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FRAUD AND EMBEZZLEMENT

INCLUDING THE
USE OF OFFICE MACHINERY, STATISTICS, ETC.
AS PREVENTIVE MEASURES

BY

IRVINE HUBERT DEARNLEY

ASSOCIATE OF THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES
ASSOCIATE OF THE INCORPORATED SECRETARIES ASSOCIATION
FELLOW OF THE ROYAL ECONOMIC SOCIETY
CHIEF ASSISTANT TO THE WAKEFIELD CITY TREASURER
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DEDICATION
TO
THE MIND OF THE SYSTEMATIZER

*Wheresoever Disorder may stand or lie,
let it have a care : here is the man that
has declared war with it, that never will
make peace with it.*

CARLYLE,

AN APPRECIATION

THE following treatise on *Fraud and Embezzlement* contains much valuable information and many useful hints to Auditors and Secretaries, and those in control of large offices.

I think it cannot fail to be of great interest to Chartered Accountants, and also to students preparing for their examinations.

CLARE SMITH, F.C.A.

EXCHANGE CHAMBERS,
BRISTOL.

FOREWORD

By W. ALLISON DAVIES, O.B.E., F.S.A.A., F.I.M.T.A.
*Borough Treasurer of Preston,
Past President (1928) Institute of Municipal Treasurers and
Accountants (Inc.)
Member of the Council of the Society of Incorporated Accountants
and Auditors.*

IN pursuance of his calling it falls to the lot of an Accountant from time to time to design systems of accounts which will give full and complete information as to the result of transactions in money or money's worth. Furthermore, those results, when obtained, must be beyond impeachment, both as to their accuracy in every detail and as to their presentation in such a form as will be easily intelligible to those for whose guidance or information they have been compiled. The successful achievement of the former object requires the possession of a highly developed technical skill, for in prescribing the general scheme it is essential that such safeguards shall be provided as will tend to obviate the possibility of the omission of any material factor, or, on the other hand, the inclusion of any misleading particulars which might be introduced for the purpose of misrepresenting the true state of affairs.

Attention has in recent months been directed to the responsibility resting upon Accountants and Auditors concerning the publication of financial statements, in the preparation of which the exercise of the greatest caution is demanded.

One of the tasks to be faced by an Accountant in the discharge of his functions is to make such arrangements as will cause the way of the transgressor to be as hard as may be, and in the present work on "Fraud and Embezzlement" Mr. Dearnley has succeeded in compressing into the compass of a comparatively small volume a mass of information which cannot but be helpful to all who desire to make a study of this phase of Accountancy.

In the earlier chapters prominence is given to the legal aspect of the subject, whilst suitable references are made in the later chapters to case law governing the particular point under discussion. A glance at the table of contents will indicate the extensive scope of the work, which has been classified and set out in a manner which makes easy the reference to any question under review.

Numerous instances of actual occurrences are quoted under the appropriate headings, and a special feature is the number of maxims with which the text is interspersed—guiding principles which will be appreciated alike by students preparing for a professional examination, and by practising Accountants charged with the duties of an Auditor.

Although Municipal Accounts are frequently regarded as being in a special class, the subject matter of this volume is equally as interesting to anyone engaged with Local Authority Finance as it is to an Accountant whose principal experience is in the sphere of Commerce.

Particular interest attaches to the chapter on the various types of mechanical appliances now in use, in which concise explanations are given of the purposes served by each. The Author is to be complimented on the production of a readable and instructive book which should prove valuable to all who are desirous of securing the probity of our business and public life.

W. A. D.

PRESTON,
January, 1933.

PREFACE

Fraud prevention is preferable to fraud discovery.

WHILST the professional auditor seeks to discover irregularities after their occurrence, the systematizer endeavours to make their perpetration well nigh impossible in the first place. Both of these functions of an Accountant have been fully dealt with herein.

SCOPE.

It is the object of this research treatise to set forth practical and scientific methods for the circumvention or speedy detection of Fraud, Embezzlement, or Forgery on the part of employees, directors, or the public; this is the very essence of modern auditing and, as such, the present work may be used as an "Advanced Auditing" textbook by professional examinees.

An earnest attempt has been made to establish certain basic principles which appear to underlie the perpetration and prevention of fraud: a number of these maxims have been stated in heavy type.

PUBLICITY OR IGNORANCE ?

It has usually been considered contrary to public policy to describe in works of this nature the *modus operandi* of fraud cases; rather has it been deemed advisable merely to indicate the appropriate preventive measures.

Whilst the above has been the general principle adopted, experience confirms that ignorance by the executive of the means whereby fraud has been or could be perpetrated, is frequently the root cause of irregularity. The author, therefore, offers no apology for his discretionary inclusion of several ingenious methods of fraud perpetration.

PREVENTIVE METHODS.

“Traps” and amateur detective work—such as the deposit of marked coins in slot machines, cash tills, or even in open drawers—and similar undesirable methods are now almost a memory. They are being replaced by the more scientific and essentially preventive methods indicated throughout this book and summarized in Part IV.

AUDITING.

The judicial opinion that an Auditor should “go behind the books” appears to call for a little of the “bloodhound” spirit as well as that of the more domesticated “watchdog.”

The special nature of the duties of Internal Auditors, systematizers, and other members of the executive should certainly make them more inquisitive than their practising brethren.

MACHINERY.

In America, the use of machinery as an agent in fraud minimization has been firmly established for many years. Its comparatively recent introduction into Great Britain appears to justify the space devoted to this subject in the “Fraud Prevention” section. (Chapter XV.)

MUNICIPAL APPLICATION.

Where convenient, both commercial and municipal examples have been furnished to illustrate each type of fraud, and to emphasize the universal application of the preventive methods.

The writer sincerely trusts that his fraud prevention and systematizing experiences in both the commercial and municipal spheres, as set forth herein, will enable him to be of service to both these groups of his readers.

SYSTEMATIZING.

The author is not without hope that the principles which he has sought to express may be worthy of careful consideration by all who are seeking the true causes underlying fraud perpetration, and that they will afford a guide in eliminating those weaknesses of system which tend to encourage fraud and other financial disorders.

I. H. DEARNLEY.

WAKEFIELD,

January, 1933.

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W. Allison Davies, Esq., O.B.E., F.S.A.A., Borough Treasurer of Preston, Past President, Institute of Municipal Treasurers and Accountants (Inc.), Member of the Council of the Society of Incorporated Accountants and Auditors.

Wm. Bateson, Esq., J.P., A.C.A., Blackpool (Past President, Institute of Municipal Treasurers and Accountants); R. Hardy Smith, Esq., A.C.A. (Hons.), Liverpool; Irvine R. Dearnley, Esq. (The Clerk to the Preston Insurance Committee); P. Hulme, Esq. (Justices' Clerk's Department, Bootle).

The Manufacturers for illustrations of their office machines and to their very helpful staff representatives.

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PART I
INTRODUCTORY

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CHAPTER I

FRAUD

SYNOPSIS

DEFINITION OF "FRAUD."

REPRESENTATIONS WHICH ARE NOT FRAUDULENT—

- (1) Persons not Deceived;
- (2) Honest Belief;
- (3) Carelessness;
- (4) Opinions;
- (5) Misrepresentations of Law.

ACTIONS FOR FRAUD—

- (1) Two rights;
- (2) Proof of Motive;
- (3) No Limit on Period for Action;
- (4) Action to Recover Goods;
- (5) Fraud of Agents;
- (6) Fraud of Partners;
- (7) Doctrine of Estoppel;
- (8) Misrepresentation of Credit (example);
- (9) Frauds on Third Parties;
- (10) Course of Conduct (example)—Aiding and Abetting.

CONTRACTS—

- (1) False Impressions—Fraudulent Misrepresentation;
- (2) Innocent Misrepresentation;
- (3) "*Caveat Emptor*" and Implied Warranty;
- (4) Non-disclosure of Defects—Exceptions;
- (5) "Material Facts";
- (6) Written Memorandum—Sale of Goods Act, 1893.

“

CHAPTER I

FRAUD

DEFINITION OF FRAUD

Fraud is a false representation made—

(1) knowingly, *or*

(2) without belief in its truth, *or*

(3) recklessly, careless whether it be true or false,

thereby inducing a person to do an act through belief in its truth, with the result that some loss or liability is incurred.

(*Derry v. Peek*, 1889.)

REPRESENTATIONS WHICH ARE NOT FRAUDULENT

1. *Persons not Deceived.*

A person has no right of complaint at law if he was not actually misled by the representation.

2. *Honest Belief.*

False statements are not fraudulent if they are proved to be issued with an honest belief in their verity. (*Derry v. Peek*, 1889.)

3. *Carelessness.*

If there is fraud it is actionable, but not if it is mere "carelessness" or "negligence": these are different offences entirely.

4. *Expressions of Opinion.*

Opinions are not usually fraudulent, although a professional opinion may give rise to an action for negligence.

5. *Misrepresentations of Law.*

A misrepresentation that has reference to the law only, and not to a fact, does not entitle the person misled to any legal remedy. Everybody is presumed to know the law in all its

detail. A "mistake of law"—even if it has to be established by a subsequent "test case"—gives no right of action. (*Ignorantia juris neminem excusat.*)

ACTIONS FOR FRAUD

1. TWO RIGHTS.

There are two rights of action available to a defrauded person—

(a) Damages for deceit, and

(b) Right to relief from, and rescission of, any contract to which it is attached, i.e. the contract is not void but *voidable* at the option of the defrauded party: he may (i) avoid or repudiate the contract with or without damages (Chancery Division), (ii) affirm the contract and ask for fulfilment so far as possible, with damages for the unfulfilled portion.

2. PROOF OF MOTIVE.

The action must prove "*Fraud*," and nothing short of that will suffice. An intention to cheat or injure are immaterial considerations if fraud is proved.

3. NO LIMITED PERIOD FOR ACTION.

Although an excessive delay in taking action after the actual discovery of a fraud may prejudice the proceedings and penalty, it is now a firmly accepted principle, to use the words of a former Master of the Rolls, that "those who may be disposed to appropriate to themselves the property of others may be assured that no time will secure them in their plunder, but that their children's children will be compelled by the Court to restore it to those from whom it has been fraudulently abstracted."

4. ACTION TO RECOVER GOODS.

If a person obtains goods by fraudulent misrepresentations and sells them to a third party, who takes them without knowledge of the fraud, then the goods cannot usually be reclaimed by the person from whom they were fraudulently obtained.

5. FRAUD OF AGENT.

A principal is liable for the fraud or other tort of his agent, committed in the ordinary course of his employment as agent and whilst acting within his authority.

At the option of the person injured, the agent, even when acting in the ordinary course of his agency, can also be held liable. If, however, the act is *ultra vires* his agency, the agent alone is liable.

6. FRAUD OF PARTNER.

The foregoing principles of agency are also followed under the *Partnership Act*, 1890, where the liability of the other partners for a partner's torts, committed in the ordinary course of their *usual* business, is joint and several.

In the case of *Blair v. Bromley*, where a client instructed his solicitor to invest money in certain *specifically named* investments, (a "normal" part of any solicitor's business), but where the solicitor misappropriated the money, the partners of the defaulting solicitor were all held liable for the money. Where, however, a *discretionary* power was given, as in *Harman v. Johnson*, to invest a client's money it was held to be outside the scope of a solicitor's business, and the other partners were not liable for their partner's default.

7. DOCTRINE OF ESTOPPEL.

Where one person has induced another, whether by assertion or conduct, to believe in or act upon a particular state of facts, he cannot be heard as against that other party, to deny the truth of those facts. This is the rule of evidence known as "Estoppel."

8. MISREPRESENTATION OF CREDIT.

Any representation as to the conduct, character, credit, ability, etc., of another in order to induce any person to trust one, may be ground for an action for deceit or fraudulent misrepresentation, if the representation is *in writing and signed by the person making it*.

Example—A man in answer to an inquiry wrote that a

certain person was "honest and of good credit," whereas, in fact, that person was absolutely dishonest and insolvent. The misinformer was made liable for the loss which the inquirer had suffered as a consequence of his relying upon such a representation.

9. FRAUDS ON THIRD PARTIES.

Deceit or fraudulent misrepresentation may take place and thereby create a liability for damages *by a mere act or course of conduct*, and without being made directly to the persons intended to be prejudiced. This should be accepted as a grave warning by anyone tempted to misrepresent any fact.

Thus, a false representation made by *A* to *B*, and acted upon by *C*, to whose knowledge it comes, is the same, as regards *A*'s liability, as if it had been made to *C* himself, provided it was made with the intention that *C* should act upon it. But if such was not the intention, *C* has no remedy against *A*. Thus, in *Peek v. Gurney* (1873), it was held that one who bought shares in a company from a previous holder had no remedy against the directors for false statements in the company's prospectus, since the statements were made only to induce the original holders of the shares to apply for them.

The following is an actual case of this type of fraud :

10. COURSE OF CONDUCT.

In order to enable a Company to possess a fictitious credit in case of inquiries at their bankers, a friend of the Company placed money to their credit which he told the company *to hold in trust* for him. Some of the money having been drawn out with his consent, and the company having been wound up whilst a balance remained, it was held that the accommodating friend could not claim to have the balance repaid to him.

CONTRACTS

1. FALSE IMPRESSIONS.

A false impression or belief may arise—

(a) Through a genuine error or mistake, or

(b) By misrepresentation, or

(c) By fraud.

Although mere *non-disclosure* is not generally regarded as fraudulent, a false impression produced by stating some only of the material facts, and concealing others, may amount to a *fraudulent misrepresentation*.

2. INNOCENT MISREPRESENTATION.

Where the misrepresentation is made innocently (i.e. an untrue statement of fact which is likely to influence the decision of the other party) and who, being misled thereby, is induced to enter into the contract because of his reliance upon that statement and who suffers damage, can avoid the contract in either of two ways—

(i) by an action to rescind,

(ii) by resisting an action for breach of contract if and when such an action is brought.

3. "CAVEAT EMPTOR."

With the exception of the provision in the Sale of Goods Act, 1893, and certain Statutes (e.g. Seeds, Ships' Cables, etc.) the seller gives no *implied* warranty or condition as to the quality or fitness for any particular use of the goods sold and the Common Law rule of *caveat emptor* ("let the buyer beware") usually applies.

Numerous recent law cases have, however, modified the application of the general rule of *caveat emptor*.

4. NON-DISCLOSURE.

A seller of goods who is aware of defects therein which the buyer cannot perceive, is not deemed to commit a fraud in abstaining from informing the buyer of the defects, even though knowledge of them would probably have prevented the buyer from purchasing.

5. MATERIAL FACTS.

There are, however, certain contracts to which this rule is inapplicable—so far, at least, as they may be set aside on the grounds of non-disclosure of material facts.

The following, amongst others, are liable to be vitiated by non-disclosure—

- (a) Contracts for the purchase of land.
- (b) Contracts for the taking of Shares in a Company.
- (c) Contracts of Insurance.
- (d) Contracts of Suretyship (possibly).

6. WRITTEN MEMORANDUM.

The Statute of Frauds, 1677 (Charles II's reign), as consolidated and re-enacted in the *Sale of Goods Act*, 1893, provided a measure of protection against fraud and verbal misrepresentation.

Section 4, *Sale of Goods Act*, 1893, provided that—

“A contract for the sale of any goods of the value of £10 or upwards, shall not be enforceable by action—

(i) Unless the buyer shall:

- (a) Accept part of the goods so sold, *AND*
- (b) Actually receive the same,

OR

(ii) Give something in earnest:

- (a) To bind the contract, *OR*
- (b) In part payment,

OR

(iii) Unless some note or memorandum in writing of the contract:

- (a) Be made, *AND*
- (b) Signed,

by the party to be charged, or his agent in that behalf.”

CHAPTER II

EMBEZZLEMENT

SYNOPSIS

EMBEZZLEMENT—

- (1) Definition ;
- (2) Distinction from Larceny ;
- (3) Fraud plus misappropriation.

LOSSES BY EMBEZZLEMENT—

- (1) Manipulation of Accounts ;
- (2) Fraud Loss for Income Tax Purposes ;
- (3) Insurance against Loss ;
- (4) Fidelity Bonds ,
- (5) Appointment of Employees ;
- (6) Character Inquiries.

PREVENTION—

- (1) Duty to Remove Temptation ;
- (2) Moral Effect of Internal Audit ;
- (3) Internal Audit and Internal Check.

SIGNS OF IRREGULARITY—

- (1) "The Danger Signals."
- (2) Checking Bank Pass Books (*Maxim*).

CLASSIFICATION OF DEFALCATIONS—

- (1) Income ;
- (2) Expenditure ;
- (3) Manipulation ;
- (4) Robberies.

CHAPTER II

EMBEZZLEMENT

1. DEFINITION OF EMBEZZLEMENT.

"*The fraudulent appropriation of property by a person to whom it has been intrusted; as, the embezzlement by a clerk of his employer's money; embezzlement of public funds by the public officer having them in charge.*" (*Webster's International Dictionary*).

2. DISTINCTION FROM LARCENY.

(a) *Larceny* denotes a *taking*, by fraud or stealth, from *another's* possession;

(b) *Embezzlement*, on the other hand, means an *appropriation*, by fraud or stealth, of property *already in the wrongdoer's possession*.

3. FRAUD PLUS MISAPPROPRIATION.

It is clear from the above than an embezzlement (or *defalcation*, as it is commonly termed) implies more than simple fraud—it means fraud combined with a misappropriation of entrusted property, i.e. putting money, or money's worth, to a use other than that for which it was entrusted.

LOSSES BY EMBEZZLEMENT.

1. MANIPULATION OF ACCOUNTS.

To a great extent the Professional Auditors (and, in the case of municipal authorities, the "District Auditors") guard this avenue of fraud quite well, but a separate Internal Auditor could exercise a more frequent and minute review of this admittedly difficult problem. Failing a separate Internal Auditor, a suitable member of the executive could perform his functions—in so far as his normal duties do not render him unsuitable for acting as a check upon the transactions.

Each case will call for its own applicable safeguards and a number of ingenious methods of manipulation will be indicated later, together with the necessary preventive methods.

2. FRAUD LOSS FOR INCOME TAX PURPOSES.

In computing the amount of profits or gains to be charged under Cases 1 and 2 of Schedule "D" the following are allowable deductions: Losses by theft, burglary, embezzlement, etc. (not covered by insurance), and loss by fire of stock (but not of capital assets).

3. INSURANCE AGAINST LOSS.

The fidelity of an employee may be insured—

- (a) By a private bond or guarantee, *or*
- (b) By creation of an Insurance Reserve Fund within the business, *or*
- (c) By a policy of indemnity with an outside Insurance Company.

The latter (c) appears to possess distinct advantages over (a) and (b).

Policies should also be taken out against loss by Theft, Robbery and of Cash in Transit. In order to prevent any possibility of an uncovered loss, or of an insurance company pleading technical exclusions of certain types of fraud, it is desirable that a comprehensive policy should be taken out in the first place.

4. FIDELITY BONDS.

The three main types of an Insurance Company's Fidelity Bonds are—

(a) **The Individual Bond**, covering for a specified amount a particular person by name, position held, etc.

(b) **The Schedule Bond**, covering the several persons named from time to time in the schedule attached to the bond, and for agreed amounts. Here again each individual is identified by name and position. Changes in the personnel of the schedule are made by addition or deduction certificates, with corresponding adjustments of premium.

(c) **The Position Bond**, insures the *position* held as distinct from the *individual* holding that position. The schedule to the policy in this case enumerates the positions covered.

5. APPOINTMENT OF EMPLOYEES.

There is a valuable moral effect in requiring an employee to enter into a fidelity bond. The application form, requiring in reasonable detail his past experience, living conditions, debts, income, etc., is likely to impress the employee with the seriousness of any irregularities in connection with his position. The Bonding Companies have been noted for their persistence in bringing defaulters to justice and, therefore, the mere fact that he is under bond may tend to have a deterrent effect upon an employee.

6.—CHARACTER INQUIRIES.

Mr. H. A. Hopf (U.S.A.), speaking with reference to inquiries for Fidelity Insurance said: "There is a better way of finding out about people than just sending out promiscuous inquiries to former employers; that is, to send to the former employer an intelligent letter asking him to score the individual on the basis of his demonstration of performance in four or five qualifications essential to the position to be filled. A rating sheet is enclosed with this letter, to be filled in by the person to whom the inquiry is addressed."

"Two very interesting things happened through the introduction of that method. The number of responses to the inquiry was greatly increased; and the need for meticulous care in rating the individual imposed the proper kind of restraint upon the person who responded, causing him to take the trouble to put his check-marks where he thought they belonged. In that fashion we obtained a clearer, more convincing and certainly more accurate picture than can be conveyed by an answer written in general terms."

". . . There is an area of investigation outside of the period of time when the individual is under observation,

i.e. home conditions; avocational activities; what he does, not between 9 a.m. and 5 p.m., but between 5 p.m. and 9 a.m. Information as to changes in domestic and social conditions, frequently will bring out information of great value in preventing the occurrence of a serious situation. . . .”

“We are inclined to make these inquiries in altogether too routine a fashion. . . . I wish the Bonding Companies would make a change in the form of inquiry. I have seen forms from certain institutions that have not been changed in phraseology, paper, ruling, etc., in the past twenty years.”

PREVENTION

1. DUTY TO REMOVE TEMPTATION.

The frequently uttered complaint against the installation of systems of fraud prevention—that the risk of loss from this source is being borne by the Insurance Company—is regrettable, indefensible, and unfair to employees.

It is an employer's moral duty to remove temptations to dishonesty from both young and old employees, and this can best be achieved by utilizing proper methods of accounting and systems of check.

2. MORAL EFFECT OF INTERNAL AUDIT.

The moral effect of an active and intelligent system of Internal Audit is not to be underrated. An independent full time “Internal Auditor” is frequently appointed to carry out these important functions, more especially in the larger firms and public bodies.

3. INTERNAL AUDIT AND INTERNAL CHECK.

The term “Internal Audit” covers the work which is performed by the Internal Auditor and his staff as distinct from the accounts staff.

The term “Internal Check” however, implies that some fact has been verified by arriving at the same result by two independent methods, so that the responsibility for the

accuracy or bona fides of that fact has been assured from two independent parties. In most cases it simply means the intervention of a third party—such as a member of the general public (e.g. where receipts are issued), or even by a machine.

Both Internal Check and Internal Audit will be fully discussed in Chapters XI and XII, respectively.

SIGNS OF IRREGULARITY

I. "THE DANGER SIGNALS."

After a thorough analysis of all the leading fraud cases of the last few years, one is forced to recognize certain "danger signals" which are indicative of irregularity.

Important research rules and theories are stated throughout this book, but the following typical features of fraud should also be noted—

(1) Arrears and chaos of accounting records often cover defalcations; usually only the delinquent can understand the transactions.

(2) Delinquent's duties performed in a secretive manner; jealous of others participating in the routine; unwilling to absent himself for long from his routine, either for holidays, illness or business; some, however, may be suspiciously over-anxious for *certain* sections of their work to be checked and thus create a false confidence in their integrity.

(3) Unwarranted reliance upon the integrity of servants—especially old and trusted employees, who were needlessly subjected to great temptations towards **temporary borrowing**.

(4) Large defalcations have long been associated with a lack of current supervision (e.g. independent internal audit) and where a number of different functions have been concentrated in one officer's hands (i.e. absence of Internal Check).

(5) An inflexible system of audit checking; also a fore-knowledge by the delinquent of the checks employed, and times of audit.

(6) Embezzlements very often start in small amounts and

increase to stupendous figures as the period of non-detection extends, giving the delinquent more confidence.

(7) Delinquent lived in a social state inconsistent with his income.

2. THE GOLDEN RULE.

It is very surprising that greater use is not made of the following elementary method of fraud detection, which could have prevented many recent cases, viz.—

“MAXIM FOR CHECKING BANK PASS BOOKS”

“In a great number of cases, fraud can be detected by a thorough and intelligent examination—as distinct from routine checking—of the cash book with the bank pass book.”

This very simple method is available for both the income and the expenditure defalcations which are discussed hereafter in their appropriate chapters.

CLASSIFICATION OF DEFALCATIONS

The main broad classes of fraud in accounts are—

1. INCOME.

The exclusion of items of *income*, or the partial exclusion thereof by accounting for a lesser amount than was actually collected (Chapter III).

2. EXPENDITURE.

The inclusion of false or excessive items of expenditure (Chapter IV). Forgery also may be involved (Chapter VI).

3. MANIPULATION.

The misrepresentation of items which are correct in the aggregate, but misleading in their representation (Part III).
Examples—

- (a) Treating capital receipts as income;
- (b) Granting Public Assistance Relief in order to pay it back as collections on which there is a commission payable;

(c) Manipulation of the Final Accounts to defraud the Inland Revenue.

4. ROBBERIES.

Common pilferings, thefts and robberies, with or without attempts to conceal their effect on the liquid balance (Stock, Cash or Bank) as compared with the book figures (Chapters IV and V).

PART II
MISAPPROPRIATION

CHAPTER III . . .	INCOME FRAUDS
CHAPTER IV . . .	EXPENDITURE FRAUDS
CHAPTER V . . .	MISAPPROPRIATION OF GOODS
CHAPTER VI . . .	FORGERY AND ALTERATION

CHAPTER III INCOME FRAUDS

SYNOPSIS

INTRODUCTORY—

- (1) Psychology ;
- (2) Impersonation of Collectors—Temporary and Spurious Receipts ;
- (3) Division of Duties ;
- (4) Robbery and Theft ;
- (5) Tracing Stolen Bank Notes.

OMISSION OF SALES—

- (1) Cash Sales ;
- (2) Use of Stock Accounts ;
- (3) Verification of Sales ;
- (4) Preventive methods.

USE OF THE MAIL—

- (1) Postal Verification ;
- (2) Complaints ;
- (3) Interception of Post ;
- (4) Postal Remittances ;
- (5) I O U's and Cashing Cheques (*Maxim*).

RECEIPTS AND OTHER ACKNOWLEDGMENTS—

- (1) Delay in Acknowledgment ;
- (2) Temporary Receipts ;
- (3) Official Printed Receipts ;
- (4) Municipal Frauds ;
- (5) Control of Receipt Books ;
- (6) Receipt Forms Issued out of Order ;
- (7) Frauds in Issuing Receipts ;
- (8) Misappropriated Cheques ;
- (9) Collector-Cashiers.

BANK LODGMENTS—

- (1) Ante-dated Deposits ;
- (2) *Maxim* for Bank Lodgments ;
- (3) Auditor's Duty ;
- (4) Substitution and Transfer of Balances ;
- (5) Certification of Bank Balances.

BORROWING AND "DAY TO DAY" FRAUDS—

- (1) "Feeding" Bank Lodgments;
- (2) Temporary Borrowing.

"THE CHEQUE TEST"—

- (1) Earmarking of Cheque Receipts;
- (2) Accounts (Payment into Bank) Order, 1922;
- (3) Circumvention of the Cheque Test.

FICTITIOUS ALLOWANCES TO COVER MISAPPROPRIATION—

- (1) Discounts and Allowances;
- (2) Discretionary Allowances—Rule;
- (3) Fictitious Irrecoverables.

CHAPTER III
INCOME FRAUDS
INTRODUCTORY

IN comparison with expenditure frauds, the fraudulent exclusion of income is more difficult to detect.

1. PSYCHOLOGY.

The people from whom money is to be received are not always keen and understanding business men, they may be unsuspecting and trusting people of average intelligence who do not think of possible subsequent irregularities. The systematizer, therefore, cannot place great reliance upon the "outside public" as a link in the chain of internal check.

2. IMPERSONATION OF COLLECTORS.

It should be emphasized that the psychology of the debtors is to be deeply studied in designing any system of safeguard against Fraud.

For instance, anybody could pose as an accredited representative, receive money with, or without, the issue of a receipt, or by issuing a spurious, "temporary," or even a stolen receipt. The comparative ease with which this fraudulent impersonation has been successful of recent years makes it essential that sufficient publicity should be given to the practice of the firm or Corporation, e.g. that all collectors will wear the official uniform, or wear an appropriate official badge, or produce a written authority upon request.

3. DIVISION OF DUTIES.

The importance of the division of duties, especially as regards: (a) the authorization, (b) the checking of transactions, and (c) the handling of the actual cash, will be stressed throughout this book—particularly in the chapters dealing with "Methods of Prevention."

From bitter experience, many can testify to the dangers of allowing employees who collect accounts, to write up their own office records, send out their own bills, make discretionary allowances, and even write off so-called "irrecoverable debts."

If circumstances permitted, it would be infinitely preferable to forbid a traveller who books orders, or an officer who initiates any transaction, to collect or pay money. This is not always possible in practice.

4. ROBBERY AND THEFT.

Open robbery or theft, sometimes followed by absconding, is often attributable to a sudden temptation. In addition to insuring against such a loss, instructions should be issued for—

(a) The deposit of all sums immediately with a bank. Payments should, wherever possible, be made by cheque rather than in cash. Police protection or other escort on the way to a pay parade or the bank is a safeguard against outside violence, "staged" robbery or an absconding clerk. (The claims files of insurances companies could, no doubt, reveal many ingenious false claims.)

(b) Minimization of balances and the safeguard of such minimized balances in suitable receptacles (e.g. a safe for cash and locked bins for stocks and stores). Advantage should be taken of the facilities afforded by the big banks for the safe deposit of takings overnight in their "Night Safes."

(c) The necessity for keeping the books up-to-date—not forgetting that stock accounts are for this purpose quite as important as cash records.

(d) The appointment of a suitable type of employee at an adequate salary, paying due regard to the responsibilities and temptations of the post he is to hold.

5. STOLEN BANK NOTES.

If cash is stolen and the serial numbers of the notes are known, it is useful to remember that there is a "Bank Note Library" at the Bank of England, showing when each note

is surrendered for payment by the Bank. Very often this has proved invaluable in locating the branch bank at which the notes were paid in and by whom—particularly in respect of the larger denominations of Bank Notes.

OMISSION OF SALES

1. CASH SALES.

It is a difficult problem to ensure that small cash or counter sales are duly accounted for. The sales should be frequently vouched and tested in the presence of the employees, if only for its moral effect. A till, or cash register, is regarded generally as indispensable and its advantages and shortcomings will be dealt with more fully in the chapter on "Fraud Prevention by Machinery" (Chapter XV).

The methods of "Internal Check" and "Comparative Methods" (q.v.) should also be applied wherever possible. Suspicion has frequently been aroused by an unwarranted decrease or, when the defaulter was on holiday, an increase in the figure of cash sales.

2. VALUE OF STOCK ACCOUNTS.

Stock Accounts may also throw light upon misappropriations of cash sales and the proceeds of credit sales, which might otherwise pass undetected (Chapter V). The method whereby goods are charged out to branches or departments at selling price provides an immediate check upon stocks, cash sales, and debtors.

3. VERIFICATION OF SALES.

It is not sufficient to commence with the invoice when vouching sales. The Goods Issued Book or a gate office "Outward" record book, forms the basis for the invoice, but even these records may be manipulated to coincide with a fraudulent invoice. These records of issue may, in their turn, be checked, not only with the travellers' order books, but with the customer's official confirmatory order forms and the

“Delivery Signatures Book.” Alterations of figures and quantities in these records may be ground for suspicion. The exclusion of sales, which would have enabled the proceeds to be misappropriated, may thus be discovered or prevented.

4. PREVENTIVE METHODS.

(a) In addition to checking Day Book and Cash Book postings into the Ledger, the audit should cover the supporting documents and records mentioned above.

(b) For preference, the Debtor's Ledger should be self-balancing, and the balances should be agreed by some independent means. (See below—“Postal Verification.”)

(c) Ascertain that no money has been collected which has not been accounted for. The best way to do this is to install a proper system of collection, necessitating the giving of official receipts and the frequent changing and effectual supervision of the collectors.

(d) The invoices and periodical statements should be made out in the office by a member of the staff who is not a collector.

(e) Statements should invariably commence with the old outstanding balance, viz: “Account Rendered . . . £ s. d.” Similar forms should be made out in respect of outstanding accounts, even where there are no subsequent transactions.

USE OF THE MAIL

I. POSTAL VERIFICATION.

A very simple but efficient means of verifying the accuracy of the Debtors' Ledger balances is available to the fraud investigator, by which method numerous instances of excluded income have been discovered, viz—

(1) See that statements of account are made out for every balance on the ledger.

(2) Compare all such statements in detail with the ledger.

(3) Add a notice at the foot: (a) indicating the date to which the account was corrected as to cash and quantities, (b) requesting the customer to report any discrepancies *direct*

to the investigator's address (*NOT to the firm*) by a letter marked "Personal," or by a personal call.

(4) Non-replies do not justify the assumption that the balance is correct. A prepaid addressed envelope could be sent to such customers or, where convenient, a personal call made on such firms by the investigator. This latter procedure is also desirable in order to examine the receipted bill where payment is alleged to have been made.

2. COMPLAINTS.

The efficacy of the above system is dependent upon the debtor complaining of its inaccuracy. Interception of the post containing such complaints is a possibility which has been guarded against by the above suggestion (No. 3*b*), that replies should not be addressed to the client's office.

3. INTERCEPTION OF POST.

In one case where this circularizing method was adopted by a firm with customers in all parts of the world, both the remittances and subsequent complaints of inaccuracy in statements rendered were extracted by the defaulter. Thus, the discrepancies were not discovered until an American customer on a visit to England, called at the office to complain of the "faulty book-keeping" and the erroneous statements of account frequently sent out to him.

4. POSTAL REMITTANCES.

The post box (or even a locked post bag received direct from the post office) should only be accessible by a responsible official who is not otherwise concerned in cash transactions or cash records.

He should open the box or bag and extract remittances in the presence of another official, who should note on the cover letter the amount enclosed and enter particulars in a "Postal Remittances Book"—differentiating between (a) cash, (b) cheques, and (c) those cheques where a form of receipt is required on the cheque, or on the customer's own receipt

form. (See ruling for a "Postal Remittances Book" in Chapter XIV Prevention by Records.)

The latter (c) has proved to be a fruitful source of fraud, and great care must, therefore, be exercised to ensure that an official receipt is also written out, the original cancelled and left in the book, and the money duly accounted for as if it were an ordinary remittance. It is a good practice to enter the receipt number against the side of each item in the "Postal Remittances Book" in order to earmark each remittance. (See later: *The Cheque Test*.)

5. MAXIM FOR CASHIER.

Wherever possible, the cashing of cheques and the use of office IOU's should be forbidden.

RECEIPTS AND OTHER ACKNOWLEDGMENTS

1. DELAY IN ACKNOWLEDGMENT.

The receipt of moneys without the issue of an official receipt is one of the greatest difficulties to be faced by the systematizer.

It is essential that every precaution should be exercised, and a very serious view taken of any breach of office regulations imposed, or of any slight irregularities or delay in sending official receipts.

2. TEMPORARY RECEIPTS.

Interim receipts by bankers, pending the issue of statutory forms of securities for loans, can be justified, but in other cases the issue of temporary receipts should be forbidden. Official receipts must be issued and mailed immediately for every receipt of money.

MAXIM.—It is far better to entrust a receipt book to a junior clerk or a branch official than to sanction the issue promiscuously of temporary receipts on official notepaper.

3. OFFICIAL PRINTED RECEIPTS.

However careful one may be to make red ink announcements lucid—that “only the official printed receipt will be recognized”—one still finds cases of people accepting worthless scraps of paper as “receipts.”

Some, more intelligent than the rest, accept a rubber stamped impression of the firm’s name on any plain receipt form as being a “PRINTED” official receipt.

The author has sometimes encountered cases of debtors *refusing* to accept any receipt for their money, in the strange belief that their action might be construed as doubting the integrity of the payee or the cash official.

4. MUNICIPAL FRAUDS.

(a) In a Public Assistance Department, relief grantees, who were repaying their previous week’s assistance to the Relieving Officer, had been led to believe that no receipt was necessary if the Relieving Officer returned their surrendered cash Payment Card to them.

(b) Further, it appears to be a prevalent belief amongst grantees of kind relief that no receipt is necessary if they subsequently repay the value of the assistance. The apparent logic is that the whole transaction is similar to the purchase of food over a shop counter, or on a week’s credit. Prominent notices in the Relief Stations should help to dispel these erroneous conclusions.

5. CONTROL OF RECEIPT BOOKS.

In arranging for the safe custody, responsibility for issue and control of receipt books, it should be realized that *each individual receipt form is worth a sum of money to a defaulter, equivalent to the largest individual payment received by him and misappropriated.*

Each book of receipts issued: (a) should bear serial numbers; (b) should be of the carbon type, and (c) should be signed for by the collector when it is originally issued to him. The fully used books should be returned to the issuer and recorded in

the same "Receipts Stock Book." Normally, only one book should be in the hands of each collector at any time. This prevents a book being kept back for a time until it is lost sight of, and then being used without accounting for the proceeds.

All amounts shown by the carbon counterfoils should be verified: (a) with the cash handed to the Cashier or Bank, and (b) with entries in the cash book, ledger and other records, but in addition the receipt books in circulation must all be examined to ensure that all moneys received have been handed over. The above-mentioned "Signatures Book," or "Receipts Stock Book," should ensure this.

MAXIM.—The person entrusted with the custody and issue of receipt books must not be a cash official.

6. RECEIPT FORMS ISSUED OUT OF ORDER.

In one case, receipt forms were used from the end of the book which enabled the defaulter to borrow the moneys collected until the serial number of such misused receipts became consecutive with current collections. To enable this borrowing to succeed it was necessary to manipulate the dates of the irregular receipt forms. In the meantime the outstanding ledger balances were explained by false reasons. Where the customers were in the habit of making payments on account the fraudulent collector actually paid in small amounts to allay suspicion, thus adding further complications to his original offence.

The weakness in the system of this firm lay in their collector or cashier using the same receipt book continuously. The books could be issued indiscriminately to the collectors each day.

In passing, it should also be noted that this was a case where a compulsory annual holiday would have lessened the chances of its extended success. In any case, the receipt books should have been more frequently exchanged, checked, and re-distributed to different collectors.

7.—FRAUDS IN ISSUING RECEIPTS.

There are three common methods of embezzlement in connection with receipts—

(1) Failure to issue a receipt *unless asked for*.

(2) By a customer or ratepayer accepting a receipt endorsed on a cheque in lieu of an "official" printed receipt; this has been the source of a series of defalcations and is still a difficult problem.

(3) By removal of the carbon paper when issuing a perfectly correct receipt. The blank counterfoil thus obtained is then prepared for a smaller amount purporting to be received from some other person in arrears and known to be making small payments on account.

In all these cases the defaulters only accounted for the amounts actually appearing on their receipt counterfoils and this illustrates the folly of confining an audit to the checking of receipt counterfoils with the Cash Book. This should be accompanied by an intelligent comparison with (a) the amount of the cheque received (if any); (b) the amount and balance of the account. Occasional inspections by the auditors of receipts issued have proved invaluable.

8. MISAPPROPRIATED CHEQUES.

Where one of the remittances (for which no receipt was issued) happened to be a cheque made payable to the firm, the cheque was actually paid in to the cashier, but an equivalent amount of cash was kept back. The total cash and cheque paid in thus agreed with the day's collections.

A keen cashier would have noticed that this cheque did not represent any specific item and, further, the fact that the drawer was a customer of the firm should have sent him upon inquiry. The system of entering receipt numbers against each cheque recorded in the "Remittances Book" might also have located this fraud (*The Cheque Test*).

MAXIM.—Customers should always be requested to cross cheques and to make them payable to the firm, charity, or corporation, and not to individuals.

Otherwise the misappropriated cheque could be paid into the defaulter's own private bank account.

9. COLLECTOR-CASHIERS.

In the event of the cashier acting also as the collector, or in cases where a collector is authorized to endorse cheques payable to his principal, and to pay them into the bank, the opportunity of examining the cheques is lost.

The constitution of cheques and cash on the bank paying-in slip could be tested to see if the "cheques" total agreed with a specific group of receipts issued. As pointed out later in this chapter (under the heading of *The Cheque Test*), even this valuable test can be circumvented and offers no solution to the embezzlement of "cash" items.

BANK LODGMENTS

1. ANTE-DATED DEPOSITS.

Of recent years the co-operation of bankers in the minimization of fraud has increased. In particular, the modern banker should always view with suspicion any attempt or request to ante-date deposits. A moment's reflection will show that such a method of feeding a deficient day's takings with the next day's receipts destroys the whole object of earmarking each day's deposits into the bank.

Experience has proved that the daily banking of all sums received is the most satisfactory method of control.

2. MAXIM FOR BANK LODGMENTS.

Delay in lodgment at the bank of current receipts may be a sign of temporary borrowing, or a "day-to-day" fraud.

Frequent surprise checking of apparent Cash Balances is desirable to minimize the possibility of these temporary borrowing or "feeding" frauds. Very often it is discovered that not only is the balance non-existent, but also certain collections have been entirely omitted from the records in

a vain endeavour to "catch up" and thus cover the original cash borrowing.

3. AUDITOR'S DUTY.

An Auditor must certainly verify the existence of cash balances (*London Oil Storage v. Seear, Hasluck & Co.*) and this should include the balances at the bank.

In the case of *Chas. Fox & Sons v. Morrish, Grant & Co.* (1918) the accountants were held liable for damages for omitting to examine the bank pass book, which would have revealed certain defalcations immediately.

The accountants were not engaged to conduct a full audit, but merely "to check the books and prepare accounts." It would therefore appear that this ruling would apply *a fortiori* if a "full audit" had been undertaken.

4. SUBSTITUTION AND TRANSFER OF BALANCES.

Where separate concerns, or even separate funds, are audited at different dates, it has often been found possible for the defaulter to make good a deficiency on one fund, or concern, by temporarily transferring cash from the other.

For instance, in verifying the balances held by the Police and Justices' Clerk, the cash required to balance: (1) Petty Cash; (2) Bail Moneys; (3) Prisoner's Property; (4) Found Property; (5) Fees and Fines; (6) Separation and Bastardy Contributions, etc., may be transferred from one box to another, according to the fund being checked, unless all moneys are called for and agreed at the same time.

5. CERTIFICATION OF BANK BALANCES.

The reason which would appear to make the periodical certification of all bank balances desirable, especially at audit times, are—

(a) That there may be other banking accounts, the pass-books for which have not been submitted to the auditor by the cashier;

(b) That the entries in the pass-book, as submitted to the auditor, although correct as far as they go, may not be completely written up to the day on which the accounts are closed;

(c) That the pass-book submitted to the auditor by the cashier may have been manipulated by the cashier, or may be entirely different books written up by him to suit his own purposes, or to conceal misappropriations or fraud in his books.

BORROWING AND "DAY-TO-DAY" FRAUDS

1. DAILY BANK LODGMENTS.

The artificial "feeding" of a bank lodgment out of a current day's takings in order to make the lodgment agree with a previous day's receipts has already been indicated. This method may be employed in conjunction with a temporary borrowing in order to perpetuate its concealment from day to day for an indefinite period.

2. TEMPORARY BORROWING.

The majority of embezzlements appear to have originated from temporary borrowings which accumulated and, as repayment became impossible, were ultimately covered up by manipulations.

"THE CHEQUE TEST"

1. EARMARKING OF CHEQUE RECEIPTS.

Reference has already been made to the valuable means of fraud detection which lies in comparing the amount of each cheque received, with (a) the corresponding account in the ledger, and (b) the amount shown by the Receipt Book. Such a test has frequently revealed—

(1) Cheque items where no receipts have been issued—an equivalent amount of *CASH* being misappropriated to make the bank lodgment (including the cheques) tally with the total value of the day's receipt counterfoils;

(2) Entries which, while purporting to give discounts and allowances, have been disproved when it was discovered that the cheque was drawn for the *gross* amount, and

(3) The cashing of cheques for officials, customers and others, contrary to office regulations.

2. ACCOUNTS (Payment into Bank) ORDER, 1922.

The municipal regulations issued by the Ministry of Health for the minimization of bank lodgment defalcations could be followed voluntarily by commercial and other bodies with considerable advantage.

The principal provisions of the Accounts (Payments into Bank) Order, 1922, will be made clear in the following extract from a circular letter of the Ministry of Health (361—1923)—

“ it will be the duty of every officer of a local authority who pays money into a banking account of the authority, or of their treasurer, to keep copies of the particulars which he is required to enter on the bank paying-in slip, and to produce the book containing these copies for examination as and when required by the authority or the district auditor. Audit experience has shown the need for such records.

In addition to the particulars which are usually entered on a paying-in slip, the officer is required by Article 4 of the order to enter on the slips, in the case of each cheque paid in by him, some reference (such as the number of the receipt given or the name of the debtor) which will connect the cheque with the debt or debts in discharge or partial discharge of which it was received. The same particulars must be entered on the counterfoil or duplicate of the paying-in slip. If any cheque paid in has not been received in discharge or partial discharge of a debt due to the local authority (e.g. if it is a cheque which has been accepted by the officer in exchange for cash) and, in consequence, the above reference cannot be made, the officer is only required to make a note of the fact on the counterfoil or duplicate of the paying-in slip.

The order applies to every local authority whose accounts are subject to audit by a district auditor.”

3. CIRCUMVENTION OF THE CHEQUE TEST.

Before recommending *The Cheque Test* to the systematizer it should be pointed out that the fertile brain of the defaulter has not failed to discover a means of circumventing the

test. Whereas the original paying-in slips were correctly listed and analysed as to (1) cash, and (2) cheques, it was found in some cases that the analysis on the counterfoils did not agree with that on the original retained by the banks, and in others that the analysis had either been altered, filled in afterwards, or substituted after the lodgment.

If the counterfoil analysis apparently proves correct on comparison with the receipts issued it does not follow that the analysis on the original slip is the same. An occasional comparison of the counterfoils should be made with the original slips borrowed from the bank.

MAXIM—

Far too great a reliance is often placed upon the bona fides of counterfoils, especially of carbon duplicates.

An alternative to the testing of the original bank paying-in slip is for a third copy of the original paying-in slip, showing each cheque listed separately, to be certified and returned by the bank direct by post to the "office chief," or the Auditor's office. Even then care must be taken that access is not subsequently obtained to these slips.

With an exercise of due caution in other directions, *The Cheque Test* may be considered to be an invaluable contribution to the defence against fraud.

FICTITIOUS ALLOWANCES TO COVER MISAPPROPRIATION

1. DISCOUNTS AND ALLOWANCES.

It has already been indicated how the application of *The Cheque Test* can detect false discounts and allowances used to cover up a partial misappropriation of an account collected.

Unless the cashing of a cheque or the giving of change for a cheque is countenanced—both undesirable practices—the amount of the cheque should always coincide with the net amount of the account discharged.

The return of a discount in cash may assist the customer's

employee to misappropriate the amount, or this alleged cashing of the cheque may be untrue and thus constitute a fraud on the firm receiving the cheque.

2. DISCRETIONARY ALLOWANCES.

In a stockbroking case it was the practice during a rush period not to press their clients to pay certain stamps and fees with which, by an oversight, they had either not been charged or had omitted to pay.

The defaulter commenced to pass an occasional half-crown registration fee through his books as borne by the firm, whereas this either (1) had been already paid by the client, or (2) was not payable at all (e.g. Bearer Bonds).

He was also guilty of entering debits for the same transactions twice. Suspicion was eventually aroused by the abnormal debit to Profit and Loss Account for these exceptional discretionary allowances (discovered by "Comparative Methods," Chapter XIV).

MAXIM for Discretionary Allowances—

Since Discretionary Allowances may be used to cover defalcations, the authorization of such allowances should vest in a few responsible senior officials, who are not otherwise engaged in making, recording, or collecting the proceeds, of the related transactions.

3. FICTITIOUS IRRECOVERABLES.

A collector who has misappropriated the proceeds of an account will be anxious to advise the writing off, to prevent any further investigations.

MAXIM—

As a principle of internal check a collector should not deliver his own invoices, demand notes or other statements of accounts, nor should the ultimate decision to write off a bad debt rest with him.

The best method for ensuring that all debts to be written off are irrecoverable is for a return to be filled up by the collector of the amounts he is unable to collect, giving reasons for non-collection. This return of balances should be agreed with the books and, after a week or two, another collector should be sent out from the office to the places included in the return. Amounts which are not collected on this second application should be entered in the Bad and Doubtful Debts Register (illustrated in Chapter XIV), and legal proceedings should be taken in respect of all amounts which it is thought possible to recover through the Courts. Care should be taken to ensure that no amounts are written off the books, except those which have passed through the above-mentioned process.

CHAPTER IV
EXPENDITURE FRAUDS

SYNOPSIS

FALSE EXPENDITURE.

WAGES FRAUDS—

- (1) Causes and Prevention;
- (2) "Dummy" Men;
- (3) Insurance Stamps;
- (4) Error Leads to Fraud;
- (5) Tally System of Wage Payment.

INVOICES—

- (1) Vouching Invoices;
- (2) Duplicate Invoices;
- (3) False Invoices; examples of Invoice Frauds.

OUTSTANDING LIABILITIES—

- (1) Creditors for Goods;
- (2) Creditors for Work Done;
- (3) Verification with Records;
- (4) Creditors for Contracts and Accruals;
- (5) Omission of Liabilities.

TITLE—

- (1) Pledged Assets; temporary redemption to produce deeds at audit;
- (2) Documents of Title, *in re City Equitable Fire Insurance Co., Limited, 1924.*

SYSTEMS OF PAYMENT—

Modern Methods—

- (1) Cheque System;
- (2) Receipts on Cheques;
- (3) Machines and Printed Signatures;
- (4) Bank Credits—Uses.

CHAPTER IV

EXPENDITURE FRAUDS

FALSE EXPENDITURE

WHILST expenditure frauds comprise no inconsiderable portion of recent cases, this section of fraud research work will be found to be a comparatively simple study—especially if the rules for fraud prevention enunciated in the later chapters of this book are put into force.

The auditor or fraud investigator will satisfy himself as to (a) the existence; (b) authority (minutes, etc.); (c) purpose (i.e. business, private or speculative); (d) legality (*intra vires*); (e) accounting (not only the recording, but the paying over of funds) and (f) accuracy—of each transaction.

Only too frequently has it been observed in fraud cases that the auditor, or other person responsible for current supervision has only verified (f)—the arithmetical accuracy—a simple comparison with some other equally spurious record.

In view of the prominence given throughout this book to the methods of preventing expenditure frauds, it is only proposed to deal at this point with a few salient features of frauds perpetrated in connection with (a) Wages; (b) Invoices; (c) Outstanding Liabilities, and (d) Title to Assets.

WAGES FRAUDS

I. CAUSES AND PREVENTION.

The main causes and methods of preventing wages frauds are—

(a) *Preparation of Roll.* It should not be prepared by persons paying wages. (See "Internal Check".)

(b) *Inadequate Time Records.* Men receiving pay for time wasted, or not devoted to the business should be prevented.

(c) *Inadequate Piece-work Records.* Enabling pay to be

At the time and place of payment, the foreman should attend, and it should be his duty to recognize each man as he comes up to receive his money. Each man should hand his numbered brass token to the pay-clerk, and receive in exchange his money, enclosed in the envelope. If any of the men do not attend personally, or send a recognized substitute, such as wife or child, their money should be returned to the cashier. ("Unpaid Wages Book".)

When all the men who attend have been paid, the pay-clerk and the foreman should sign the following certificate, impressed at the foot of the sheets by means of a rubber stamp, viz.—

	Date,	19
The foregoing men, excepting Nos.	
	who did not attend, were this	
	day paid the several sums set opposite their names	
by		Pay-Clerk,
in the presence of		Foreman.

The cashier should examine the sheets as they come back, and he should agree the money returned to him with the amounts due to the men who have not been paid.

When these men subsequently attend at the office with their tallies to be paid, it is advisable to obtain their signatures to a voucher or in the "Unpaid Wages Book" for the payments.

INVOICES

1. VOUCHING INVOICES.

Not only should all purchases and items of expenditure be verified by reference to an original invoice, but the latter should be cancelled when vouched. This prevents its further use to support a similar but spurious transaction, under cover of which an equivalent sum could be misappropriated.

2. DUPLICATE INVOICES.

A copy of any missing invoice should be obtained from the creditor. In this respect it is urged that no creditor should

issue a second copy of an invoice unless it is clearly marked "DUPLICATE."

Some firms appear to adhere to the very undesirable practice of sending one copy of the invoice as a delivery note with the goods, and a second copy by post. In other cases there is nothing to distinguish an "invoice" from a detailed "statement of account," particularly when there is only one item outstanding, and this leaves the defaulter with two supporting documents, one of which may be used for the genuine, and the other for a spurious transaction.

The standardization of the forms and rulings and the appropriate use of commercial documents, particularly delivery notes, invoices, and statements, has much to recommend it. (See Chapter X, "Prevention by Legislation and Regulations.")

3. FALSE INVOICES.

In at least one embezzlement case false invoices were supplied by reputable firms, both in this country and abroad.

The defaulter in another case brought considerable pressure to bear upon the suppliers by threatening to withdraw the firm's custom from them if he was not supplied with the false invoices.

Again, invoices have been innocently supplied as duplicates but, at the request of the defaulter, who told the suppliers that he would get into serious trouble if it was discovered that the originals were lost, the copies were not marked "Duplicate."

These cases emphasize the importance of obtaining some independent evidence—however small it may be—as to the bona fides of the invoices produced.

OUTSTANDING LIABILITIES

1. CREDITORS FOR GOODS.

Care should be taken to ensure that sums included in the liabilities for goods purchased are in respect of goods actually ordered and received.

If there is a system of stores accounting, the "Stores Received Book" can furnish evidence of the receipt of the goods. (Chapter V.)

2. CREDITORS FOR WORK DONE.

There should be a proper system of official orders for all work done (including material used for repairs) to ensure that no liability is incorporated in the accounts when the work has not actually been carried out.

As accounts are paid, the counterfoils of the "Official Orders" should be marked, or the corners cut off. Those not so treated at the end of the financial year will represent the items outstanding.

3. VERIFICATION WITH RECORDS.

Wherever possible the outstanding balances should be verified, not only with statements of account furnished by creditors at the year end, but with the original invoices. These should be certified by the proper officials for payment in due course, which should be during the two or three months following the close of the financial year.

If Creditors Ledgers are kept, the invoices should be compared with the ledger balances. Unless it is the practice to make lump sum payments on account, the balance outstanding to each creditor should represent specific items.

4. CREDITORS FOR CONTRACTS AND ACCRUALS.

Balances under Contracts should be estimated and certified by the engineers.

Provisions made to meet accruing and other liabilities, such as Interest, Wages, etc., should be examined so as to make certain of their sufficiency. If necessary, the responsible Chief Officials should be consulted.

5. LIABILITIES OMITTED.

As opposed to the fraudulent inclusion of liabilities—whether as a means of misappropriating money or misrepresenting the financial results or position—there is the more common

fraud of excluding actual liabilities. This latter may be perpetrated (*a*) to inflate the results or financial state of the business, or (*b*) to hide the existence of certain items which according to the books purport to be settled but where, in fact, the settlement moneys were misappropriated.

TITLE

1. PLEDGED ASSETS.

Fraudulently "charged" assets may be temporarily redeemed on the day of examination, by the utilization of cash balances which have already been checked. In this respect a bank payment to Bearer or a fictitious payee which, in fact, is used for such redemption purposes, is not infrequent.

This action usually gives a further period of twelve months in which to conceal the fraud. One instance of this type of fraud was the drawing of £1,000 "Pay Wages" cheque on Wednesday (instead of the customary Friday). The cash was immediately utilized for the redemption of fraudulently pledged securities which were to be examined on the Thursday by the Auditors. Immediately after this examination, the securities were pledged again for £1,000 in order to pay the usual weekly wages on Friday night.

This type of fraud is too risky for the ordinary defaulter, but it again stresses the importance of checking all cash balances and securities at the same time. An interim spot check would also minimize the chances of this type of fraud succeeding. Each bank book and account book entry immediately before and after the time of such an examination, as well as before and after the date of the financial year end, should be carefully examined as a guard against such manipulation and "window dressing."

2. DOCUMENTS OF TITLE.

Where securities are deposited with solicitors, stock-brokers, bankers, and others for safe custody, sale, or for reference purposes, the Auditor should wherever possible

inspect the actual documents of title (*in re City Equitable Fire Insurance Co., Ltd.*, 1924).

In any case, a certificate should be obtained from the holder to prove that the assets are held free from any lien, mortgage, or other charge thereon.

SYSTEMS OF PAYMENT

MODERN METHODS.

Particularly in municipal undertakings and the larger commercial concerns, progressive steps have been taken during the last few years to develop their methods of payment on more modern lines, viz.—

1. CHEQUE SYSTEM.

The cheque payments system has now largely replaced the cash system, except for smaller weekly wage earners, public assistance relief, and the like. Cheques permit of a greater degree of control than is possible with cash transactions, and a further safeguard is provided by crossing the cheque "Account Payee Only."

Although essentially American in its application, the following statement by Mr. A. K. Willey, Assistant Secretary of the General Electric Company is of interest. He said (1932): "The General Electric Company was carrying pay-roll hold-up insurance five years ago of over \$1,500,000 distributed through its various plants. To-day we carry none, because every employee is paid by cheque, or by direct deposit to his individual bank account. *Our armoured cars* have been transferred to industrial use, or disposed of. Our purpose in making this change was not the cost of the hold-up insurance, but primarily to keep pay-roll clerks and messengers from the danger of losing their lives in connection with their duties."

2. RECEIPTS ON CHEQUES.

Cheques bearing a form of receipt, either in addition to or to serve as an endorsement, have been widely adopted.

As illustrated in the previous chapter these cheques may prove to be a very mixed blessing unless the drawer insists upon having an official printed receipt attached to his cheque. There is a regrettable tendency for the drawer to content himself with the plain written discharge given on his cheque by the payee's representative. This is not fair to his payee, because such an attitude enables employees to receive and misappropriate money without issuing any official receipt.

3. MACHINES AND PRINTED SIGNATURES.

Mechanical methods, such as cheque writers and lithographed signatures, will be dealt with later. (Chapter XV, "Machinery," and Chapter VI, "Forgery.")

4. BANK CREDITS.

Payments by "Bank Credits" direct to the accounts of the creditors have shown an increasing tendency during recent years and this development is to be welcomed: (*a*) in preventing misappropriation; (*b*) in preventing the prolonged or fraudulent retention of moneys received, and (*c*) as tending to expedite the transfer of funds.

This system has been used instead of the post: for (*a*) the collection of hire-purchase instalments, Life Insurance premiums and subscriptions; (*b*) payment of Government Exchequer Grants to local authorities; (*c*) payment of salaries (in some cases); (*d*) payment of interest and dividends, and its extension has been suggested to (*e*) payment of creditors' accounts.

There is still a great field for the extension of the system of payment by bank credits.

CHAPTER V

MISAPPROPRIATION OF GOODS

SYNOPSIS

USE OF STORES AND COST ACCOUNTS—

- (1) Petty Pilferings ;
- (2) Bin Tickets ;
- (3) Stores and Costs Accounts—*Nottingham Corporation Gas Fraud, 1931*—Danger of Formality and Routine—Control of Sales by Stock and Cost Accounts ;
- (4) Internal Check, Division of Duties ,
- (5) Dietary and Component Control ;
- (6) Goods for Private Use ;
- (7) Weighbridge Manipulations.

RETURNS OF GOODS—

- (1) Allowances ;
- (2) Returns to Stores ;
- (3) "Empties."

STOCKTAKING—

- (1) Discrepancies ;
- (2) Bulk Stocktaking ;
- (3) Auditors' Attitude Toward Stock, *in re Kingston Cotton Mills.*

CHAPTER V

MISAPPROPRIATION OF GOODS

USE OF STORES AND COST ACCOUNTS

1. PETTY PILFERINGS.

SMALL thefts of household, useful or easily saleable stores are frequently covered up by manipulation of records. Where there are no stores records such petty pilferings often pass unnoticed, unless they are sufficiently large *in cumulo* to be apparent by the application of comparative methods. (Chapter XIV.)

2. BIN TICKETS.

The author has heard the use of "bin" cards, in addition to stores ledgers, condemned as redundant. He would submit, however, that an internal or double check of this nature is not always a redundancy. The necessity for recording the quantities of receipts and issues on the receptacle card has, in his experience, proved not only a valuable moral check upon the employees and storekeepers, but also a means of locating and minimizing waste, stock and book differences, manipulation of the main records, omission of items from the cost cards, and the fraudulent use of goods for private purposes (e.g. petrol).

3. STORES AND COST ACCOUNTS.

Commencing with the authoritative issue of Official Orders, and the effective certification of invoices (as distinct from the *formal* signatures which characterized the *Nottingham Corporation Gas* (1931) fraud case) experience has proved the need for an adequate system of stocks and stores accounting which shall form part of the main financial accounting system.

In the *Nottingham Gas* case, the order clerk issued bogus orders to tradesmen with whom he worked in collusion. The false invoices, unsupported by any genuine delivery of goods,

were *formally* initialled by a superior officer, as authorized, but the duty of certifying the quantities and due delivery was usurped by the defaulting Order Clerk. This case not only illustrates the need for accurate stores and costing records, linked with the double entry financial accounts, but reveals the danger of systems, checks and audits developing into a formal routine.

A "Store and Costing" system should prevent the omission to account in full for the sums realized by sales of stocks and merchandise, but the application of detailed stores ledgers to any particular undertaking must have regard to its suitability in that particular case. Coal, for instance, can easily be controlled in one book as regards weights received, issued and remaining in stock, whilst an undertaking where several hundred lines are kept could not hope to maintain a running record of stock variations.

4. INTERNAL CHECK.

At this point it is advisable to emphasize and to supplement the particular application of internal check systems to the control of stocks and stores.

The duties of employees should be distributed as advantageously as the numerical strength of the personnel will permit, as regards—

- (a) Using the goods (workman);
- (b) Custody of the main stocks (storekeeper);
- (c) Preparing primary records of labour and materials;
- (d) Periodical and surprise stocktaking (stores clerk);
- (e) Summarizing and pricing out stores, costings and financial records;
- (f) Making charges for work or goods, and
- (g) Collection of accounts thus rendered.

5. COMPONENT CONTROL.

Not only is it desirable for Store Accounts to be linked with the financial accounts, but a further link in the chain of control may be forged by such methods as prescribed Dietary Tables (Institutional Management), or other similar schedules of

standard components of the final product (e.g. yards of cloth used per dozen suits).

6. GOODS FOR PRIVATE USE.

In passing, a partnership fraud case may be cited with advantage as regards the scrutiny and interpretation of Stores Accounting.

Goods which should have been debited to the defaulter's private "Drawings Account," were charged out to fictitious foreign customers and finally written off as bad debts when the accounts were returned through the "G.P.O. Dead Letter Office."

7. WEIGHBRIDGE MANIPULATION.

A weighbridge-note is not always a sufficient proof of delivery. It has been possible for duplicate payments to be made on Corporation housing schemes for bricks which have either been "checked-in" twice, or in respect of which two "Weigh-notes" have been obtained from private and public weighbridges.

MAXIMS FOR WEIGHBRIDGES—

- (a) Systems of Payments based solely upon "weigh-notes" are exceedingly dangerous.
- (b) It is advisable that there should only be one appointed weighbridge—preferably near to the site—and that appropriate instructions be given to the operator of the scales to prevent loads being weighed twice.
- (c) Finally, beware of collusion, which is very prevalent in this type of fraud.

RETURNS OF GOODS

I. ALLOWANCES.

In augmentation of the remarks already made in Chapter III on the authorization, control and dangers of allowances, it is appropriate that the problem of returns to stores and "empties" should now be dealt with.

2. RETURNS TO STORES.

In practice, a *surplus* on individual stores accounts is not infrequent. This phenomenon is not always due to error, duplicated entries for issues, or even to absorption of moisture, but more frequently to goods returned to stores not being recorded at all.

The issue of "returns inwards" acknowledgments for the materials returned is suggested. This system, however, tends to fall into disuse in practice unless there is some incentive for the person returning the goods to insist upon such a "return note." Where, for instance, a man's cost card is debited with the original materials, he will be anxious to return any surpluses to stores and obtain a credit note to substantiate his cost card entries.

Another dangerous aspect of surplus material is that they may not be returned at all from a job. They may be either misappropriated for private use or carried to another job where, perhaps, the cost card provides for a bonus. Where possible the surveyor and foreman himself should keep a measure of check upon the materials appearing in the completed job and compare these with the issues recorded in the stores accounts.

3. EMPTIES.

The stock sheets in one case included items of empty containers, although—

(1) Allowances for their return had already been made, or

(2) In other cases, no charge had originally been made for the packages and the book values should, therefore, have been "nil."

STOCKTAKING

I. DISCREPANCIES.

Stock sheets, showing columns for (1) book figures and (2) actual quantities should be prepared at the financial year end, and at irregular intervals throughout the year.

Differences must be explained satisfactorily as well as corrected in the stores accounts and bin cards, for it is here that irregularities may have taken place.

2. BULK STOCKTAKING.

Where stock is kept in bulk it is not always possible for a complete weighing or counting to take place. In cases such as coal, coke, granite setts, etc., it is convenient to measure the dimensions of the heap, reduce to cubic yards, and count or weigh a representative cubic yard. Assuming the ground is level and that the bulk is composed of the same material, the total quantity can thus be ascertained by multiplication and the worth evaluated.

3. AUDITOR'S ATTITUDE TO STOCK.

Whilst one hesitates to censure the auditing profession as a whole, it must be conceded that, in certain quarters, too great a reliance is placed by an auditor upon the limitations which the Courts of Law have placed upon his liabilities and duties to clients. (See Chapters X and XII.)

In view of the quickly changing conditions and improved commercial methods of modern times, it is a question whether the old *Kingston Cotton Mills* ruling could still be relied upon to protect an auditor sufficiently from liability in respect of an obviously inflated stock value.

Many cases of irregularities in stocktaking and evaluation could have been prevented by the exercise of a little perspicacity, the examination of available stores records, or even by the application of comparative methods, e.g. comparison over a period of years of the percentage which the Gross Profit bears: (a) to purchases, or (b) to sales. (See Chapter XIV.)

CHAPTER VI

FORGERY AND ALTERATION

SYNOPSIS

THE RISK—

DUTY AND OBLIGATION.

ALTERATIONS—

- (1) Errors and Alterations—sometimes Fraudulent Manipulation ;
- (2) Deletions—Ink Eradicator ;
- (3) Figures ;
- (4) Methods of Stealing Cheques.

SUBSTITUTION—

- (1) Bank Pass Books ;
- (2) Card and Loose Leaf Records.

SIGNATURES—

- (1) Temptation ;
- (2) Ratification of Forgery ;
- (3) Adoption of a Forgery ;
- (4) Banker's Liability—*Bills of Exchange Act, 1882* ;
- (5) Lithographed Signatures.

UNAUTHORIZED DOCUMENTS—

- (1) False Minutes ;
- (2) False Documents ;
- (3) Printer's Co-operation—*Bank of Portugal v. Waterlow & Sons*
(H. L., 1932) ;
- (4) Forged Transfer of Securities.

STOCK AND SHARE CERTIFICATES—

- (1) Unauthorized Scrip—Hatry Frauds ;
- (2) Authority to Print ;
- (3) Contractors' Scrip—Municipal—*Stock Regulations, 1932.*

THE MUNICIPAL METHOD OF SCRIP CONTROL—

- (1) Issues of Scrip ;
- (2) Fully Paid Scrip ;
- (3) Rule for Registration ;
- (4) Object of 1932 Regulations ;
- (5) Where own Documents are Issued.

CHAPTER VI

FORGERY AND ALTERATION

THE RISK

LOSSES resulting from forgeries and alterations have been estimated to be in the following approximate proportions—

1. Forgery of signature, 45 per cent.
2. Forgery of endorsement, 50 per cent.
3. Alteration of instrument, 5 per cent.

DUTY AND OBLIGATION

Some years ago, a well-known K.C. stated that it is a "somewhat undefined but appreciable doctrine of the duty of an honest man to prevent his name being used without authority to the prejudice of his fellow man; a duty, moral in character, but apparently nearing recognition as of legal obligation."

ALTERATIONS

1. ERRORS.

Fraud is closely allied to error in a great number of instances, the former is intentional, whilst the latter is accidental.

The fraud investigator should heed this oft repeated warning—

MAXIM FOR APPARENT ERRORS—

What at first sight appear to be "errors" may, on investigation, prove to be "fraudulent manipulations."

One alteration should be a ground for caution, and two alterations for suspicion.

2. DELETIONS.

The use of a knife or of chemical ink eradicator should be forbidden. Whilst neatness in office records is a virtue, the

concealment of original entries—even if erroneous—is a curse. It is infinitely preferable to have visible deletions of genuine mistakes in the records than to have the uneasy feeling that a carefully substituted entry is concealing the original truth.

Erasure by knife and chemicals are not unknown in items which have passed the internal or interim professional audits. In nearly all these cases the alterations were not made by professional forgers—the paper was discoloured, or the alteration should have been obvious to the audit clerk checking the additions.

3. FIGURES.

The number of alterations of figures on petty cash vouchers, books of record, and accounts, in an attempt to cover petty peculations show little signs of abating. The addition of the figure “one” to the front of smaller sums is a favourite form of this fraud.

The favourite alterations of amounts in cheque forgeries are from 8 to 80 (by the addition of the letter “y” to the words and the cypher to the figures); 9 to 90; and the prefixing of one hundred to a smaller amount, where the precautions of starting the words close to the margin and of ruling lines to prevent any addition to the amount, has not been strictly observed.

4. STEALING CHEQUES.

Professional forgers used to obtain possession of cheque books as the basis for their operations. This method, however, has been made more difficult by the improved control of cheque books exercised by the banks. It has been largely abandoned in favour of a system involving the wholesale stealing of ready-made cheques bearing genuine signatures, or by altering the amounts of small cheques received in the ordinary course of business from big firms.

A bag is sometimes placed, after office hours, inside the letter box of an office or even in a street letter box. Later, the

operator comes round, draws up the bag with the letters in it, extracts any cheques, sends them to expert forgers who take out the crossing stamp (unless printed or made by machinery) and frequently add to the amounts for which they were drawn.

As the forged cheques are usually presented in a rush hour as soon as the bank opens, the funds in the account are usually sufficient to honour the cheque. (See Cheque Writers in Chapter XV, dealing with "Prevention by Machinery.")

SUBSTITUTION

1. BANK PASS-BOOKS.

In order to circumvent the use of partially or completely forged bank pass-books as a cover for misappropriations, it is suggested that a banker's certificate of the balance should be sent direct to the auditor's office or to the proprietor's private address, according to the person making the test.

No altered certificates should be accepted, even if initialled, for it is felt that no efficient modern bank manager would allow an altered certificate to be issued when a correct copy could be prepared in a further few minutes.

2. CARD AND LOOSE LEAF RECORDS.

Loose leaf pass-books may help to minimize pass-book frauds in future, because each transaction shows the resultant balance and the alteration of one item would thus involve the alteration of every "balance" item to the end of the book. (See illustrations in Chapter XV, "Campos Machine.")

It is admitted that loose leaves can be fraudulently substituted, both in bank pass-books and commercial accounting books, but it is felt that this danger has been largely exaggerated by the writers of auditing textbooks. Given a reasonable control of (i) the stock, (ii) issue, and (iii) extraction of sheets and cards, a system of audit ticks and the frequent balancing of the records, there should be little danger of this type of fraud occurring.

SIGNATURES

1. TEMPTATION.

The greater issuance of cheques in recent years, coupled with the frequent industrial depressions, has led many an honest but financially hard pressed employee—as well as the ordinary criminal class—to discover that the alteration of cheques is often one of the easiest of the various dishonest methods of obtaining large sums of money.

Forgery, however, is rarely used in office frauds, except in conjunction with other forms of embezzlement. It does not usually remain hidden very long, for where it does occur, it is usually quite obvious and accompanied by absconding.

2. RATIFICATION OF FORGERY.

Where a wife forged her husband's cheques, and no action was taken against the bank until the death of the wife, the court held that, although ratification had no applicability to a forged signature, the husband was estopped from alleging the forgeries, because his silence until his wife's death had caused the bank to lose their right of action against the forger. *Greenwood v. Martins Bank, Ltd.* (Court of Appeal, 1931.)

3. ADOPTION OF A FORGERY.

A forged signature could, however, be *adopted* by one saying for instance: "I will recognize this signature as my own; you may debit my account with this cheque."

4. LIABILITY OF BANKER.

A cheque is said to be forged if either the amount or name of the payee has been falsified, or if the drawer's signature is not genuine.

The banker is liable to make good any loss caused by his paying such a forged cheque, but he is not liable for any loss incurred through an endorsement being forged.

Section 79 (2) of the Bills of Exchange Act, 1882, extends its protection to bankers, thus—

“Provided that where a cheque is presented for payment which does not at the time of presentment appear to be crossed, or to have had a crossing which has been obliterated, *or to have been added to or altered*, otherwise than as authorized by this Act, the banker paying the cheque in good faith and without negligence shall not be responsible or incur any liability, nor shall the payment be questioned . . . by reason of the cheque having been added to or altered . . . , etc.”

5. LITHOGRAPHED SIGNATURES.

With the universal adoption of cheque payment systems the signing of cheques, etc., individually, has come to be regarded as a wasteful and tedious process.

The use of lithographed and rubber stamped signatures calls for the exercise of a closer custody and control of both the cheque books and the signature dies. Confirmatory initials and secret marks known only to the bank are almost essential as a guard against the unauthorized issue of cheques. Many firms and local authorities provide their banker with a list of all cheques drawn as a double check upon such frauds.

UNAUTHORIZED DOCUMENTS

1. FALSE MINUTES.

A few years ago an Education Authority suffered heavily through “Ghost names” in the Teachers’ Salaries sheets. This fraud had been continued over an extended period by the insertion of unauthorized pages of appointments in a loose leaf minute book.

Such a fraud could easily have been perpetrated in a commercial concern in a similar manner and, therefore, suggests the advisability of minutes being recorded in a bound book to be read at the next meeting, and signed by the chairman.

MAXIM—

Care should be taken that the chairman's certification of the minutes does not become a formal matter devoid of any genuine verification of authenticity.

Internal check methods also should be applied, whereby the department preparing the authorization documents (e.g. Legal Department) should not be concerned in the paying process (Finance Department).

2. FALSE DOCUMENTS.

The printing of unauthorized minutes is a very rare occurrence owing to the great risk of discovery, but the unauthorized ordering of receipt books, mortgage bonds, documents of title and the like are of more frequent occurrence.

3. PRINTER'S CO-OPERATION.

Since Messrs. Waterlow & Sons were held liable for damages, amounting to £610,392, for negligence in the printing of unauthorized Portuguese bank notes (*Bank of Portugal v. Waterlow & Sons*, House of Lords, 1932) a greater degree of co-operation has been sought between printers and their customers, with a view to preventing the private or unauthorized ordering by employees and others of official receipts and documents.

The printers should be instructed (a) not to accept orders for such documents unless supported by an authoritative letter setting out the serial numbers which the printed documents should bear; (b) not to debit the cost of any official documents to a private account, nor (c) to accept a cash settlement or any other means than by an official cheque. (Defaulter might buy them out of his own pocket.)

4. FORGED TRANSFER OF SECURITIES.

Even if a forged transfer is passed for registration without detection and a certificate issued, the person named as transferee can acquire no rights in the securities.

On the other hand, the company or other body passing the forged transfer is liable to the true owner for any dividends he may have lost through their action, and they can be compelled to re-enter the true owner's name in their registers. (*Barton v. L. & N. W. Railway*, 1890.)

Power is given to local authorities, joint stock companies, incorporated friendly societies, and building, or other provident societies, by the Forged Transfers Acts, 1891-92, to charge an extra fee for each transfer registered. Such fees provide a fund out of which to compensate the *transferee* for his loss through the forgery.

STOCK AND SHARE CERTIFICATES

1. UNAUTHORIZED SCRIP.

Wakefield and other corporations were the victims of one aspect of the "Hatry Frauds" (*Corporation & General Securities, Ltd.*) several years ago, and it would appear that this matter deserves the attention of commercial men also—not only as regards share issues through an Issuing House, but also where the control of scrip certificates lies in their own office.

2. AUTHORITY TO PRINT.

The Issuing House in the above case was authorized to print the stock certificates for their principals, and they fraudulently exceeded their authority by issuing scrip in excess of the total authorized issue and by retaining the proceeds of such an excess.

3. CONTRACTOR'S SCRIP.

The Municipal Stock Regulations, 1932 (S. R. & O. 1932, Nos. 434 and 436, viz.: "The County Stock Regulations, 1932," and "The Stock Regulations, 1932") dealt with the practice of a person (or company) purchasing the whole of the issue of stock at a contracted price, which he later places upon the market for his own benefit. The use of "Contractor's Scrip"

(i.e. scrip issued by a bank or issuing house on its own behalf) is forbidden in the case of municipal issues by these regulations, and it is provided that all documents shall be such as to establish a *direct* contractual relationship between the local authority and the holder of the document.

Before any allotment letter or scrip is issued, the contractor under the above system must pay into the local authority's bank account, all sums which may be due from the contractor in respect of the sum certified in the letter or certificate as having been paid by the holder of the document.

THE MUNICIPAL METHOD OF SCRIP CONTROL

1. ISSUES OF SCRIP.

In municipal issues, the issuing house or bank is required, by the Stock Regulations, 1932, to furnish the registrar of the stock with a complete record of the scrip certificates issued.

2. FULLY PAID SCRIP.

The issuing house must immediately notify the registrar when payment is made in full on every scrip certificate.

3. RULE FOR REGISTRATION.

Only on production of a fully paid scrip certificate may the registrar inscribe or register the holder's name.

By the 1932 Regulations, not even an allotment letter can be accepted by the registrar in lieu of a fully paid scrip certificate, except in those very exceptional cases where no scrip certificates are issued. In the latter event, a fully paid allotment letter may be accepted.

4. OBJECT OF 1932 REGULATIONS.

In this way, one is assured that each scrip certificate issued is duly accounted for. The possibility of their misuse

is avoided—no scrip being left in circulation, since the whole of the stock is registered or inscribed only upon production of a fully paid scrip certificate or fully paid letter of allotment.

5. WHERE OWN DOCUMENTS ARE ISSUED.

This regulation does not apply, of course, where the local authority issues its own interim scrip—a very desirable method where the domestic regulations imposed on the Authority's own officers are not inferior to the above Stock Regulations. Here again the problem resolves itself into one of "Internal Check"—

MAXIM—

Those receiving the subscription moneys should not be responsible for issuing certificates.

PART III

FALSIFICATION, MANIPULATION AND MISREPRESENTATION

- CHAPTER VII . . . FALSIFICATION TO MISREPRESENT
RESULTS
- CHAPTER VIII. . . PROMOTION, ISSUE OF CAPITAL, ETC.
- CHAPTER IX . . . INSOLVENCY FRAUDS

CHAPTER VII
FALSIFICATION TO MISREPRESENT RESULTS

SYNOPSIS

INTERNATIONAL EFFECT—

Kreuger, Hatry, Bevan, etc., Cases.

CLASSES—

- (1) Falsification to Evade Taxation;
- (2) Employer's Benefit Only;
- (3) Market Value of Securities;
- (4) Inflation of Stock Values;
- (5) Obtaining Credit by Falsification—Bank Loans on Stocks;
- (6) Checking Deeds—Register of Local Land Charges.

MANIPULATION OF RESERVES—

KYLSANT CASE 1931—

- (1) Use of Secret Reserves,
- (2) Abuse of Secret Reserves;
- (3) Hiding Irregularities;
- (4) R.M.S.P. Dividends;
- (5) Directors' Duty to Shareholders;
- (6) Publicity of a Company's Finances.

CHAPTER VII

FALSIFICATION TO MISREPRESENT RESULTS

INTERNATIONAL EFFECT

THE vital importance of this section of fraud research work is emphasized by the international repercussions resulting from the "Kreuger," "Hatry," "Bevan," and similar fraud cases.

To make a summary of all the amazing varieties of manipulations wrought during recent years by the fertile but wayward human mind would be to attempt a Herculean task. The resultant record, although of absorbing interest to the systematizer, would greatly exceed the appointed limits of this work. It is, therefore, proposed to confine this section to recording the more typical examples of manipulation where no direct misappropriation was involved.

CLASSES

1. FALSIFICATION TO EVADE TAXATION.

High taxation induced one Company to attempt evasion of taxes by excluding sales, and thus creating a secret cash reserve outside the business. A similar result was achieved in another case by passing "dummy men" through the Wages Roll.

The cash reserve thus created was eventually used for legitimate business purposes. The more usual purpose was the purchase of Capital Assets which could not, of course, appear in the books or balance sheet of the Company.

This manipulation was so successful that, after a time, the moneys were used for non-business purposes and for the directors' personal benefit.

Whilst the former method was a fraud upon the Inland Revenue, the later was also a fraud upon the company—an embezzlement of "entrusted" moneys.

The effectiveness or otherwise of the heavy penalties imposed under the Income Tax Acts will be discussed in Chapter X ("Prevention by Legislation").

2. EMPLOYER'S BENEFIT.

Where employees' office positions were likely to be enhanced, it is notable that they have perpetrated frauds on other firms and the public for the sole benefit of their employers.

Whilst it may be regrettably true in a minority of such cases that the defaulters were encouraged by their principals to indulge in a little "sharp practice," it is felt that their original action was usually precipitate and mistaken.

Procured Torts. A tort, or actionable wrong, arising independently of contract, committed by one person at the request of another, makes both such parties liable therefor.

3. MARKET VALUE OF SECURITIES.

This is a type of manipulation frequently used for the personal benefit of directors and managers.

One of the many examples is the inclusion of fictitious sales and the "export" of false cargoes. Before the subsequent adjustments are made, the manipulator sells his own holding and, perhaps, buys the securities again after the adverse effect of the adjustment has been felt. Sometimes the managing director obtains a commission on such false sales, so that there is a double inducement to manipulate such transactions.

4. INFLATION OF STOCK VALUES.

Reference has already been made to frauds in connection with goods. (Chapter V.) The practice of inflating the ending stock values is now too well known to the auditing profession to call for any comment here.

Normally, such stock inflation methods can only be used for one year-end, unless the values are increased systematically on each occasion.

5. OBTAINING CREDIT.

Bank loans were obtained in one case on the strength of the good results shown by such manipulated accounts. Good dividends were paid and the market value of the shares therefore rose appreciably, thus enabling the managing director to dispose of his own shares at a considerably enhanced figure.

The abnormal value of unsold stocks made the bank suspicious and lose their previous confidence in the company—especially as it carried on a seasonal trade, and the stocks should have been very low at the time of closing the accounts. Upon visiting the warehouse, only a few empty sacks were to be found in stock.

Evidently the basis for the bank loans should have been certified stock sheets, *with supporting documents*, prepared by an independent, disinterested person, and not merely the unsupported certificate of the managing director.

6. CHECKING DEEDS.

An auditor should be cautious in undertaking audit work which involves the verification of deeds.

An accountant is not necessarily a skilled lawyer, and therefore a fraudulently minded solicitor could no doubt achieve a measure of success by the manipulation of deeds.

Apart from the foregoing note of caution, the auditor should not forget the use to which the "Register of Local Land Charges" can be put. No doubt in years to come this Registry will be made so comprehensive that, by consulting it, one may be satisfied of documents of title being indisputable.

MANIPULATION OF RESERVES

1. USE OF SECRET RESERVES.

It was said by a very learned Judge on one occasion, by way of observation, and not by judgment, that a company, that is to say, the shareholders, could not complain if the

position of the finances of the company was better than the accounts disclosed. This has been quoted from time to time as a justification for the method of keeping reserves secret.

2. ABUSE OF SECRET RESERVES.

Mr. Justice Wright in his summing up in *Rex v. Kysant* (1931) (Royal Mail Steam Packet Company case) said—

“ there may be very great evils if those who have control and management of the company, and who control and manage companies for the benefit of the shareholders who entrust their moneys to companies, if very large portions of the company’s assets are left in the secret disposition of the managing authority.”

3. HIDING IRREGULARITIES.

“ It may work very well in many cases, on the other hand it may be the subject of almost intolerable abuse. Such a system may be used to cover up negligences, irregularities, and almost breaches of faith.

It is said to be a matter of domestic concern between the company and the shareholders, but if shareholders do not know and cannot know what the position is, how can they form any view about it at all ? ”

4. R.M.S.P. DIVIDENDS.

With special reference to the *Royal Mail Steam Packet Co.* (Kysant) case, the learned Judge gave the following example : “ You have here a series of large sums of money, the nature of which, and the propriety of which, and the use of which, have remained secret from the shareholders.”

“ There were balance sheets and profit and loss accounts published for a period of seven years which did not disclose one way or the other whether the company was earning any profit or not. During those seven years there was expended out of those items, which were mainly connected with the war, a sum of no less than five million pounds—not out of current earnings at all, but out of these items which in the main arose out of the war.”

“During all that period the shareholders were told nothing, and they drew their dividends presumably in the simple faith that all was well with the condition of the company.”

“If the shareholders had been told that this company had no earnings, because earnings are the life blood of a company—a company cannot go on indefinitely using its capital assets unless it is earning—surely they might have taken steps for the reconstruction and re-arrangement of the company’s affairs. It was never brought to the shareholders’ knowledge what the position was.”

5. DIRECTORS’ DUTY TO SHAREHOLDERS.

“It is a little astounding, and one cannot help wondering whether those who manage big companies do not forget sometimes that the body of directors of a company are the agents and the trustees of the shareholders, that they owe them full information, subject to proper and reasonable commercial necessity; they owe them full information, and it is their interests that they have to study; they are not to regard shareholders as people who may look up if they are not fed; they are the people whose money they are using, and it is to be remembered that a joint stock company is a creation of law.”

6. PUBLICITY OF A COMPANY’S FINANCES.

“A joint stock company has the enormous advantage of limited liability, and the Legislature has intended, it seems to me, although by halting steps, to secure that those who enjoy those privileges of limited liability, and who control and manage joint stock companies should be subject to some condition as to publishing their accounts at least to the shareholders, and at least to those who are entitled to be summoned to general meetings.”

Further reference will be made to this subject in Chapter X (“Future Legislation”) and Chapter XII (“Auditors’ Duties and Liabilities”).

CHAPTER VIII
PROMOTION, ISSUE OF CAPITAL, ETC.

SYNOPSIS

PROTECTION OF THE INVESTOR.

PROSPECTUSES—

- (1) Larceny Act, 1861;
- (2) Fraud by Concealment—Kylsant Case, 1931;
- (3) General False Impression;
- (4) Intent to Deceive;
- (5) Deliberate Falsehoods;
- (6) Prosecution under Companies Act, 1929.

EFFECT OF UNTRUE STATEMENTS—

- (1) Contract Law,
- (2) Rescission;
- (3) Damages for Fraud;
- (4) Compensation under Companies Act, 1929.

ISSUE OF CAPITAL AND SECURITIES—

Recent Defalcations—"Hatry Frauds."

- (1) Proceeds in Private Bank Account;
- (2) Surplus Funds lent to Issuing House;
- (3) Printing Scrip;
- (4) Municipal Stock Regulations, 1932

RESOLUTIONS—

- (1) Fraud on Minority;
- (2) Other Third Party Frauds.

CHAPTER VIII

PROMOTION, ISSUE OF CAPITAL, ETC.

PROTECTION OF THE INVESTOR.

It is impossible for the Legislature to prevent the foolish investment of moneys in highly speculative, or hopelessly under-capitalized or over-capitalized concerns, especially where the investor is given all the necessary information for him to deduce these facts. It has been found possible, however, by such statutes as the Companies Act, 1929, to afford a measure of protection to the investing public against their being misled and defrauded by untrue statements, even if made innocently.

PROSPECTUSES

1. LARCENY ACT, 1861.

Section 84 of the Larceny Act, 1861, dealing with publishing fraudulent statements, says—

“Whosoever being a director, manager, or *public officer*” (public officer would include the auditor) “of any *body corporate* or public company shall make, circulate, or publish, or concur in making, circulating, or publishing any written statement or account which he shall know to be false in any material particular, with intent to deceive or defraud any member, shareholder, or creditor of such body, or to entrust or advance any property to such body corporate or public company, or to enter into any security for the benefit thereof, shall be guilty of a *misdemeanour*.”

2. FRAUD BY CONCEALMENT.

In *Rex v. Kysant* (1931), Mr. Justice Wright considered that “the application of Section 84 of the Larceny Act, 1861,

was not limited to a case where you point to a written account or written statement," and said: "Here are certain figures, here are certain words which are false. I think that is to narrow unduly the words in any material particular. In my judgment to construe it in that way would be to shut out a type of fraud in connection with written documents or written accounts which may be of the utmost importance, and that is *the type of fraud which may be found in a document, not fraudulent in the sense of what it states, but in the sense of what it conceals or omits.*"

3. GENERAL FALSE IMPRESSION.

"It will cover the case where you have a written statement which is false, not in any specific words or any specific figures which it contains, but which is false in the way in which a document may be fraudulent, namely, where you may take every word and every figure, and say: 'Now there is nothing false about this, there is nothing false about that,' but the document as a whole may be false not because of what it states, but because of what it does not state, because of what it implies."

4. INTENT TO DECEIVE.

"That type of falsity is more difficult to establish than the case where you can point to a specific false word in a sentence, because where the falsity consists *in a fraudulent desire to create a false impression*, while keeping accurately to the limited facts which *appear* in the document, where the falsity consists of that, you have to show affirmatively that there was a *deliberate intent to create a false impression.*"

5. DELIBERATE FALSEHOODS.

"If you have a definite falsehood, that speaks for itself. A man who has told a definite falsehood, or written a definite falsehood, may perfectly well be able to show that though it was false he did not know it was false, or in certain cases, though he knew it was false, he did not intend to deceive

anybody but made a false statement, an inaccurate statement, thinking that it was substantially true, though he knew all the facts which ought to have told him it was untrue. That is a much simpler case than where you have a case in which a written statement is alleged to have been false in the sense that it was concealing the true facts."

6. PROSECUTION UNDER COMPANIES ACT, 1929.

Under the Larceny Act, 1861, there are three essential ingredients: (1) the falsity itself, (2) the knowledge thereof, and (3) an intent to deceive. This was applicable in the *Kylsant* case (the Royal Mail S.P. Co. being a company formed by *Charter*) but the third ingredient is not a necessary ingredient under the Companies Act, 1929, either as regards investors or shareholders.

EFFECT OF UNTRUE STATEMENTS

1. CONTRACT LAW.

The general law and rules of contract apply to the offer and acceptance of shares or stock in a company. (See Chapter I.) If non-disclosure, however, is sufficient to give a totally false impression, it is fraudulent. (*Sheppard v. Broome*, 1904, and *re Christenville Rubber Estates*, 1911.)

2. RESCISSION.

An applicant who was induced to take the shares by fraud, or misrepresentation, may rescind his contract and require his name to be deleted from the company's registers of shares and members.

3. DAMAGES FOR FRAUD.

The promoter may be sued for damages for fraud, but the defrauded party cannot both claim damages and retain the shares under the contract. (*Houldsworth v. Glasgow Bank*, 1880.)

4. COMPENSATION UNDER COMPANIES ACT, 1929.

The Companies Act, 1929, also makes a Director or Promotor liable for compensation for misrepresentation (formerly the Director's Liability Act, 1890). Such a misrepresentation need not have been the *sole* reason for the applicant entering into the contract to take shares, but he must actually have acted upon the misrepresentations (*Edgington v. Fitzmaurice*, 1885).

THE ISSUE OF CAPITAL AND SECURITIES

In respect of both commercial and Municipal Capital Issues losses have occurred in recent years—particularly in the “Hatry Frauds”—in the following avoidable circumstances—

1. PROCEEDS IN PRIVATE BANK ACCOUNT.

The terms of issue allowed the payment of the money subscribed by the public to be paid into the private banking account of the issuing house. There should have been a condition that subscription moneys and subsequent instalments should be paid direct to the local authority's banker.

2. SURPLUS FUNDS LENT TO ISSUING HOUSE.

In some instances the money subscribed was improperly left on deposit with the issuing house, instead of being applied by the Corporation or Company, either (*a*) to the purposes for which it was borrowed, or (*b*) in the case of Corporations especially, temporarily invested in trustee securities.

3. PRINTING SCRIP.

The Issuing House was in a position to print documents purporting to pledge the credit of the Corporation or Company, and to place them upon the market without control or check by their principals (e.g. “Hatry Frauds”). “Contractor's Scrip” is now forbidden in Municipal Issues. (See “Forgery”.)

4. MUNICIPAL STOCK REGULATIONS, 1932.

“The Stock Regulations” (1932) (S. R. & O., 1932, Nos. 434 and 436) aim at the prevention of the above and similar

irregularities, and their principles could be followed with advantage in commercial issues.

These regulations prevent the undue retention of subscription moneys and provide for all such moneys to be paid into the banking account of the local authority *within three days after allotment*, subsequent receipts of stock moneys to be paid into the same account within twenty-four hours of their receipt. This does not apply to surplus subscriptions as this is a matter to be settled between the issuing house and the subscribing public. (See also pages 67-9.)

RESOLUTIONS

1. FRAUD ON MINORITY.

A resolution must not be to the detriment of the minority, unless there is a prospect of benefit to the company as a whole. (*Menier v. Hooper Telegraph Works*, 1874; *Brown v. British Abrasive Wheel Co.*, 1919.)

2. OTHER THIRD PARTY FRAUDS.

Other types of fraud on third parties (e.g. the prospectus frauds in *Peek v. Gurney*, 1873) and frauds similar to the inflation of bank balances, have been mentioned in Chapter I ("Frauds on Third Parties," *et seq.*).

Apart from the special features outlined in this chapter, the frauds which could be perpetrated against a limited liability company are common to other forms of association and to sole traders. It is, therefore, not proposed to reiterate any such types and examples of irregularity or manipulation at this juncture.

CHAPTER IX
INSOLVENCY FRAUDS

SYNOPSIS

FRAUDULENT DEBTORS—

- (1) List of Misdemeanours ;
- (2) Fraudulent Preference in Bankruptcy ,
- (3) Application to Limited Companies.

FALSE CREDITORS—

- (1) Bogus Loans ;
- (2) Property in Wife's Name.

CHAPTER IX

INSOLVENCY FRAUDS

FRAUDULENT DEBTORS

1. LIST OF MISDEMEANOURS.

ANY person who is adjudged a bankrupt, or whose affairs are liquidated by arrangement is, in each of the following cases, guilty of a misdemeanour, and liable on summary conviction to two year's imprisonment with hard labour—

- (1) Non-disclosure of estate to trustee.
- (2) Non-delivery of estate to trustee.
- (3) Non-delivery of books, documents, etc.
- (4) Concealment of property.
- (5) Fraudulent removal of property.
- (6) Material omissions in Statement of Affairs.
- (7) Failure to inform trustee of false claims on estate.
- (8) Preventing production of books, etc.
- (9) Destruction or concealment of books, etc.
- (10) Making false entries in books, etc.
- (11) Fraudulently altering, etc., documents.
- (12) Fictitious accounts of losses.
- (13) Obtaining property on credit by fraud (by false representation within four months next before the presentation of the petition).
- (14) Traders obtaining goods by fraud.
- (15) Disposing of goods otherwise than in the course of trade (pawns, pledges, gifts, or fraudulent assignments).
- (16) False representation or fraud to obtain consent of creditors to an agreement.
- (17) Absconding with £20 worth of property after or within four months before presentation of the Petition.
- (18) Undischarged bankrupt obtaining credit of £20.

2. FRAUDULENT PREFERENCE IN BANKRUPTCY.

In addition to the above misdemeanours, it should be noted that a deed which purports to prefer one or more creditors to others may be set aside, for any such an attempted preference, with or without a deed, is a fraud upon the other creditors.

A fraudulent preference is an Act of Bankruptcy upon which any aggrieved person may present a petition.

Section 44, Bankruptcy Act, 1914, enacts that—

“Every conveyance or transfer of property, or charge thereon made, every payment made, every obligation incurred, and every judicial proceeding taken or suffered by any insolvent persons . . . in favour of a creditor, or of any person in trust for a creditor, *with a view to giving such creditor, a preference over the other creditors*, shall, if the persons” (making the preference) “is adjudged a bankrupt on a bankruptcy petition presented within *three months* after the date of” (making the preference) “*be deemed fraudulent and void as against a trustee in Bankruptcy.*”

3. APPLICATION TO LIMITED COMPANIES.

In practically all cases the law and the types of insolvency frauds are the same with limited companies as for individual debtors and the same precautions should therefore be exercised.

FALSE CREDITORS

False or even inflated claims by creditors in a bankruptcy are misdemeanours which are punishable with one year's imprisonment with hard labour.

1. BOGUS LOANS.

Not only are creditors occasionally guilty of proving for unfounded claims, but the debtor, in preparing his statement of affairs often attempts to introduce apparent “repayments” of bogus loans. This is a favourite method of snatching a small “nest egg” on the eve of a bankruptcy.

2. PROPERTY IN WIFE'S NAME.

The wife of the debtor often claims that the furniture, bearer securities and other personal or unregistered property are her own personal possessions within the meaning of the *Married Women's Property Acts*.

Whilst this claim is often true, a receipted invoice or some other supporting evidence should be asked for as a safeguard against such property having been fraudulently transferred by the debtor. *Out of what personal funds did the wife buy the goods?*

A verification of the purchase by an independent personal call at the shop has often proved fruitful in discovering such frauds. Care should be taken to guard against collusion between the shopkeeper and the bankrupt.

PART IV

PREVENTION

- CHAPTER X . . . PREVENTION BY LEGISLATION AND REGULATIONS
- CHAPTER XI . . . PREVENTION BY STAFF ORGANIZATION
- CHAPTER XII . . . PREVENTION BY AUDIT
- CHAPTER XIII . . . PREVENTION BY RECORDS
- CHAPTER XIV . . . PREVENTION BY COMPARATIVE METHODS
- CHAPTER XV . . . PREVENTION BY MACHINERY (*Illustrated*)

CHAPTER X

PREVENTION BY LEGISLATION AND REGULATIONS

SYNOPSIS

REFORMING BY LAW—

Efficacy and Effect.

LEGISLATION—

- (1) Acts of Parliament: Sale of Goods Act, 1893—"Statute of Frauds"—Trustee Act, 1925;
- (2) Corruption—Public Bodies Corrupt Practices Act, 1889—Prevention of Corruption Acts, 1906 and 1916;
- (3) Companies Act, 1929—Profit and Loss Account—Directors' Report and Reserves—Kylsant (1931) Case.

FUTURE LEGISLATION—

- (1) Company Law Reform;
- (2) Standardization of Commercial Documents.

REGULATIONS—

- (1) *National Compulsory Regulations*;
- (2) *Voluntary Domestic Regulations*—
 - (a) Compulsory Holidays to Discover Irregularities or Inefficiencies—Reluctance to take Holidays Suspicious;
 - (b) Employees' Private Bank Accounts—Underwood *v.* Bank of Liverpool;
 - (c) Clients' Entrusted Moneys—Complete Separation of Funds.

CHAPTER X

PREVENTION BY LEGISLATION AND REGULATIONS

REFORMING BY LAW

It is frequently urged in opposition that it is impossible to reform the wrongdoer by legislation or regulations. On the other hand, there is a strong deterrent in the penalties or practical obstacles imposed.

Perhaps it is true to state that the anti-fraud legislation and stricter domestic regulations in the matter of accounts—both commercial and municipal—of recent years have made fraud and embezzlement more difficult to perpetrate. It might be added, as an observation, that where such frauds have succeeded they have been for huge sums, which evidently goes to prove that the smaller frauds, once so frequent, are not worth the risk involved to-day.

LEGISLATION

I. ACTS OF PARLIAMENT.

It is impossible within the narrow limits of this book to attempt a résumé of all the protection afforded by the legislature against fraud and embezzlement.

The requirements of the *Sale of Goods Act*, 1893 (and the "Statute of Frauds") as to contracts which must be in writing have been dealt with fully in Chapter I.

The *Trustee Act*, 1925, *inter alia*, permitted a trustee to invest in bearer securities, but, as a safeguard against misappropriation, required such bearer certificates to be lodged with a banker for safe custody.

There are innumerable provisos, protections, and precautions of this nature which the reader can recall for himself, or discover by a study of the Statutes—particularly in the *Companies Act*, 1929.

2. CORRUPTION.

The Public Bodies Corrupt Practices Act, 1889, makes every person guilty of a misdemeanour who *corruptly* solicits, receives or agrees to receive for himself, or any other person, any gift, loan, fee, reward for, or otherwise on account of any member, officer or servant of a public body doing or forbearing to do anything in respect of any matter or transaction in which the public body is concerned.

Both the person corrupted and the person guilty of corrupting are liable to two years' imprisonment, with or without hard labour, or a fine of £500, and other pains and penalties, such as the liability to lose pension and compensation rights.

This liability is extended to transactions of all agents on behalf of their principals by the *Prevention of Corruption Act, 1906*.

It is made a still more serious offence by the *Prevention of Corruption Act, 1916*, in respect of contracts with any Government Department, or any public body: the penalty in this case being seven years', but *not less than three years'* penal servitude. It was hoped that the severity of these penalties would be a sufficient deterrent.

3. COMPANIES ACT, 1929, SAFEGUARDS.

For the first time the *Companies Act, 1929*, gave shareholders the right to demand a copy of the yearly balance sheet, *and a profit and loss account*. There are penalties imposed upon directors who do not comply with such a request by a shareholder.

The balance sheet must contain a summary among other things of the liabilities and assets, together with such particulars as are necessary to disclose the general nature of the liabilities and assets of the company, and to distinguish between the amounts respectively of the fixed assets and the floating assets, and state how the values of the fixed assets and the floating assets have been arrived at.

Directors' Reports and Reserves. It further provides that

there is to be a report by the directors with respect to: (a) the state of the company's affairs, and (b) the amount, if any, which they recommend should be paid by way of dividends, and (c) the amount, if any, which they propose to carry to the reserve fund, general reserves and reserve account shown specifically on the balance sheet, or (d) to the reserve fund or general reserve, or reserve account, to be shown specifically on a subsequent balance sheet.

Mr. Justice Wright, in the *Kylsant* (1931) Case, said: "There may be some justification for the maintenance of an undisclosed or secret reserve, *if the fact that there was such a reserve clearly specified somewhere in the report*, so that the shareholder could know, and if the majority of them desired, to insist on its disclosure, and its amount, and its utilization, they could do so. However that may be, it is clearly the intention of these sections that the accounts of companies in future should be published with greater particularity and with greater information to the shareholders."

FUTURE LEGISLATION

The commercial community would probably not tolerate a great measure of legislative interference. We do not desire a "Code Napoleon," nor for dictation from any Central Department as to the way our commercial offices should be organized.

1. COMPANY LAW REFORM.

This warmly debated subject could not be better dealt with than by the following quotation from the Report of the Society of Incorporated Accountants and Auditors (7th April, 1932) on the *Companies Act, 1929*—

1.

2.

3. We have reviewed the provisions of the Companies Act, 1929, in the light of happenings in Public Company Practice since the Report of the Company Law Amendment Committee in 1926, particularly in the years 1928 and 1929, and in connection with the proceedings in the *Royal Mail* case in 1931.

4. In the report referred to it was stated that the evidence

satisfied the Committee that the great majority of limited companies, both public and private, were honestly and conscientiously managed. While we concur in this view, we are of opinion that the provisions of the Companies Act, 1929, relating to accounts and audit, do not sufficiently protect the investing public in certain particulars.

5. We recommend, therefore, that the Government should be asked to appoint a Departmental Committee to consider amending legislation. We have not attempted to set out all the amendments which we deem necessary, but we are of opinion that provisions to the following effect should be included in any amending legislation—

(a) That the Profit and Loss Account should show the true balance of the profit or loss for the period covered by such account.

(b) That in the Profit and Loss Account any debits or credits which are abnormal in character or extraneous in their nature to the ordinary transactions of the company, together with any reserves from a previous period no longer required, should be stated separately.

(c) That Free Reserves should be disclosed on the face of the Balance Sheet. The need for such disclosure should not extend to provisions made for estimating losses or expenses not definitely ascertainable at the date of making up this Company's accounts, but to which losses or expenses it is sound and proper to have regard in arriving at the profit or loss for the year or other period.

(d) That where a Holding Company has investments in one or more subsidiary and/or sub-subsidiary companies, there should be stated on the face of the accounts of the Holding Company, the total of the ascertained profits or losses of such subsidiary and/or sub-subsidiary companies appertaining to the interest of the Holding Company in such subsidiary and/or sub-subsidiary companies, in so far as such profits or losses have not been brought into account in the Profit and Loss Account of the Holding Company.

6. . . . we feel that the paramount consideration is the maintenance of public confidence in the administration of industrial, commercial, and financial undertakings.

7. We do not consider it desirable to make any recommendations for alterations of a voluntary character in the compilation and/or certification of Company Accounts, since in dealing with such alterations Auditors might be placed in a difficult position in regard to the law as it now stands. The only effective action must be by amending legislation.

2. STANDARDIZATION OF COMMERCIAL DOCUMENTS.

Many auditors and their staffs must have secretly wished that the legislature, or the Board of Trade, would order the

compulsory adoption of uniform commercial documents—such as delivery notes, invoices, and statements—particularly in respect of: (a) the headings; (b) the date, and (c) debtor's name, and the positions thereof on the documents.

It is often very tiresome to distinguish between such documents in the absence of the bold descriptive headings: "Invoice," "Statement," etc.

The danger of fraud in this respect has already been indicated (Chapter IV).

Suggestions —

(a) Credit Notes and *only* Credit Notes should be printed in red.

(b) The date, name of the debtor, and name of the creditor should always be in the same position, so as to facilitate reference, filing and office routine.

(c) As a special preventative for fraud, it should probably be compulsory for old balances to be stated in every "Statement," under the separate heading of *Accounts Rendered*. Brewery Companies, for instance, sometimes make the unusual practice of sending "monthly statements" to their customers which do not bring forward any old outstanding balances of previous months. This illustrates one of the dangers of verifying balances with creditors' "Statements" (Chapter IV).

(d) Appropriate uses and descriptive headings of documents should be stipulated. At the present time, in the absence of headings, it is often possible to use either a "delivery note" or a "detailed statement" as an invoice to support spurious or fraudulently duplicated purchases (Chapter IV).

(e) A *Delivery Note* should not show any money figures, and a *Statement* should merely state *To Goods*, or *To Invoice No. . . .*, or some short reference to the original invoice.

REGULATIONS

1. NATIONAL COMPULSORY REGULATIONS.

In the Civil and Municipal Services and, to a lesser degree, in the larger public utility undertakings where considerable

capital or public money lies invested (e.g. railways, water, gas, electricity, etc.) a measure of control and dictatorial powers have been accorded to the Central Departments of State.

An excellent example of such compulsory "Departmental" regulations as a preventative of fraud, and one which could be regarded with advantage as a model for commercial undertakings, is to be found in the *Accounts (Boroughs & Metropolitan Boroughs) Regulations, 1930*, imposed on certain municipal corporations by the Ministry of Health. This document and its accompanying Memorandum (150 Accts.) will be quoted later (Chapter XI), but the full text will repay a detailed study.

2. VOLUNTARY DOMESTIC REGULATIONS.

As distinct from such compulsory regulations, there is the more usual practice of domestic regulations imposed voluntarily by a firm, association, or council, upon its employees as part of their routine or office practice, with a view to preventing fraud.

Such regulations may be complementary or supplementary to the general business organization and management and may constitute a form of internal check to achieve its purpose (e.g. no invoices to be passed for payment unless they bear the certifying initials of (a) the Order Clerk; (b) Storekeeper, as received; (c) manager, as approved).

Such everyday regulations as the prompt issue of receipts, the use of an escort to the bank, and the other important maxims stated throughout this book, will instantly come to the reader's mind. It only seems necessary to mention that such domestic regulations should be made to suit the particular circumstances of the case and should be rigidly enforced.

(a) *Compulsory Holidays.* Many irregularities have come to light by a change of staff duties, particularly during annual holidays or sudden illnesses.

Some firms and corporations go so far as to stipulate in written Service Agreement that employees are compelled to take at least two weeks holiday a year.

MAXIM—

It is felt that a reluctance to be away from duties for any length of time is a ground for suspicion.

Apart from annual leave, it is sometimes desirable that an employee's duties should be varied or temporarily transferred to another—not only as a fraud preventative, but also as a mental tonic which may encourage improvements of systems by the newcomers.

(b) *Employees' Private Bank Accounts.* A banker's position is unenviable where he owes a dual duty to a firm and to an employee of that firm, both of whom are customers of the bank.

The banker may be tempted to trust such a person more freely than any employee's position warrants. He may be tempted to take unreasonable risks in respect of transactions on the firm's account. In one case the bank actually accepted the unauthorized signature of the firm's cashier to cheques and alterations therein and, in the case of *Underwood v. Bank of Liverpool*, permitted the firm's cheques to be paid into an officer's personal bank account. In the latter case the bank was held liable to make good the loss occasioned by their negligence.

MAXIM—

It has been suggested that it is undesirable for employees handling business moneys to keep their private bank accounts at the same branch bank as their employer.

This probably goes a little too far to be entirely practicable, but it is a point worthy of further consideration.

(c) *Clients' Entrusted Moneys.* Whilst the subject of private bank accounts is being discussed, it is appropriate that the complete earmarking of trust moneys should be urged—especially the desirability of keeping a separate bank account for such trusts.

The merger of private moneys with funds belonging to an

employer, client, or other trust, is an exceedingly dangerous practice, and has been repeatedly condemned. This applies not only to their liquid forms of cash in hand, or in the bank, but also to such funds as are invested or pledged.

MAXIM—

The accidental use of "trust moneys," by over-drawing the private portion of a common account, borders so closely upon fraudulent misappropriation as to make the physical separation of such funds of vital importance from the moment they are first received.

CHAPTER XI

PREVENTION BY STAFF ORGANIZATION

SYNOPSIS

SYSTEMATIZATION—

- (1) Art of Delegation ;
- (2) Division of Duties ;
- (3) System Planning ;
- (4) Statements of Account by Post—Rate Demands ;
- (5) Personnel and Remuneration ,
- (6) Initiative to Improve Systems.

INTERNAL CHECK—

- (1) Personal Checks ;
- (2) " Pay-at-the-Desk " ;
- (3) Summary of the Principles ;
- (4) Municipal Internal Checks—Memo 149/Accts. and 150/Accts. (1930) ,

COLLUSION—

- (1) Defeating Internal Checks ;
- (2) Faithful Servant's Reward ;
- (3) Wholesale Collusion—*Nottingham Corporation Gas* (1931) Fraud ;
- (4) Risk of Discovery as the Deciding Factor.

CHAPTER XI

PREVENTION BY STAFF ORGANIZATION

By far the most potent method of fraud prevention, in the author's opinion, lies in the scientific organization of the staff and their duties.

SYSTEMATIZATION

1. THE ART OF DELEGATION.

A sole proprietor can usually exercise a minute control of a small business, for he has no occasion to delegate the handling of money or money's worth (including ledger accounts) to his assistants.

When a business grows, however, it becomes impossible to supervise financial transactions in such detail. The root of trouble lies, at this point, at the injudicious delegation of the proprietor's own functions.

2. DIVISION OF DUTIES.

The problem, which should receive very careful thought and planning, lies in the allocation of duties among the staff in such a manner as to allow one employee to act as a check upon another.

To emphasize the importance of such a division of functions, it may be pointed out that an investigation of the causes in recent fraud cases reveals a remarkable tendency to assign self-contained sections of work to one man, e.g. Sales Department (sometimes including the collection of accounts) is assigned to a "Sales Manager," whilst the proprietor concentrates exclusively upon the purchasing side of the business. It is obvious that there is no internal check in such cases upon the integrity of the Departmental Manager.

3. SYSTEM PLANNING.

In planning, criticizing, or amending a system with a view to preventing fraud, its weaknesses should be thoroughly tested and hypothetical methods of defrauding under the existing system should be thought out. Such possible loopholes should then be met by introducing new safeguards. This is one of the reasons why the suppression of literature dealing with fraud is considered to be undesirable.

4. STATEMENTS OF ACCOUNT BY POST.

The custody and service of statements of accounts, invoices, rate demand notes, etc., should not form part of the normal duty of a collector in that he should take no share in rendering an account which it will be his subsequent duty to collect.

It would appear that service by post does not lead to any particular difficulties, and that the adoption of such procedure simplifies to some extent the collectors' duties. If the demands, invoices, and statements are served by post, the Post Office acts as an independent check upon the honesty of the collector and, furthermore, the time saved to the collectors would enable them to start their active collecting much earlier.

5. PERSONNEL AND REMUNERATION.

The staffing problem should also be considered in relation to the adequate remuneration for services and risks involved. There should also be a wide choice of personnel, giving special weight to the temptations presented by the duties allotted, and the character of each employee.

Whilst an adequate remuneration should not be essential for keeping a man honest, it is significant that judicial censure has frequently to be passed on employers in fraud cases.

6. INITIATIVE TO IMPROVE SYSTEMS.

Adam Smith submitted that the concentration of one's mind on one simple process or section of one's work leads to

the discovery of means for the alleviation of one's toil. On the other hand, the effect of devoting one's mind to a single idea tends to have a deadening effect on the intellect which is inimical to any inventive capacity.

It will be noticed in practice that improvements are rarely made by the person engaged on such routine work, but by outsiders whose vision is less cramped by detail. For this latter reason it is urged that the Internal Auditor or systematizer (whatsoever designation he may bear) should not be burdened with detail work to the extent that his inventive and progressive spirit is stifled by insufficient opportunities to consider improvements in the current system.

INTERNAL CHECK

1. PERSONAL CHECKS.

Reference has been made throughout this work to the potency of internal checks or "cross-checks," and, therefore, it calls for little more than a summary at this stage.

The check which one human being exercises upon the actions of another is a most powerful personal force and, for this reason, such internal checks are being more widely employed to-day by the systematizer and office manager.

2. PAY-AT-THE-DESK.

Simple, everyday examples of internal check are the "pay-at-the-desk" system and the pneumatic tubular cash conveyors, used in cafés and certain shops. The ticket given by the waitress, or counter hand, acts as a check upon the cashier, and *vice versa* where a commission is payable.

The stipulations that all cheques and valuable documents shall bear two authoritative signatures; that a safe or common seal shall only be used by applying two keys (held by different persons); that letters (many of which contain remittances) shall be opened in the presence of two people; that a shop-walker shall initial all sales slips; are everyday examples of internal check in its simplest forms.

3. SUMMARY OF THE PRINCIPLES.

Internal check is a system of fraud prevention which has been strongly impressed upon local authorities by the Ministry of Health and its District Auditors.

The following is an extract from a Ministerial communication. It gives such an excellent summary of the principles underlying internal check systems and staff organization that its message should be found equally forceful in non-municipal concerns.

4. MUNICIPAL INTERNAL CHECKS.

Paragraph 13 (General Provisions) of Memorandum No. 150/ Accts. (accompanying the "*Accounts (Boroughs and Metropolitan Boroughs) Regulations, 1930*") and Memorandum 149/ Accts. for County Councils, emphasized the need for careful definition and division of duties and the institution of a comprehensive internal audit and system of internal checks—

Memo. 150/ Accts.—General Provisions

13. The Regulations do not contain any provisions which would limit the discretion of a Council in regard to the officers it employs or the duties it assigns to each. But, in view of the important bearing which wise allotment of duties has upon the efficiency, economy, and security of the account keeping, it is thought desirable to refer here to the principles which appear to be of chief value in this connection—

(i) That the duty of providing information, calculating, checking and recording the sums due to or from the Council should be separated as completely as possible from the duty of collecting or disbursing those sums.

(ii) That officers charged with the duty of examining and checking the accounts of cash transactions should not themselves be engaged in any of those transactions.

(iii) That responsibility for the maintenance of current supervision of all accounts and records relating thereto should rest upon one chief financial officer, even when a separate departmental accountant is employed, as the efficiency of internal audit depends largely upon its independence. And that the officer charged with this duty of supervision should have access at any time and authority to apply any test or check into the accounts and records.

(iv) That responsibility for the organization of efficient accounting systems should also rest upon this officer. But that he should in all cases consult the chief officer of the department concerned

as to the form and manner of keeping any records, statements or accounts which have to be kept in that department, due regard being paid on the one hand to the provision of prompt, reliable and complete information for the preparation and verification of accounts, and on the other hand, to the avoidance of unnecessary delay or increase of cost in the execution of work.

COLLUSION

1. DEFEATING INTERNAL CHECKS.

In placing reliance upon any system of internal check it must be remembered that collusion between members of the staff can entirely defeat its object.

MAXIM—

Other things being equal, the greater the division of duties and the number of persons employed on a section of work, the less the chances of undiscovered irregularities.

2. FAITHFUL SERVANTS.

Further, there is always a possibility that an employee, when approached by a fellow clerk with a view to collusion, will consider it more to his ultimate advantage to avoid the risk involved by such a retrograde step, report the matter to his principal, and so receive the reward due to a faithful servant.

3. WHOLESALE COLLUSION.

The Nottingham Corporation Gas (1931) fraud, however, illustrated the extent to which wholesale collusion could succeed and remain undetected for a long period. Such cases are exceptional, of course, but show that additional means of fraud prevention should also be employed wherever possible and that no single system is infallible.

4. RISK OF DISCOVERY.

The measure of the risk of discovery is very often the deciding factor in committing a fraud. For this reason, those

responsible for system enforcement and audit should make it clear that "the way of transgressors is hard," by making fraud perpetration more difficult if not impossible.

MAXIM—

Honesty is often the policy chosen because dishonesty would not be worth the great risk of discovery; an increase in this risk decreases the temptation and consequent possibilities of fraud.

CHAPTER XII

PREVENTION BY AUDIT

SYNOPSIS

THE AUDIT METHOD.

ANNUAL AUDITS—

- (1) Ante-Audits—Shortcomings;
- (2) The Company Auditor;
- (3) Liability for Profit and Loss Accounts;
- (4) Liability for Balance Sheet;
- (5) Liability for Dividends and Reserves;
- (6) "Reasonably Cautious";
- (7) Qualities of Good Auditors.

INTERNAL AUDITS—

- (1) Internal Auditor's Duties and Qualities;
- (2) Auditing not Accountancy;
- (3) Improving and Designing Systems,
- (4) Advantages of Internal Audit

INTERIM AUDITS AND TEST CHECKS.

- (1) Interim Checking;
- (2) Test Checks;
- (3) Dangers of Test Check.

AUDIT PROGRAMMES—

- (1) "Progressive" not Fixed Programmes;
- (2) Routine Checking—Limits of Auditor's Duty.

NEGLIGENCE—

- (1) Auditors' Negligence Cases;
- (2) Transactions and Entries Subsequent to the Year-end;
- (3) Bank Pass-Book;
- (4) Reliance upon Sub-Certificates;
- (5) Legal Protection of Auditors—Auditor should sometimes exceed his Authority and Legal Rights.

CHAPTER XII

PREVENTION BY AUDIT

THE AUDIT METHOD

THIS method of fraud prevention has merited its universal acceptance, and has possibly justified the large quantity of fraud literature already published under the guise of auditing treatises.

ANNUAL AUDITS

1. ANTE-AUDITS.

At times, however, one feels that too great a reliance is placed upon the infallibility of auditing operations as a method of fraud prevention or discovery.

In the first place, annual audits, unless accompanied by interim audits, take place after the close of the financial year and, although they may *discover* irregularities, they are several months too late to *prevent* them.

Secondly, such audits are conducted by human beings who are liable: (a) to make mistakes themselves; (b) to fail in discovering the irregularities of others; or (c) to seek the protection of case law decisions, which have, perhaps, been comparatively kind to outwitted auditors.

2. THE COMPANY AUDITOR.

The law requires the appointment of an auditor, who is the servant of the company, and his duty is to report to the shareholders (after a proper examination) on the accounts which the directors are going to present to the company.

3. LIABILITY FOR PROFIT AND LOSS ACCOUNTS.

In *Rex v. Kylsant* (1931) "The Royal Mail" Case, Mr. Justice Wright said: "The law does not impose an impossible burden on auditors; it does not make them insurers; it does

not require of them the skill and vigilance which is beyond their power, but it does require them to report ; and to report on the accounts would certainly include a very careful investigation of the profit and loss account as one of the accounts, even if it is not expressly covered in the certificate which is generally accepted as a complete report."

4. LIABILITY FOR BALANCE SHEET.

"Then they have to give a certificate as to whether in their opinion the balance sheet referred to in the report is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs, according to the best of their information and the explanations given to them."

5. LIABILITY FOR DIVIDENDS AND RESERVES.

"Now, if the account on which the dividends are being paid, or if the account on which the current expenses of the company are being met is being fed by undisclosed reserves, it seems to me very difficult to see how the auditor can discharge his duty of giving a true and correct view of the state of the company's affairs without mentioning and drawing attention to this fact, which may be of the most vital importance as indicating the state of the company's affairs."

6. "REASONABLY CAUTIOUS."

However perfect the system of Cross Checks (i.e. Internal Checks), or however efficient an audit may be, pilferings or fraud to a greater or less degree may occur, in which unfortunate event those responsible for financial control should be in a position to reply to the inevitable criticism with confidence, that both they and the auditors (internal and professional) have been "reasonably competent, careful, and cautious," having due regard to the particular circumstances of the case.

It must be admitted that such apologies are the auditor's last line of defence ; he has failed to prevent or discover the frauds, but he has "done his best."

7. QUALITIES OF GOOD AUDITORS.

In certain famous and oft quoted law cases it has been stated that a professional auditor "is a watchdog and not a bloodhound," but also that "he must go behind the books and satisfy himself that the entries are reasonably correct."

INTERNAL AUDITS

1. INTERNAL AUDITOR'S DUTIES.

It is submitted that internal auditors and those responsible for financial supervision, holding as they do more domesticated offices than those of their practising brothers, should have the blood of both the watchdog and the bloodhound coursing freely through their veins, and exercise to the full their rights of access to any book or record in any section of the office.

The internal auditor's time will, in the main, be expended in the verification of book-entries up to the point of their appearance in the books, so that the work of the internal and professional auditors will to a large extent dovetail or overlap.

In some cases irregularities have been brought to light by juniors detecting quite small points in the course of internal audit routine.

2. AUDITING NOT ACCOUNTANCY.

On the other hand, the internal audit staff should be relieved by the accounts staff of such ordinary routine checking as could never form the basis for fraud. One function of an internal auditor is certainly the rectification and testing of arithmetic, but also the more important function of minimizing the possibilities of dishonesty.

3. IMPROVING AND DESIGNING SYSTEMS.

By virtue of his unique position, the internal auditor is a designer of systems, but if he is already overburdened with detailed routine work, his human nature will deter him from suggesting further extensions of his own duties.

4. ADVANTAGE OF INTERNAL AUDITS.

Not only does an internal audit system improve the organization of finances, but, by keeping the records up-to-date, it exercises a moral effect and continuous check upon the staff as well as preventing the hiding of defalcations under arrears of accounting work.

Fraud can thus be prevented or discovered at its inception, and the routine checking at the annual professional audit may, if warranted, be confined to "test checks"—provided the internal audit is reliable and there is no suspicion of irregularity.

INTERIM AUDITS AND TEST CHECKS

1. INTERIM CHECKING.

In small concerns there is often no continuous independent internal audit and the annual professional audit (if any) is commenced after the close of the financial year.

This may be necessary in order to reduce accounting and professional charges, but it means that any irregularities would probably remain undetected until the next annual audit.

The knowledge by the defaulter that his offences would not be liable to discovery for many months to come, have often induced him to extend his operations in the pious hope of repaying his "borrowings" before the audit takes place.

The alternative to a continuous internal audit as a preventive for such frauds (although very often only a poor substitute) is for the professional auditors to conduct one or more interim audits during the currency of the accounting period. Every standard auditing textbook deals fully with such interim audits and their usefulness need not be further laboured herein.

2. TEST CHECKS.

In annual, interim or internal audits, it is not always possible or necessary for an exhaustive or detailed examination of

transactions to be made and, in such carefully approved cases, occasional surprise checks may be found to suffice.

Any suspicion or dissatisfaction arising from such "spot checks" should be followed by a detailed examination at the point where the deficiency is noticeable, until the auditor feels conscientiously satisfied. For future safety, amendments to the system of internal check and the auditor's routine or periodical checking may then be necessary.

3. DANGERS OF TEST CHECKS.

A cashier noticed that the same two months—the opening and closing months of the audit period—were chosen for "spot checking," each year. He therefore confined his manipulations to the other ten months, thus enabling his defalcations to continue undetected over a period of years.

MAXIM—

If a complete audit cannot be made, care must be taken that this is not so obvious as to tempt the staff to take advantage thereof. In addition to exhaustive tests covering certain periods, "spot" checking of items taken at random from the remaining part of the accounting period is advisable.

The above case illustrates one of the dangers of a stereotyped audit programme.

AUDIT PROGRAMMES

1. " PROGRESSIVE " NOT FIXED PROGRAMME.

An audit programme should represent the auditor's progressive and restless spirit for reformation, and should never develop into an unalterable form or routine inconsistent with improvements which have taken place in the system from time to time since the form was drafted.

2. ROUTINE CHECKING.

Routine checking as guided by an audit report or programme is a good servant, but a bad master. Auditing should only be

bound to a routine to ensure that the *minimum* of vital checking has been performed.

An audit programme should be regarded merely as a basis for an audit—a plan of campaign rather than a complete schedule of duties. The only limits of an auditor's duties are those of his own conscience and not those which the law has mercifully provided for his protection.

NEGLIGENCE

1. AUDITOR'S NEGLIGENCE.

Clients and the investing public have the right to expect a reasonable degree of efficiency from those holding the watchdog position of auditor.

Unfortunately, cases of negligence appear before the Courts occasionally. *Examples—*

(1) Failure to detect defalcations (test case—*Astrachan Steamship Co., Ltd. v. Harmood, Banner & Son, 1900*).

(2) Failure to verify a Cash Balance (test case—*London Oil Storage Co., Ltd. v. Seear, Hasluck & Co., 1904*) and the existence and ownership of assets generally (*in re City Equitable Fire Insurance Co., Ltd., 1924*).

(3) Failure to detect the suppression or carrying over of invoices for purchases (*Irish Woollen Co., Ltd. v. Tyson and Others, 1900*).

(4) Unwarranted acceptance of a fraudulent list of bad debts for inclusion in the annual accounts (*A. E. Green and Co., v. The Central Advance & Discount Corporation Ltd., 1920*).

2. AFTER THE YEAR END.

MAXIM—

Much can be learned from entries and transactions made subsequent to the close of the balancing period.

This applies not only to the Bank Pass Book, but to all books of record.

3. BANK PASS BOOK.

Where fraud could have been discovered by an intelligent examination of the bank pass book, the auditors were held by the Courts to be liable for damages through their negligence. (*Chas. Fox & Sons v. Morrish, Grant & Co.*, 1918.)

4. RELIANCE UPON SUB-CERTIFICATES.

Comment has already been made upon the ruling in the famous *Kingston Cotton Mills Case* (Chapter V.) The unwarranted reliance which a few auditors have, from time to time, placed upon the certificates of managing directors and others is deplorable, and tends to undermine the implicit trust which it is quite justifiable to place in the skill of the auditing profession as a whole.

5. LEGAL PROTECTION OF AUDITORS.

The protection which the law affords to an outwitted auditor is little comfort to the helpless defrauded parties who regard him as their never failing guardian against fraud. Moreover, in that such decisions afford no assistance in the suppression of fraud, they preserve a fruitful vineyard for the propagation of future irregularities, which the blade of the auditor is "not legally bound" to penetrate.

**Should not an auditor exceed his authority and
legal rights occasionally ?**

In his presidential address to the Institute of Chartered Accountants in England and Wales, Mr. H. L. H. Hill said (4th May, 1932)—

"It is frequently urged that the hands of auditors should be strengthened by fresh legislation. The purpose of legislation that concerns us is mainly to formulate rules by which we must abide if we wish to avoid trouble in the Courts, but, just as in corporate life proper relationship to one's neighbour is not the result of legislation, so in our professional life proper conduct has not been brought about and cannot be brought about by legislation. I do not suggest that the law is incapable of improvement in many respects, and, perhaps, especially the law in regard to subsidiary companies, but I do suggest that we require no increased powers to enable us faithfully and properly to discharge our duties.

It is our duty to report upon the accounts in terms laid down by statute, but it is also our duty, and we have power, to *amplify our report* without restriction in cases where in our judgment there may exist a possibility of the *accounts otherwise conveying an impression not warranted by facts.*

I am thankful to believe that the time will never come when legislation can be so definite and comprehensive that auditors will be reduced to mere automata, to obey *audit programmes laid down by statute.* There is always a lag and legislation with which we are concerned is always based upon the best accountancy practice. We must, therefore, take the lead so that, if and when fresh legislation is enacted, there may be by that time an established practice in accountancy conforming with the letter of the law, but based on the spirit of the law, an established practice that will assist and direct those who frame our laws to institute further safeguards for investors and the public.

The goodwill of our Institute has been created and maintained not by those who have regarded the letter of the law as their ultimate guide, but by those who have developed and adopted a code of ethics embracing, but *not restricted to legal requirements.*"

CHAPTER XIII

PREVENTION BY RECORDS

SYNOPSIS

CONTROL by records prevents fraud.

INTER-RELATED RECORDS—

- (1) Columnar and Analysis Books;
- (2) Comparisons;
- (3) Stock Books—Jewellers, Stockbrokers, Farm Produce Dealers—Combined Stock, Purchases and Sales Records—How it Prevents Fraud,
- (4) Other Columnar Records—Public Assistance—Old Age Pensions Register—Chart
- (5) Bad Debts Control—Form of Bad and Doubtful Debts Register;
- (6) Mail Embezzlements—Form of Postal Remittances and Cheques Record Book;

MODERN METHODS—

- (1) Carbon Copy Methods—Dangers of Unwarranted Faith in Carbons—Virtues of Methods.

DUPLICATED POSTING METHODS—

- (1) Automatic Check;
- (2) How "D.P." Works;
- (3) Control of Ledgers and Transactions;
- (4) Attempted Forgery by Tenant;
- (5) Safe Delegation by Systematizing;
- (6) Removal of Temptation to Defraud;
- (7) Advantages to Landlord or Municipality;
- (8) Protection against Manipulation;
- (9) Fraud by Collector.

EFFICIENCY AND ORGANIZATION—

- (1) Accurate Records Prevent Mistakes—Frauds often begin with Genuine Mistakes;
- (2) Rule for Accounting Arrears—Suspicious Chaos;
- (3) Control of Accounting Arrears—Department's Financial History—Confidential Relations between Staff and "Chief";
- (4) Building up a Model System.

CHAPTER XIII

PREVENTION BY RECORDS

CONTROL

THE control, which is afforded by up-to-date, efficient and illuminative records, provides a well established method of circumventing fraud which is not to be under-rated.

INTER-RELATED RECORDS

1. COLUMNAR AND ANALYSIS BOOKS.

Probably greater steps have been taken in recent years in this direction than along any other avenue of fraud prevention. The tendency to install columnar forms of records in order to eliminate postings, duplicated work, and "errors" in transfers, has incidentally enabled a more frequent review to be made of transactions at one opening of a single book.

2. COMPARISONS.

Such comparisons of the ultimate effect of transactions have frequently revealed irregularities, inefficiencies, sales apparently under cost price and false invoices for alleged purchases.

Whilst the art of comparison will be discussed more fully in the next chapter, it is appropriate at this point to give two examples—one commercial (paragraph 3) and one municipal (paragraph 4)—of the means whereby fraud can be detected by the scientific arrangement of records.

3. STOCK BOOKS (COMMERCIAL).

Stockbrokers, jewellers and farm produce merchants—extreme examples of commercial enterprise—usually keep a combined "Purchases and Sales Day Book," showing

quantities and descriptions in addition to the normal financial columns. The record thus serves also as a Stock Book.

On the left-hand side are shown the quantity, description (or reference) of each item received into stock (e.g. three silver cruets) or purchased for delivery elsewhere (e.g. a haystack), as well as the invoice purchase price.

On the right-hand side opposite each item is recorded a summary of the corresponding sale transaction (selling price and quantities). There are sometimes several sale transactions corresponding to (e.g.) one haystack, but this is provided for in the horizontal rulings.

The balance unsold of each purchase entry at any time should agree with the actual stock on hand. Such a method is particularly applicable to businesses dealing in a few valuable articles, but would be impracticable for an ironmongery business, for instance.

From such a self-contained record, the fraud watchdog can verify that—

- (1) Stocks are actually in existence.
- (2) Stocks are correctly valued at cost or market selling price if lower (comparison with partial sales).
- (3) No sales have been omitted.
- (4) No fictitious purchases have been included or excluded.
- (5) No stock differences have been hidden.
- (6) The proprietor (or company) has received the advantage of each transaction.

The virtues of such methods are that they earmark each article, group, or transaction, and trace it individually instead of merging its identity into the grand total of purchases or sales.

4. OTHER COLUMNAR RECORDS (MUNICIPAL).

The following, although municipal in its application, is a suitable illustration of the manner in which an internal check can be exercised by means of records (see Chart).

When a patient (column 2) who is an old age pensioner is admitted to a Public Assistance Hospital (column 4), it is

customary to seize his or her pension book (column 8), make a Committee Order (i.e. resolution) (columns 17 and 18), for the moneys to be collected and appropriated to the cost of the patient's maintenance (columns 21 *et seq.*).

A number of frauds have been perpetrated in connection with such pension moneys, and the following system is designed to prevent their recurrence.

An acknowledgment (Form 1) should be issued to the person depositing the pension book, and a similar acknowledgment (Form 2) obtained when the Council parts with the book. The former is in book form, with a carbon duplicate, and will clearly show (i) the date of admission to the Institution; (ii) the class of pension (military, old age, etc.); (iii) the serial number of the pension book; (iv) office of issue; (v) name of pensioner; and (vi) date of the next pension "Order Coupon" in the book when received.

Similarly, the acknowledgment obtained on returning the pension book will show the same details except the date of admission to the Institution.

From these two acknowledgment forms the "Pensions Record Book" (usually with the ruling of a collector's ledger attached) is entered up. *The difference in the dates of "Pension Order" coupons should be accounted for by collections in the ledger portion of the book ruling.*

The comparisons and checks available, together with the files and other records which dovetail into this Pensions Record Book, are indicated.

5. BAD DEBTS CONTROL.

The possibilities of defalcation in relation to bad and doubtful debts have already been dealt with. (Chapter III.) The following is considered to be a suitable form for a "Bad and Doubtful Debts Register," which could, if desired, form part of the double entry system by acting as a ledger, especially if such debts are only "reserved for," as distinct from being written off.

BAD AND DOUBTFUL DEBTS REGISTER

Page.....

Name....

Address .

Date of Supply	Particulars	Amount	Amounts recovered or written off			
			Date	Particulars	Folio	Amount

Particulars of Proceedings, etc.

Account first sent.....
 First personal demand made.....
 Second ditto.....
 Letters, etc., sent.....
 Particulars of Legal proceedings.....
 Reported to Committee.....
 Decision of Committee.....

6. MAIL EMBEZZLEMENTS.

The Cheque Test of preventing embezzlement and the dangers of cheques bearing a form of receipt acting as an endorsement, have already been dealt with at some length. (Chapter III.)

A most useful book for this purpose is the record of postal remittances and cheques received. (Illustrated on the next page.)

MODERN METHODS**1. CARBON COPY METHODS.**

Whilst it is not proposed to describe all the ingenious methods now in use to prevent fraud, it appears necessary to issue one word of warning :

MAXIM—**Put not your faith in carbon copies.**

There seems to be a growing tendency to place unwarranted confidence in carbon duplicate methods. Such methods are undoubtedly an improvement on the old system of tear-off counterfoils, but they breed a greater confidence than they merit to-day. Fraudulently prepared carbon copy counterfoils are not infrequent. Sometimes they are uttered by the customer and sometimes by the collector.

It is noticeable that some audit checking goes no deeper than these carbon copies instead of attempting to find independent support for such items or amounts.

The above comments on the virtues and shortcomings of carbon methods are not to be confined to receipts, but are equally applicable to invoices, "weighing-in" tickets and other important documents.

Apart from these inherent defects, there are several invaluable carbon methods available which can minimize the possibilities of fraud.

DUPLICATE POSTING METHODS

1. AUTOMATIC CHECK.

Although no machine is required, the duplicate posting ("D.P.") system of Messrs. Alfred Gilbert & Sons is purely automatic and mechanical in its operations, and touches far more points of check than most accountancy systems. It has been widely adopted for municipal rent collecting, but is equally adaptable to numerous commercial purposes.

2. HOW "D.P." WORKS.

The under surface of the posting strip is covered with an ink preparation. The upper surface, being left white for ruling and writing upon, bears vertically the columns for the cash (or quantities) and folio into which the entries are to be posted. The strip is placed in position upon the column into which the figures are to be posted and the duplicate entry made with a hard manifold pen.

3. CONTROL OF LEDGERS AND TRANSACTIONS.

(a) No alterations should be permitted on "D.P." strips, however unsightly the deletions may appear. Book-keeping is, first and foremost, a servant, and only a "gem of art" incidentally if the handwriting is exceptionally good.

(b) The "D.P." strips should be numbered and a strict control of their issue should be maintained to prevent misuse.

(c) In order to avoid the posting of items to the wrong side of an account, it is desirable that the debit side folio column should be arranged on the left and the credit side on the right of the cash or quantity columns.

(d) The "D.P." strips should be independently added up at points to correspond with the totals in the book of entry.

(e) Until the Trial Balance, the "D.P." strips should be preserved by pasting them into the pages of the "D.P." Guard Book, or between filing boards, under their various sections according to the source of entry, and indexed.

4. ATTEMPTED FORGERY BY TENANT.

An Urban District Council discovered one of its tenants forging the collector's signature, not only on her own card, but also on those of her neighbours who had left the rent money with her to pay to the collector. This was immediately discovered by the signatures appearing on the cards in ink or pencil instead of the typical sharp carbon impressions given by "D.P." strips.

5. SAFE DELEGATION BY SYSTEMATIZING.

A municipal treasurer's responsibility to his Council as their custodian of the public purse is a very onerous one. As he obviously cannot collect and bank the rents himself, he can only discharge that responsibility by installing the most efficient service in staff and system it is possible to obtain. Duplicate posting has repeatedly been recommended by Government auditors for this purpose.

Similarly, an office manager in the commercial world must delegate the routine work to others, whilst still retaining a measure of control over the transactions or operations *in cumulo*.

A new set of collecting strips every week, and a new rent card every year (or half-year), which is required under duplicate posting, give a sufficient measure of control over the operations.

6. REMOVAL OF TEMPTATION TO DEFRAUD.

Executives who take a broad and enlightened view of their responsibilities will appreciate the fact that duplicate posting, by making fraud more difficult, removes temptation from employees and the public that would otherwise be created by greater opportunities to defraud.

7. ADVANTAGES TO THE LANDLORD OR MUNICIPALITY.

(a) "D.P." saves the expense and unpleasantness of adjusting errors between the tenant's record and the landlord's (or municipal) records.

(b) There can be no differences.

(c) It is a safeguard against loss by embezzlement.

(d) It minimizes the necessity and expense of inspecting and checking tenants' accounts.

(e) It has proved in practice to be a safeguard against fraudulent attempts to collect rents by bogus collectors who have no "D.P." strips in their possession.

8. PROTECTION AGAINST MANIPULATION.

Whilst it is claimed that the "D.P." carbon impression is distinguishable from those obtainable from ordinary carbons, it is not advisable to close one's eyes to the possibility of such manipulations.

Any suspicion or attempt by a tenant to tamper with entries on the rent card calls for a comparison with the facsimile originals on the collecting strips. The tenant cannot

claim that the collector has made an error in the rent book alone.

9. FRAUD BY THE COLLECTOR.

Fraud by the collector is made difficult under duplicate posting, for the following reasons—

(a) The duplicate nature of the entry, and the manner in which it is made, debars the collector from pleading the excuse of "a clerical error" on the rent book or strip only.

(b) The collector has only one week's collecting set in his possession at a time, and therefore has no access to past week's records.

(c) If the collector attempts to manipulate an entry, he leaves a permanent and definite record as to his falsifications, which he must repeat every week, until he repays his speculation, and even then cannot expunge the record of his manipulations.

(d) "D.P." enables him to present an absolutely correct record of entries given in the tenants' rent cards, and thus safeguards himself against doubt or suspicion which might otherwise arise.

(e) It makes it difficult to defraud and so removes temptation from the collector's path.

EFFICIENCY AND ORGANIZATION

I. ACCURATE RECORDS.

It might be assumed erroneously that good book-keeping has no bearing upon immunity from fraud. Experience has proved, however, that in many cases a genuine mistake, which was not detected in the first instance, and left a few shillings surplus on the hands of an employee, led him to attempt the same method for purposes of embezzlement.

For this reason it would have been desirable, had space permitted, to indicate other modern methods, records and ingenious machines which aim at a general accounting efficiency rather than at a direct prevention of fraud.

2. RULE FOR ACCOUNTING ARREARS.

MAXIM—

Chaos and delay in the keeping of records, especially by those responsible for the control of goods or cash—frequently act as a convenient cloak for fraud. Such chaos should make the auditor extremely cautious.

3. CONTROL OF ACCOUNTING ARREARS.

“Work in Progress” sheets could be made out by the chief clerk of a department or section setting out the state of the records in his department and explaining the reason for any arrears of accounting work. This is also his opportunity to bring forward suggestions for improvements of the system.

The “Work in Progress” sheets could be filed with the Internal Audit Report (if any) to form a complete record of the department’s history, but it must be borne in mind that both such reports are confidential communications to the “Chief” alone.

There may be matters which the audit clerk feels it his duty to report upon which should not be revealed to the sectional head, and *vice versa*. The relationship between the departmental head or the Internal Auditor and his Chief calls for the highest degree of confidence, and this confidence should be honoured by both.

4. BUILDING UP A MODEL SYSTEM.

It is only by conscientious and continuous attention to detail that the possibilities of fraud can be minimized. Suggestions and criticisms of existing systems should be encouraged and listened to with patience, even if the suggestions are impracticable at the moment. It is only by this patient and conscientious attention to detail that an efficient accounting system may be built up of which a “Chief” may feel justifiably proud.

CHAPTER XIV
PREVENTION BY COMPARATIVE METHODS

SYNOPSIS

VISION—"Routinists."

STATISTICS—

- (1) Interpretation of Figures;
- (2) The Statistician;
- (3) Correlation;
- (4) Comparisons in Quantities—Fallacies.

COMPARISONS—

- (1) Direct Numerical Comparison;
- (2) Graphical Comparisons;
- (3) Percentage Comparisons;
- (4) Gross Profit Test;
- (5) Principles of Comparison (Rules).

ABNORMALITIES—

- (1) Modern Auditing Methods—Maxim for Abnormalities;
- (2) Examples of Abnormalities which Revealed Frauds—Regular Income is not Conclusive Proof of Principal's Existence.

CHAPTER XIV

PREVENTION BY COMPARATIVE METHODS

VISION

THERE is a vast difference between a good routine clerk who is quick at figures and a good accountant who understands and can interpret the message conveyed by numerical statements.

To some excellent routine clerks, figures, however scientifically arranged they may be, are merely a "mass of figures." This is yet another example of the havoc wrought by too close an attention to detail.

A primrose by the river's brim,
A yellow primrose was to him—
And it was nothing more.

STATISTICS

1. INTERPRETATION OF FIGURES.

The true fraud watchdog will interpret the full significance of accounts, or any other numerical or financial statement. He will be able to go behind the figures and ascertain whether the causes for any abnormalities are due to negligence, dishonesty or to economic or natural causes (e.g. unemployment or bad weather).

2. THE STATISTICIAN.

The collection and tabulation of data are the work of the statistician and, in so far as he is able to interpret such statements without prejudice, he will also be acting as a fraud detector.

3. CORRELATION.

The degree of correlation between two commercial variables should reveal any excess in the one item, where there is no corresponding increase in the correlated item.

For example, there should be some definite relationship or fixed proportion (accidents excepted) between sacks of wheat used and flour milled, or between flour used and loaves of bread produced. If there is any marked fluctuation in the proportion, it merits further investigation to establish a cause—honourable, or otherwise.

It is felt that many auditors show a reluctance to examine stores, costing, or other records which do not form part of the double entry system.

4. COMPARISONS IN QUANTITIES.

It may be necessary to compare solely in quantities if price fluctuations make the comparison of their values misleading. For example, a statement may be made that "sales have increased." The statistician may prove, however, that the *quantities* sold or produced have actually decreased—the prices having soared owing to a trade boom, thus earning a higher percentage of gross profit and a consequent inflation of the sales figures. This form of misrepresentation is not infrequent.

COMPARISONS

1. DIRECT NUMERICAL COMPARISONS.

It is surprising that many striking fluctuations have often passed unchallenged by executive and auditors alike, when a simple comparison of the figures or quantities with a previous period would have made such an inquiry irresistible.

It is probably the fact that the method is so elementary that it is so frequently neglected; but more often it is a further example of the person preparing figures becoming so blinded by the detail work that he is unable to judge and compare his own work satisfactorily.

2. GRAPHICAL COMPARISONS.

In that they appeal more quickly to the eye, bring out trends and, if prepared in an unbiased manner on a suitable

scale, reveal any abnormalities, the graphical methods of comparisons are invaluable to the fraud watchdog.

The limitations of graphical methods lie in their inability to reveal small embezzlements and to distinguish between irregularities and unavoidable misfortunes. This shortcoming, however, is applicable to the other comparative methods and is, therefore, an insufficient reason for condemning graphical methods alone. A graph may be a very valuable servant in locating irregularity.

The chief graphs used for noting abnormalities are the *Lorenz Curve* (for percentage departures from a line of equality) the *histogram* (where no time element is involved), and the *historigram* (where there is a time element). The student is recommended to peruse a good textbook on "Statistics" in order to grasp the value of statistical methods in the control of transactions in bulk and for the prevention of fraud.

3. PERCENTAGE COMPARISONS.

It is probably unnecessary to issue any warning against the misuse of percentages. The import of the phrase "percentages can prove anything," is too well known to require further augmentation here.

On the other hand, percentage comparisons are not without a distinct value in discovering abnormalities which may ultimately prove to be irregularities.

4. GROSS PROFIT TEST.

H.M. Inspectors of Taxes make an extensive use of the percentage method in testing the reliability of the "Trading" section of the Profit and Loss Accounts.

The theory upon which this valuable test is based is that in any type of trade or business, and more certainly in any single concern or class of articles, the percentage which the gross profit bears: (a) to the sales, or (b) to the purchases, tends to remain fairly constant from year to year.

If there is any marked fluctuation in these percentages, it

may be due to manipulations in the figures for (a) stocks at beginning or end; (b) sales (excluded or spurious); (c) purchases (excluded or spurious); or (d) returns inwards or outwards.

5. PRINCIPLES OF COMPARISONS.

The Science of Comparisons is an essential method for the interpretation of figures and for the location of irregularities or inefficiencies.

The following points appear to indicate the main principles underlying the science of comparison—

(1) *Like must be compared with like.* Assuming the original data is correctly classified, it is also necessary that such groups as a whole are capable of comparison.

(2) *Comparison is not, in itself, interpretation.* Intelligence and much thought must be brought to bear on the problem. There may have been other factors which contributed to the results.

(3) *Correct or uniform classification* or analysis of data, e.g. cost of circulars included in "postages" one year but in "advertising" next year. To avoid this, a careful definition of such grading is essential.

(4) *A sense of proportion must be maintained.* Although one fact cannot safely be taken as indicative of the full position, certain isolated individual factors may require a separate detailed and, possibly, a technical study. The latter applies very particularly to fraud prevention research.

(5) *Comparisons must not be based upon insufficient data.* If test items are taken as representative of the whole, they must be—

(a) *Sufficiently numerous* to minimize the possibility of coincidence. If there is any suspicion of this, further items should be taken into the test.

(b) *Chosen at random*, to avoid bias or preconceived notions as to certain periods or sections being particularly susceptible to or free from irregularity. It is possible to draw opposite conclusions from the same facts or figures.

ABNORMALITIES

1. MODERN AUDITING METHODS.

Many ingeniously concealed frauds have been detected by such methods of comparison, and they deserve much greater recognition in auditing practice than has been accorded to them in the past.

MAXIM—

Every abnormality is attributable to one or more definite causes. These should be satisfactorily established or form the subject of deeper inquiries.

2. EXAMPLES OF ABNORMALITIES.

(a) In one concern, having a "seasonal" trade, it should have been obvious that the abnormal volume of stock purporting to be on hand at the season end was erroneous; the actual stock was later found to be almost negligible.

(b) The regular receipt of interest is not in itself a proof of existence of the principal sum. The author remembers a case of a solicitor's managing clerk who misappropriated mortgage principal repayment moneys, but actually paid the periodical interest instalments out of his own pocket, so that no suspicion would be aroused.

(c) Abnormalities, such as the non-purchase of ale by a club for a whole month, should awaken the curiosity of any intelligent investigator.

(d) The fraud watchdog can be forgiven for his failure to detect pilferings, but huge leakages which have a marked effect upon the face of the accounts are too obvious to be passed without inquiry by any competent man exercising a reasonable degree of skill, care, and caution.

CHAPTER XV

PREVENTION BY MACHINERY

SYNOPSIS

EFFICIENCY—

- (1) How Efficiency Combats Fraud—Piecemeal Machine Units without Relation to Ultimate Plan or Co-ordination (not "Efficiency").
- (2) Faith in Machines.

VARIOUS MACHINES—

- (1) Postal Franker ;
- (2) Banks' "Night Safes" ;
- (3) Letter Box Protectors ;
- (4) Lithograph and Stamp Signatures ,
- (5) Powers, Hollerith and Paramount Punching Systems ;
- (6) National Posting and Burroughs' Utility Machines, etc.

WAGES—

- (1) Modern Methods : (a) Punched Cards ; (b) Brandt Automatic Wages Paying Machines, (c) Window Wage Packets—Alleged "Shortages" ; (d) Time Recording Clocks ; (e) Weigh-bridges.

CASH—

- (1) Turnstiles and Ticket Issuers—Ticket Frauds—Internal Check Control of Tickets—Date Stamping Machine ;
- (2) Giving Change by Brandt Automatic Cashier ;
- (3) Cash Sales—Visible Cash Registers—Public in Internal Check Chain — Examples of Fraud — Cash Conveyors — Automatic Slot Machines.

CHEQUE PAYMENTS—

- (1) Preventing Forgery and Alteration ;
- (2) Perforating Methods—Cheque Punches ;
- (3) Cheque Protectors—Protectograph Cheque Writers ;
- (4) Violet Ray.

RECEIPTING MACHINES—

- (1) "National" Cash Register ;
- (2) Parata Receipting Machine—Preventing Fraudulent Manipulation of Machine ;
- (3) "Smith Premier" Receipt and Cheque Writing Machine.

BOOK-KEEPING AND POSTING MACHINES—

- (1) "Campos" Book-keeping and Accounting Machine ;
- (2) Stores Control by Machines.

IN CONCLUSION.

CHAPTER XV

PREVENTION BY MACHINERY

THE application of mechanical methods to the problem of fraud prevention is a comparatively recent innovation, and the progress which has already been made indicates that a wide field for exploration still awaits the keen systematizer.

EFFICIENCY

1. EFFICIENCY COMBATS FRAUD.

Each concern has its individual problems and distinctive characteristics of accounting which preclude any general recommendations as to the most suitable machines for any and every type of undertaking.

In that a carefully planned and co-ordinated system of mechanical appliances tends towards general efficiency and up-to-date records, it may be stated that all machines which have proved their worth in a particular office are contributing towards the minimization or quicker discovery of irregularities in that concern.

On the other hand, the presence of office machinery is not necessarily a proof of efficiency or of freedom from irregularity. It may have been commercial vanity or the desire to be fashionable, which induced the office chief to install machine units piecemeal—probably without any regard to a pre-conceived plan of ultimate complete mechanization, or of co-ordination between one machine unit and another.

2. FAITH IN MACHINES.

As in the case of carbon copy methods, so now in respect of office machinery, it is necessary to point out the growing tendency to regard machine methods as an infallible protection against manipulation. This has frequently proved to be an unwarranted confidence—especially with receipting

machines. Although we are in a mechanical age, intelligent supervision is still essential (e.g. the weighbridge frauds already cited: Chapter V).

VARIOUS MACHINES

It is not proposed to cover the whole subject of office mechanization, nor to attempt any technical description of mechanical detail, as the reader has ample sources from which his knowledge can be supplemented—through the periodical exhibitions, manufacturers' catalogues, and viewing such models in actual office use.

The purpose of this chapter is merely to indicate, by one or two prominent examples, how fraud can be minimized by mechanical agencies. The fact that certain machines have been chosen for such illustrations is no indication that they possess any particular merits over their competitors.

There are other types of machines which have not been dealt with herein, because they have insufficient bearing upon fraud prevention—as distinct from office efficiency.

(1) *The Universal Postal Franker and Accounting Machine* (sanctioned by H.M. Postmaster-General) registers on a single meter the expenditure and balance. Both electrical and hand models are available. There is a moral responsibility to prevent petty cash and postage pilferings by young employees.

(2) *Night Safes* are provided by the big banks for the safe deposit of customers' cash after banking hours.

(3) *Letter Box Protectors*, wire arrangements inside the box to prevent the stealing of letters containing remittances. In practice, the wires occasionally fail to "receive" the bigger packages—especially in the smaller letter boxes—with the result that the mail is held in the upper part of the box where it can be stolen even more easily than without the wire protectors.

(4) *Lithograph and Rubber Stamp Signatures*. (See Chapter VI, "Forgery.")

(5) *Powers, Hollerith, Paramount*, and similar punched

card methods, which prevent subsequent alteration of records. (Invaluable for Wages.)

(6) *Mercedes Add-Electra, National, Sundstrand Duplex, Smith-Premier Electro-Duplex, and Burroughs Utility Machines.* Some of these ingenious machines calculate consumption (e.g. gas, electricity, water undertakings) from the meter readings, prepare demand notes, ledger cards and summary sheets. The "Campos" Book-keeper has been taken as a suitable example for illustrating how book-keeping and stock-keeping frauds can thus be minimized.

WAGES

Great advances have been made in the application of machinery to wage payments and records, in order to prevent fraud and to relieve the weekly "peak load" in the office.

1. MODERN METHODS.

(a) Wage pay rolls can be prepared from punched job-cards. (See (5) above.)

(b) Wages (and, in some areas, Public Assistance relief) can now be made up very quickly in packets with a *Brandt Automatic Wages Paying Machine.*

(c) If the *window pattern wage envelope* is used, it relieves the pay clerk of the responsibility for inaccuracies in the contents of the sealed envelopes. Not infrequently, attempts are made by workmen to claim alleged shortages in their packages. This is prevented by a statement of the gross and net wage and deduction on the outside of the packet, and notice that no mistakes can be rectified if the seal is broken. The packets are folded so that the notes can be counted without extracting them from the packet, and the coins can be checked through the window of the envelope.

(d) The use of *Time Recording Clocks and Punched Cards* to prevent manipulations of time and costing records is now well established and deserves preferential consideration as the basis for systematizing wages methods.

(e) *Weighbridges*, to exercise a control upon goods received

and dispatched have already been referred to. (Chapter V, "Goods.")

CASH

1. TURNSTILES AND TICKET ISSUERS.

Probably one of the earliest machines introduced for the control of admissions and the checking of takings or tolls was the turnstile—with or without a numerical recording device.

It should be noted that turnstiles are liable to mechanical defects and may register "fast" or "slow." An additional check in the form of tickets is therefore advisable.

Subject to the above word of caution, the daily increase in the numbers on the meter can be compared very readily with the total tickets issued or money received. It must not be forgotten, however, that where there are various prices for admission, the more expensive ticket may be fraudulently substituted by one for a lesser value, or even by a free or "contractor's" ticket, unless the customer objects.

Careful control must be kept of the ordering, custody, issue, and accounting for all tickets. There should also be some system of internal check to prevent the re-issue of used tickets.

Examples—

(1) Date of issue to be printed on the ticket by a *Date-Stamping Machine*, similar to that used at all railway booking offices.

(2) Customer to hand the whole or half ticket to an inside attendant (e.g. cinema, public baths) who retains it on a tally stick, or deposits it in a locked box for subsequent independent reconciliation with the turnstile records.

2. GIVING CHANGE.

Brandt Automatic Cashier Machines are useful for giving correct change to customers, whether at a turnstile, restaurant, or any other cash counter. Belated disputes as to accuracy of the change are greatly diminished and protect both customer and cashier from fraud.

3. CASH SALES.

It has already been indicated (Chapter III) that the correct accounting for all cash sales presents a big problem to systematizers, but the *Visible Cash Registers*, most of which carry one or more accumulative totals, serve a very useful purpose.

In the cheaper machines only the indicator is relied upon to give notice to the customer of the amount recorded, but on more than one occasion the author has noticed the assistants in cheap stores—where one revolving register serves both sides of an island stall—swing the visible indicator away from the customer before pressing the recording keys. In other cases this indicator was hidden by the stall displays.

There are, of course, more elaborate cash registers available now which print and issue a receipt to the customer. These receipts have a strong moral effect upon the employee.

A further step is the introduction by the *National Cash Register Company* of a machine which will actually total the items of any sales and issue an itemized and totalled ticket. As many as fourteen separate accumulative totals may be provided, giving a very comprehensive dissection of the receipts. These models are to be distinguished from the "Receipting Machines" referred to on a later page.

The subject of "Cash Sales" would be incomplete without some reference being made to the several excellent *Cash Conveyors* in use. Both the overhead "railway" and the tubular pneumatic systems provide for centralized control, and for a double internal check (viz. (a) customer, (b) counter-hand, (c) cashiers).

Automatic Coin-in-Slot Machines, whilst giving a ready means of check in some cases by the number of articles sold, should be subject also to a measure of internal check by compelling the attendance of two persons when the cash box is emptied, e.g. two keys required to open the box, or two sets of initials required for the statement of cash collected.

CHEQUE PAYMENTS

1. PREVENTING FORGERY AND ALTERATION.

There are many "cheque protecting machines" on the market, but such machines are useless, if not dangerous, unless they give an impression which cannot be removed by acid or skilful alteration. (Note the modern "Safety Paper" used by the banks for their cheques.)

2. PERFORATING METHODS.

The methods of cutting completely through the cheque first took the form of a series of little holes forming the shape of the figures, and a "star" was cut at the end of the amount to prevent more figures being added, viz.—



It was not long before clever swindlers filled in the "star" with bits of paper, and cut another figure, followed by a new "star."

This system was followed by the *Cheque Punch*, which cuts out block figures resembling the impression made by ordinary stencil letters, viz.—

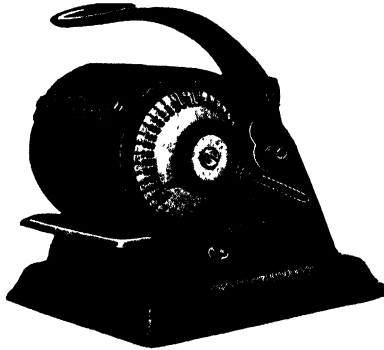


It was erroneously considered that the bigger star, cut out in one piece, would be impossible to replace. In practice, however, it was actually found to be easier to replace the one comparatively large piece of paper than the dozen or so little ones.

3. CHEQUE PROTECTORS.

As distinct from such perforating machines there are several good protecting machines on the market, such as (a) the cylindrical *Protectograph*, and (b) the *Protectograph Cheque Writer*, manufactured by Messrs. Halsby & Co., Ltd.

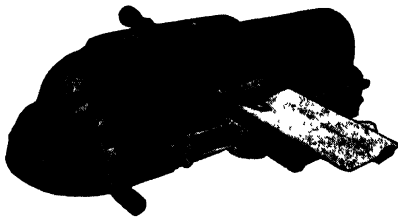
(a) *The Protectograph*. The inefficiency of surface impressions or perforating systems used separately is overcome by the *Protectograph*, which combines both such systems by stamping each cheque for either a large or a small amount in one operation, where previously several were necessary.



The paper of the cheque is shredded with small slits between the cylinder and platen, whilst at the same time the broken fibres are saturated with an aniline acid-proof ink.

NOT OVER TWELVE POUNDS

(b) *Protectograph Cheque Writer*. The *Protectograph Cheque Writer* "shreds" the full and exact amount of any cheque, draft, bill of lading, trade acceptance, stock certificate, letter of credit, etc., in the body of the document in



words in two colours, for any desired sum from the smallest to the largest amounts in any monetary system—a full word to each turn of the operating handle.

The cheque is placed on the shelf against the side and end gauges, thus bringing the cheque to position instantly and automatically. The indicator is moved to the desired word on the dial. The operating crank is then turned, which writes the word in its proper colour—red and black for alternate words—and automatically feeds the cheque the correct distance for the next word. The cheque cannot feed without printing, nor print without feeding. When the last word is written, the indicator is moved to the word “release,” at lower end of dial, which automatically releases the cheque and leaves the machine ready for the next form to be inserted.

4. VIOLET RAY.

The invention of Lieut.-Col. W. R. Mansfield, whose laboratory is at Brixton, should reveal any alterations in deeds, wills, cheques, passports, or other documents, however skilfully made.

By using ultra-violet rays in a special instrument the hidden evidence of fraud is revealed to the investigator or jury.

Scientists at the Probate Office and the British Museum have examined photographs which Colonel Mansfield has prepared by his new process, and the results are described as amazing, and a most notable advance in the detection of fraud.

Insurance companies are now including a negative print of the original proposal form as a part of their insurance policies. This prevents subsequent alterations and disputes.

RECEIPTING MACHINES

I. “NATIONAL” CASH REGISTERS.

This machine is popular among Municipalities and Public Utility concerns and probably offers the best mechanical protection available as regards receipts.

The machine is electrically driven and not only does it add, count, and distribute the records on any one operation, but it

prints three original records of every receipt issued, viz. (1) on the account itself; (2) on a posting stub, which is automatically cut off from the account, and (3) on an Audit Summary Sheet.

The posting vouchers (or "stubs") are stacked automatically in numerical order in a locked box. A recent fraud case in connection with loose stubs has emphasized the necessity for the cashier being denied access to this box.

The third record, being printed on the audit sheet, provides further protection and service. As this sheet is also recorded and preserved under lock and key inside the machine, it can only be taken away by the internal auditor, or other appointed official.

Incidentally, up to 27 dissection or analysis totals may be provided, allocating incoming revenue to funds and classifications. Some of these totals may also be allocated to separate cashiers and the useful division of duties and responsibilities thus made possible adds to the security of the accounting. The *number* of receipts issued under each dissection or classification is recorded on metal adding wheels under lock and key.

Numerical Control of Receipts. Every safeguard has been provided. For instance, there are unresettable detector counters protecting the locks of the "National" machines, giving the internal auditor absolute control over the machine, records, and money. No totals can be printed without turning a key in a lock, and each time the lock is turned one unit is added on to the detector counter, so that even if an unauthorized key were secured it could not be used without revealing the fact.

The receipt is issued immediately and not by a subsequent machine operation, and this receipt must satisfy the customer.

Thus, a valuable internal check on the transaction is created.

Each receipt is consecutively numbered, the serial number being simultaneously printed on (i) the posting stub; (ii) the

customer's receipted portion, and (iii) the summary sheet. All three records are certain to be correct, because it is not possible for the internal records to differ from the receipt handed to the customer.

2. THE "PARATA" RECEIPTING MACHINES.

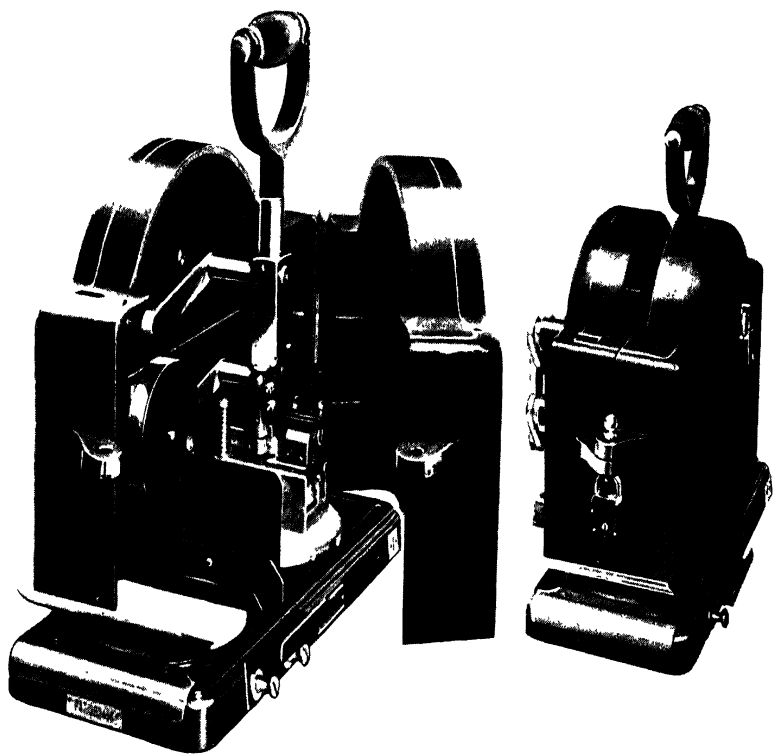
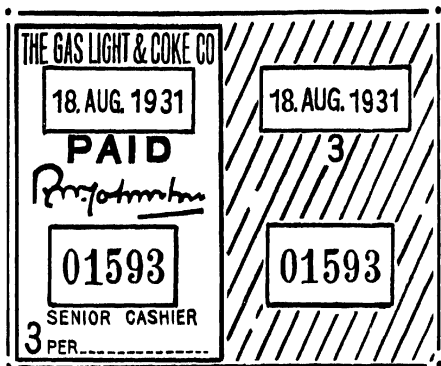
Whilst suffering from disadvantages in comparison with the "National," in that it does not print the amount of the receipt, there is little doubt that the "Parata" machine will find a wider use by reason of its comparative cheapness. For this reason and for the very adequate reason that frauds were formerly possible by its misuse, it has been chosen for illustration here. The mechanical improvements (below) have remedied most of the former opportunities for manipulation.

It is unfortunate that, in its present state, the invaluable safeguard of a printed amount is omitted.

(a) *Numerical Control of Receipts.* The principle of control with the "Parata" lies in the **NUMBER** of receipts issued by the machine and not in the **VALUE** of those receipts. The use of this model is, therefore, more suitable for concerns where accounts are almost invariably paid in full, rather than those where it is customary to accept numerous small payments on account.

A special demand note or statement of account is used. The "Parata" machine prints a form of receipt by a manual operation simultaneously on the account (which is returned to the customer) and on the detachable posting stub (which bears reference and account numbers to identify it with a ledger item). Unlike the "National" machine, which automatically drops the stub into a locked box, the "Parata" stub has to be detached by hand.

(b) *Machine Frauds.* The frauds committed in connection with various machines are so ingenious that it would be contrary to public policy to describe them here. (Members of the Institute of Municipal Treasurers and Accountants (Inc.) are referred to the "Defalcation Memoranda" issued by their Institute.)



THE "PARATA" RECEIVING MACHINE

Whilst it was not intended to go into mechanical details, the following improvements in the "Parata" are of special interest in preventing the recurrence of past manipulations of receipting machines—

(1) An eccentric movement compels the numberer in the die to rotate with every swing of the handle, thus defying any attempt to alter the numberer either backward or forward, and ensuring its recording a number on each stub. This is vital because the "Parata" machine exercises a control only on the *number* of receipts given.

(2) A steel partition in the centre of the machine between the inking pad and the receipting pad prevents any person inserting a demand or other paper in an endeavour to obtain an unrecorded receipt direct from the inking pad.

(3) Curved steel mouth guides have been fitted to facilitate the easier insertion of the demand. These are so close down on the receipting pad, that only one demand at a time can be inserted, thereby preventing any attempt at inserting a number of papers in an endeavour to receipt the top one, and withdraw it in order that a duplicate may be obtained before the number changes. This is an additional protection to the Safety Ratchet, which prevents the die from coming down again after a receipt has been made, until the handle has been returned to the inking pad. Both numberers will then have recorded.

(4) The case which surrounds the die and working parts not only prevents outside interference by wires and other instruments, but being fitted with four needles, one on each corner, pierces the demand prior to the impression being given. It does not release until the die has returned sufficiently far up into the case for the Safety Ratchet to take effect. The needles also act as a protection against any attempt at withdrawing the demand and inserting another on the same serial number. Such an attempt would be frustrated by the needles tearing the demand to pieces.

(5) The machine is fitted with two locking bars, one on the end, as illustrated, the key to which is kept by the chief

cashier (or internal auditor), and no one but he can gain access to the machine. There is also a *locking rod* running through the centre of the machine which prevents the handle from moving. In order to secure individual responsibility, the key to this lock must be held by the person using the machine, so that he can lock it on leaving his desk, and thus prevent its use in his absence. Whilst this latter lock differs on all machines, the lock on the *end* of the machine only (above-mentioned) is opened by the master key retained by the chief cashier (or internal auditor), who takes the meter readings at intervals.

3. RECEIPT AND CHEQUE-WRITING MACHINE.

The Smith-Premier Cheque/Receipt Writing Machine prepares a related group of forms and records at one typing, e.g.—

<i>Receiving.</i>	<i>Paying</i>
Receipts.	Cheques.
(Copies used as Ledger Posting Slips.)	(Copies used as Ledger Posting Slips.)
Cash Book.	Cash Book.
Paying-in Slips.	Bank List.
(Remember "The Cheque Test.")	(Or Municipal "Orders on Treasurer.")

This obviates the duplicated effort of writing the same information first on one record and then on another of the group of forms. Each is an exact copy of the original; there is, therefore, less checking involved as it is scarcely possible to alter one record without the others showing up the manipulation.

BOOK-KEEPING AND POSTING MACHINES

There are so many excellent machines on the market to-day that it is with considerable diffidence that any single model is chosen to illustrate the means whereby such inventions can be applied to the prevention of manipulation or misappropriation.



LEDGER ACCOUNT

SERIAL NO OF ENTRY	DATE	DETAILS	A/C NO.	DEBIT	CREDIT	BALANCE
8821 8822	27 5 31 31	-CASH- -CASH-	606		66.16: 7 85.16: 5	205.19. 1 - 55. 6. 1 -N 55. 6. 1 -
8826 8827 8828	29 5 31 31 31	-GOODS -GOODS -GOODS	606	76.18: 8 67.17: 8 75.18: 8		275.19. 9 -N 275.19. 9 -
8842 8843 8844 8845 8846	29 5 31 31 31 31 31	-GOODS -GOODS -DISC -DISC -RTNS-	606	77.18: 8 46.0: 8	200. 0: 0 10. 0: 0 25.14: 7	166. 3. 2 -N

ACCOUNT NO. 606

NAME: Powers-Sama
Accounting Machines Ltd.
ADDRESS: Aldwych, London, W. C. 2.

THE "CAMPOS" BOOK-KEEPING MACHINE AND LEDGER ACCOUNT
(Powers-Sama, Ltd)

The models which prepare bank pass books and ledger accounts (printing a balance after recording each transaction in order to defy subsequent manipulation) come instantly to the mind as suitable for illustration.

1. "CAMPOS" BOOK-KEEPING AND ACCOUNTING MACHINE.

The main features of this "**Powers-Samas**" machine, which was originally designed to prevent bank frauds, may be summarized as follows—

(a) Balances of all accounts are mechanically stored in the machine, thus preventing alteration, except by a separate book-keeping entry.

(b) Balances of all accounts are always up-to-date and correct. Arrears of accounting are often a cloak for embezzlement. Irregularities are, therefore, discovered sooner after their perpetration.

(c) Any or all of the balances can be automatically listed at will.

(d) Six original copies can be taken off the machine simultaneously. These, when distributed, may form a valuable internal check upon their veracity.

(e) Ledger Sheets are automatically positioned in the machine.

(f) An account must be selected before an amount can be posted. Compensating errors in the ledger and books of prime entry are avoided. Apparent compensating "errors" may, in reality, be manipulations to cover misappropriation.

(g) The selection of an account automatically brings forward and prints the old balance on that account. (This had previously been a fruitful source of fraud as well as error.)

(h) Posting an account automatically produces the new balance and stores it in the machine. No false items can therefore be introduced without a corresponding entry in the other record.

(i) The Double Entry is complete and automatic. Every posting has its contra entry mechanically recorded. The

advantages of Double Entry Book-keeping as a means of control are thus emphasized and ensured.

(j) Debit and Credit Balances are indicated by different types, and also by a plus or minus sign. Such signals immediately call for attention without the necessity of striking balances.

(k) Separate totals of all debit and credit postings are shown on visible dials. This is an excellent method of financial control, for any abnormal fluctuations call for an explanation. (Comparative methods.)

(l) Visible warning is given when the status of an account changes from a credit to a debit balance, or *vice versa*. This is particularly important in relation to customers' accounts at a bank.

(m) Each transaction automatically receives a serial number which prevents substitution or alteration to the balance of any account.

(n) **Falsification is impossible without leaving a positive trace.**

2. STOCK CONTROL.

One type of "Campos" machine has a split keyboard to permit the quantities and values of stocks being computed simultaneously. Thus, every item of stock received or issued is posted, and the revised balances shown, in both quantities and values.

The operator is less likely to forget to notify the store-keeper when the "minimum stock" balance is reached. A red light automatically reveals the deficiency, and the stock account thus affected cannot be stored without a further operation of the posting bar.

The machine can print the balances of 1,000 stock "lines" in 45 minutes—even after the staff has left the office. The machine can be shut off automatically, leaving the complete list of balances and account references printed ready for the staff upon their return the next morning or after lunch. There is thus almost a complete absence of the personal

element in respect of this machine, and this alone tends to secure freedom from fraudulent store-keeping.

IN CONCLUSION

It is felt that only the fringe of the mechanical method of fraud prevention has been investigated, not only in this book but in actual practice.

By this brief exposition, it is hoped that a sufficient insight has been given into its possibilities, and that it will inspire the keen investigator or systematizer to harness other progressive means for achieving the laudable ambition of fraud prevention.

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