential subjects but can often be a source of non-financial information pertinent to an audit/examination.

[12] Hint: Examiners/auditors should understand that formal documentation can be easily forged, so the veracity of such evidence should undergo some physical examination, at least on a sampled basis. Collateral should be examined with regard to its current value as well as the likely original value on which credit decisions were made. This examination provides valuable insight into the client's evaluation processes and internal control.

Q 13: How might examiners get a better estimate of collateral valuation, especially without arousing bankers' suspicions that the examiners were beginning to suspect fraud? Which public records may examiners check to verify business activities?

Q 14: What are the accounting transactions journal entries for building up the allowance for loan and lease losses? What is the accounting journal entry for writing off bad loans and leases?

A shell BHC is a company with few or no operations outside of holding a bank as its sole or primary asset, and the debt to purchase the bank as its primary or sole liability. Similarly, the typical BHC income statement largely shows the BHC's primary source of income in the form of dividends from subsidiary bank and expenses in the form of interest expense on the long-term debt used to acquire the bank from its shareholders. Generally, the shell BHC would exhibit little or no net income and would frequently report small losses. Consequently, it is usually a relatively easy matter to audit all holding company transactions and balances.

Notably, the income statement disclosed consulting fees and rent expenses (in and around Minneapolis, an apartment and office space in Chicago) that were unusual for a small-town BHC. J.J. explained that the BHC wanted to expand into other tangential businesses, such as processing the billing for other service businesses and setting up a mortgage loan processing facility. To do so, he argued, they had to have some presence in more populated areas. That factor, in turn, required that the BHC rent office space and, to save money, rent an apartment for housing J.J. and other bank officers while working in the area.

Regulatory correspondence and reports filed by the bank failed to mention any bank properties outside Gravois. Even though examiners would usually investigate only the documentation surrounding any such non-banking activity, the training nature of the exam also warranted an on-site visitation. The rented premises were found to be exceptionally nice and, notably, the office space housed a credit analysis facility operated by the company that GBandT had hired to review leases for credit quality. Follow-up investigations disclosed that these addresses were commonly used to route confirmations and business inquiries for several other small businesses – including a large number of tanning and toning salons.

Internal control is a system of policies, procedures, practices, and organizational structures for providing reasonable assurance that a business's operating objectives will be achieved and that undesired events will either be prevented or detected and corrected. The internal audit function is important for an effective system of internal control because it is supposed to identify weaknesses independently, allowing management to take prompt action.

This system was not the case at GBandT. J.J.'s younger son, Albert, was the organization's sole (part-time) internal auditor. His other work included helping out wherever there was a need, generally in either the bookkeeping or loan departments. His position and work immediately raised several red flags due to his lack of training, multiple job functions, and nepotism.

Further, of the few college credits that Albert had managed to obtain, none were in business. He eventually completed a condensed, six-week internal audit course sponsored by the Bank Administration Institute, and J.J. reportedly taught him anything else he needed to know. Albert's experience was limited due to the nature of his part-time work in a small institution. His files, however, were admirably completed, concise, and very precise. Notably, they were absent of any material audit exceptions. [13]

Albert's familial ties also interfered with the objectivity required by industry standards. But he was not the first part-time internal auditor with split duties whom the bank had hired. Prior examinations had repeatedly identified the problem but had not required punitive actions due to regulatory guidance about "small banks." Small-bank guidance was based on the idea that senior management, in smaller institutions, would generally be aware of all daily operations and transactions – and external audits were considered a check on other improprieties. However, that particular guidance neither anticipated collusion with senior management, nor bank supervisors' reluctance to interview external auditors in the examination process. Notably, both examiners and external auditors are often so turf conscious that they rarely interact with each other. Since Albert's and his predecessors' recordkeeping was so meticulous, and since all of them had been so affable, their

[13] Hint: Auditors and examiners should be suspicious of internal audit reports with no, or scant, exceptions – especially in an institution which has an otherwise imperfect internal control function (Rezaee and Crumbley, 2007).

records were taken at face value. The auditors and examiners had fallen into the classic trap of evaluating the person, and not the position.

Follow-up interviews conducted with GBandT's external auditor disclosed that he, too, had relied on bank weaknesses to be mitigated by an external source – the BHC or bank examiners! Although he had audited the bank each of the previous sixteen years, the regulatory authorities had never before contacted him. Sheepishly, he too admitted never having approached bank examiners. Consequently, the external auditor not only had no mitigating evidence, but he had also noted many of the same deficiencies bank examiners had reported. During one of the interviews about historical deficiencies at the bank, the auditor also mentioned a similar problem "at that little business of J.J.'s." Without arousing the auditor's suspicion, examiners casually turned the conversation to J.J.'s "other businesses" which, according to the auditor, totaled "three or four" – none of which were theretofore reported to regulatory authorities. He could not recall all the names but remembered that one of them was a toning and tanning salon. [14]

Q 15: What types of questions could a bank examiner ask an external auditor to verify examination findings, observations, or concerns? And vice versa?

Q 16: Are there any other external or internal sources that auditors and examiners could interview in the normal course of their work to examine the veracity of managerial disclosures?

Q 17: When and how would the bank examiners or auditors investigate whether upper managers had other business relationships that may or may not be conflicts of interest?

Q 18: How could the external auditors have participated more effectively in uncovering the decades of inappropriate conduct at GBandT?

Other Data Gathering

As suspicions grew over the irregularities, including the possibility of fraud, Eddie and Lynne looked at the files more critically than ever before. The examiners determined what specific opportunities may have been available for bank personnel to participate in banking irregularities, how those irregularities could have been concealed, and whether there were any mitigating controls that could have reduced or eliminated those opportunities.

Without revealing their suspicions, the examiners openly and critically reviewed each operational area of the bank and the BHC. They carefully considered opportunities for theft by individuals and groups, both internal and external to the financial institution. The examiners cross listed those ideas with the potentially affected balance sheet and/or income statement accounts. Then they considered how loan fraud might be carried out, how it could fly below the radar of auditors/examiners or be missed by auditors' job tasks, and how audit programs could be changed to gather additional evidence if need be. They also considered external institutions that might have been involved.

Another review of public records disclosed that J.J.'s name was attached to six different business operations – and that all but one was a tanning and toning salon. Worse, a check of tanning and toning salons throughout the upper-Midwest revealed that owners had similar business names that were somehow related to, or associated with, J.J. Interviews with shop owners verified the links to J.J., although some owners described themselves as no more than "a friend."

Except for maintaining a board membership in lieu of alimony payments, J.J.'s ex-wife Ellie was substantially above reproach. Additionally, she proved to be very open about discussing both bank and familial histories – but specifically *not* J.J.'s schemes. A subsequent follow-up led to a search of public records for the names of J.J.'s children, his daughter's husband, and Jr.'s partner. In each case, at least one outside business was discovered, usually a tanning and toning salon. The exception was Jr.'s partner – the records showed that he was the owner/operator of the credit analysis business that the bank/BHC had (ostensibly) independently contracted to review loan/lease credit quality. On-site verification of the business address indicated that the business had long-before closed. Documentation acquired during a review of that now defunct business disclosed the personal relationship between Jr. and his partner, which led to a broader investigation of the alleged arms-length transaction between the bank and the defunct credit analysis business. That, in turn, revealed evidence

[14] Hint: Examiners and auditors should approach their work more collaboratively – proactively contacting any/all other agencies that may have some historical information to share about the client – even if not required to do so.

suggesting that the bank's personnel had trained the so-called credit analysis employees, and even paid rent on their facilities.

A further, more detailed review of the loan portfolio (including tracing loan proceeds) also proved much more fruitful, disclosing self-interest loans, loans to friends, and loans to several other entities that were not necessarily related to J.J. *But* the loans were sufficiently suspicious to warrant closer investigation. Evidence of written-off self-interest loans, in turn, led to an investigation of J.J.'s clever but self-serving way of tax avoidance.

A search of prior (even old) financial statements that J.J. and other bank/BHC executive officers provided to federal regulators in previous years disclosed a few loans reported from other banks – but those loans disappeared from subsequent statements. The examiners contacted those banks for full loan and deposit transaction histories. The records indicated loan disbursements and payments for other businesses, which were directly linked to J.J.[15]

Q 19: Explain the fraud triangle (or fraud square or fraud baseball diamond). Which personality traits of managers may create red flags for auditors or examiners? Did anyone exhibit those red flags? Who? Which did he/she exhibit?

Each business, loan, and relationship became part of an overall hierarchical, organizational chart-like diagram linked to J. J. Johnson. His schemes filled enough printed pages to wallpaper an entire wall in the war room of the Assistant U.S. Attorney's office in Minneapolis, Minnesota. J.J.'s crimes were paired down to only three sheets, enough to ensure conviction and prison time.

The Executive Vice President in charge of operations and the Vice President in charge of lending (J.J.'s first and second cousins, respectively) were convicted of knowingly facilitating J.J.'s schemes; Gary Smith, the bank's president, was not prosecuted, mainly because he seemed to be a hapless pawn in the operation and was largely ignorant of and apparently unable to comprehend the extent or complexity of J.J.'s fraudulent schemes. Instead, he was forced into an early retirement from the bank. Albert Johnson also was prosecuted but received an extended probation in lieu of jail time. He also lost his job and was banned from banking for life. Similarly, the other relatives and all but the most essential operational staff lost their jobs. Their lack of credible references also effectively banned them from banking for life. J.J. was forced to sell his interests in the bank and BHC, which were promptly purchased by board member Dr. Clinton Ferris, who immediately brought in an outside CEO and worked with him to re-staff the bank. He subsequently placed his bank ownership in a blind trust and retired to California, purchasing a home very near Ellie Johnson's condominium.

Q 20: Should the participants in J.J.'s schemes also be considered guilty? If you believe they have culpability, describe for each if they are guilty of negligence, fraud, or unethical behavior?

Q 21: Wasn't J.J. Johnson essentially stealing from himself (as the majority shareholder)? Why or why not? If the other shareholders didn't complain, what was J.J.'s crime?

Q 22: Some of J.J. Johnson's misdeeds involved breaking bank regulations. Should those acts be considered "crimes"? Were they as serious as stealing or committing fraud?

Q 23: What possible reasons would the other shareholders/board members have for allowing J.J. Johnson to perpetrate his schemes?

Q 24: What could the bank examiners have done to more readily detect J.J.'s unlawful activities?

Instructors can obtain possible solutions to questions by contacting the author.

[15] Hint: Fraud is often like a multi-layered onion, and peeling back layers leads auditors/examiners to consecutively deeper facets ever closer to the core. It is always advisable to increasingly broaden one's analysis as evidence points toward an increasingly narrow conclusion of fraud.

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