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Crime Tendency

G. McMurtrie

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"THE CRIME TENDENCY"

Delivered by G. McMurtrie to Fond-Du-Lac Association
of Credit Men.

December 8, 1924.



In accordance with the request of your association my talk this evening will be on "The Crime Tendency", and I understand that this request was made on account of the publicity given this subject in Letter Bulletin No. 2 which was issued by the Committee on Public Affairs of the American Institute of Accountants.

Before reading my paper I have no doubt that it will be of interest to you to understand a little of the American Institute.

In 1904, at St. Louis the American Association of Public Accountants was formed by a representative body of accountants, and on September 19, 1916 this society was dissolved and the American Institute of Accountants organized. The American Institute, and its predecessor association, was I believe the first endeavor of the accountants of the United States to obtain proper recognition, and the objects of the Institute as stated in Article 1 of their constitution are as follows:

"To unite the accountancy profession of the United States; to promote and maintain high professional and moral standards; to safeguard the interests of public accountants; to advance the science of accountancy; to develop and improve accountancy education; to provide for the examination of candidates for membership, and to encourage cordial intercourse among accountants practising in the United States of America."

From the foregoing you will readily see the admirable purpose of the Institute, and, during the number of years since its organization what it has accomplished for accountants and the accounting profession in the United States would form a very large volume of interesting reading.

With this as an introduction I now take pleasure in presenting my remarks on the subject of "The Crime Tendency."

From time immemorial man, from the primitive state to his present highly civilized state, has been envious of his neighbors' wealth, whether that wealth has been acquired by honest application of wits, aggression or dishonesty. As enviousness supersedes honest application, aggressiveness and dishonesty result. It is often said that no one ever lacked

anything which he never possessed, but you will agree that the natural tendency to covet more wealth exists, and is born of the apparent inequitable distribution thereof. This is a controversial matter, however, in which I do not wish to become involved. Nor do I desire to make any remarks on the exploitation of wealth, other than to leave with you this meager, but vital and least known, statistic from which you may decide for yourselves the advantages or otherwise, which might be obtained from equitable distribution, and that is, if the total wealth of the United States alone amounting to three hundred billion dollars was divided equally the per capita share would amount to approximately \$2800.00. With reference to the earning capacity of the United States population, I would say that of the incomes reported to and published by the Federal Government for 1921, and estimating the wage earning population to approximate 40,000,000, about 97% have a taxable income of \$3,000.00 or less, and about 85% less than \$1,000.00.

The aforementioned tendency, however, in most cases becomes as it were mythical, being gradually eliminated by religious teachings, modern education and social institutions therefrom.

As already said these are more or less effective, but do not reach the man with a depraved brain or him who elects in spite of all teachings thereanent to practice bolshevism and perpetrate fraud to acquire that which is not rightly or justly his.

The most common frauds practiced today in the financial and commercial world may be expressed in four classes:

1. Embezzlements
2. Forgeries
3. Fraudulent Misrepresentation of Statements submitted for credit purposes.
4. Sale of worthless securities.

The total annual losses from the foregoing perpetrations approximate \$1, 600,000,000 divided as follows:

1. Embezzlements	\$ 100,000,000.
2. Forgeries	100,000,000.
3. Fraudulent Credit Statements	400,000,000.
4. Worthless Securities Sold	<u>1,000,000,000.</u>
Total	\$1,600,000,000.

The premiums paid on fidelity bonds by employers for the purpose of indemnifying them against losses arising from dishonesty on the part of employees have increased from \$10,000,000 in 1917 to \$29,000,000.00 in 1923. This would lend itself to the belief that the tide of dishonesty is rising, but this this is not altogether borne out by the losses paid by fidelity companies. While the losses in 1917 amounted to

\$2,000,000, in 1921 to \$11,000,000, and in 1923 approximately \$10,000,000.00, the percentage of losses paid to premiums received went from 25% in 1917, to 34% in 1923 or an increase of 9% in 6 years.

Let me quote here what Mr. F. W. Lafrentz, President of the American Surety Company has to say on this matter:

"After all is said and done, the one thing that impresses me in my experience as a surety man is the high average of honesty on the part of men of all stations, and the thing that impresses me next is that a large number of defalcations which occur would never occur if proper accounting systems were used and regular audits maintained." Of course no system, however, perfect, is an absolute shield against a designing defaulter. There is always a weak spot somewhere, but a proper system of accounts usually makes attempts of the kind easy of detection.

No fraud was ever committed without an opportunity being afforded the party contemplating the same. When you consider that approximately 6 billion checks are issued annually in the United States, the opportunity for forgery is, we might say, unlimited unless proper safeguards are rigidly enforced.

Public Accountants have repeatedly been called upon to investigate and detect fraud, but the incidence of the public accountant should not eliminate the necessity of adopting preventive measures on the part of business houses generally.

The first precaution should be to establish an internal check whereby work will be divided in such a way as to make collusion impossible. Here is an instance of defalcation caused by one employee having too many duties to perform.

The accountants in making an audit of a distributing firm which did not keep a perpetual inventory disclosed that the bank account at the end of the period was in perfect agreement. In making a test check a most peculiar condition was disclosed as it was discovered that the daily deposit as shown in the cash book in no single instance agreed with the deposits as shown by the bank statement.

After an extensive investigation it was discovered that the secretary of the company who also had charge of collections, bank reconciliations, and the general books, had been withholding most of the cash sales each day. It was necessary to enter the proper amount of cash sales as a daily report of same was sent to the president and the president would immediately have noticed any large discrepancy in cash sales.

You will readily understand that such an understatement of deposits would have immediately shown up in the bank reconciliation unless a contra manipulation was made. The secretary to overcome this difficulty covered his underdeposit by keeping a note of same and raising a check after it had already gone through the bank for the proper amount and was returned cancelled. This was comparatively simple as the company had a very large account with a big supplier in the East which necessitated a check being drawn at the close of each month for several thousands. The amount by which he raised this check he charged to Purchases and this was not readily discovered as no perpetual inventory was maintained.

The defalcation in this instance amounted to thousands of dollars and could have been avoided by a proper distribution of functions and even more readily if a proper perpetual inventory had been in force.

Further protection against the alteration of checks or any other instrument may be secured by the use of certain devices which are inexpensive and essential. The use of Safety Paper and check protectographs will tend to lessen the possibility of alterations.

A policy should be adopted of depositing all cash receipts with the bank daily, and no checks or other documents of a negotiable nature should be delivered without the signatures of at least two authorized persons and then only on the basis of vouchers passed by another responsible party. Bank accounts should be reconciled monthly and payrolls should be computed, checked, certified and paid by separate individuals.

If such precautions are not adopted it would be rather difficult after a loss has occurred to establish the fact that usual precautionary measures had been adopted. The employment of Public Accountants to make professional audits has a decided moral effect on employees who have to do with the handling of cash or any other matters pertaining thereto. The moral effect obtained is more apparent in the ease of audits conducted with frequency, thoroughness and without notice. An audit conducted each month is a certain deterrent of crime and from a creditors point of view I would say that such an audit is essential and that monthly statements should be submitted for credit purposes. How many of you here have been forced, in the absence of statements reflecting the nearest possible financial condition, to accept a certified audited statement at the close of your customers last financial year?

This deals with the third class of fraud, viz. "The fraudulent misrepresentation of statements submitted for credit

purposes" and involves losses to creditors which have been borne as a result of presenting untrue statements of operations and of net worth for the purpose of obtaining credit. A common occurrence of misrepresenting the net worth of a corporation is the issuing of stock at a discount which is the excess of the par value of stocks issued or assumed over the actual money value of the consideration received for such stock (except stock that has been sold and re-acquired).

In some States, statutes permit the issuance of stock at a discount, but in the majority of States stock can not be issued below par. Nevertheless there are several instances where stock is issued below par, the difference between the

par and the actual amount paid for the stock being charged say to "Goodwill" or some other account of an intangible nature. When a statement for the purposes of credit reflects such a state of affairs it is untrue and fraudulent as against third persons who subsequently extend credit to the corporation on the basis of the statement submitted, unaware of the actual situation. So long as the stock remains in the hands of the original purchasers or those who purchase with a knowledge of facts, there is no contingent liability for the discount attaches to the stockholders provided the existing assets are insufficient to satisfy the creditors.

Many United States Supreme Court cases could be cited in this connection, but let it suffice to quote two of the most important decisions.

In the case of Handley vs. Stutz (139 U.S. 417) the following decision was given:

"When the stockholder in a corporation who assents to an increase in the capital stock of the corporation and its gratuitous distribution among the shareholders, receives such stock as full paid stock, an obligation arises to pay for it in full, when called upon to do so by creditors whose debts are subsequent to the authorization of the increase."

In the case of Upton vs. Hansborough (3 Biss U.S. 417, 28 Fed. case 16301) District Judge Hopkins handed down the following decision:

"A secret agreement of that kind between stockholders is so palpable a fraud upon the creditors dealing with the company without knowledge of it that I shall not spend the time in further discussing it."

The reasons why such issue of stock is a fraud against the creditors may be given thus:

1. It is a violation of the express provisions of the corporate charter.
2. It is a secret agreement - The secret agreement in itself is not an illegal or fraudulent contract, but the fraud consists in presenting it to others as the true contract.
3. It misrepresents the capital stock, upon the faith of which creditors of the corporation have extended credit. Legally capital stock is the sole basis of credit representing corporate assets.
4. It distributes corporate property to stockholders before outside debts of the corporation are settled.
5. It enables the stockholders to enjoy the profits of the business, if successful, and to avoid liability, if unsuccessful, casting hazards wholly upon the creditors.

In our everyday business we sometimes come across instances of corporations promiscuously increasing their capital assets, per contra increasing Earned Surplus and publishing financial statements accordingly. In some cases this is done without any knowledge of the harm which may later entail, but more often it is done to satisfy stockholders who may have become uneasy or impatient in the absence of dividends. A cash dividend is then paid, the stockholders are pacified and from the appearance of the financial statement, the company is in a healthy condition. An investigation however discloses that the value placed upon the Capital Assets does not exist, and in place of an Earned Surplus a Deficit is revealed. The payment of a cash dividend therefore (apart from it being illegal) had the effect of impairing the Net Worth of the Company thereby threatening the security of the ordinary creditor.

Some of you gentlemen may say - "We are not so much concerned about a mis-statement of Capital Assets. What we care about is the working capital." Well here is a specific case where working capital was seriously affected by a deceitful manipulation:

A manufacturing concern contemplating a bond issue was requested to employ an accounting firm so that a balance sheet and statement of operations be prepared for the underwriters. One of the duties of the firm employed was to take an actual inventory which they did. This inventory was to show quantities, description, et. The pricing was in charge of one of the principal officials of the company. There was no thought that this official would be dishonest and in due course he returned the inventory sheets priced.

The accountants then prepared their final statement after satisfying themselves that the extensions of the inventory were correct and naturally as their representative was responsible for the quantities there should have been no question as to the corrections. It was found at the next closing period that the company did not show the results which were anticipated and after an extensive investigation it was discovered that the official who had been authorized to price the inventory had raised the quantities, as stated by the independent parties who had made the count. This might look like gross negligence on the part of the accountants, but it must be remembered that there was not the slightest inference that the official would manipulate the inventory sheets. The result if I remember correctly was that the bond issue was recalled.

This manipulation could have been avoided if the party furnishing the inventory sheets to the official had made the sheets in duplicate and retained one set in his possession to re-check the quantities after same had been priced.

This simply goes further to show how careful one must be in our professional work not to trust any one, no matter how big his position or his supposed integrity.

Another instance that comes to my mind, is in connection with the defalcation in one of the smaller middle west cities. This city furnished electricity to the population and the city clerk who looked after the billing and collections, made the remittance to the City Treasurer.

The procedure in connection with the electricity operations was as follows:

The meter reading man recorded the number of units used in his meter reading book. From this book the units used were recorded in a monthly register which showed the units at the beginning of the month and the end of the month, quantity used, rate and amount collectible.

The city clerk then billed the consumer, the duplicate being retained in the bill book.

The scope of the accounting work was a balance sheet audit with a test check of the operation, and in this test check enough of the duplicate bills were checked into the register to satisfy the auditor that they had been properly recorded.

During a conversation he had with one of the purchasers of electricity, the consumer mentioned that his bills for electricity were very large, and the accountant being interested asked if he would be good enough to show him a few.

Upon glancing over the bills he noted that the bills ran in the neighborhood of between \$250 and \$300 every month, whereas from his memory he recollected that there was no monthly bill of over \$75. in the City clerk's office. The accountant asked if he could keep the invoices for several days and after a most extensive check he discovered that the City clerk had appropriated thousands of dollars of the city's funds.

The method adopted by the city clerk was to bill the consumer for the right amount and then re-write the duplicate over a carbon inserting the meter readings so that they would agree with the amounts he turned over to the city treasurer. The city clerk had destroyed a number of meter reading books but, with the books which he had inadvertently overlooked, the accounting firm was able to prove conclusively how the manipulation had taken place. It was also rather interesting in this instance although the City Counsel understood that the City Clerk was bonded, it was found out that he had cancelled his own bond several months previously and therefore it was impossible to obtain re-payment of this large amount.

This manipulation of funds could also have been avoided if there had been a proper distribution of functions, as the trouble was, that the clerk made out the bills, collected the cash, deposited same in his own bank account and then made a monthly statement to the City Treasurer.

There are however other cases of fraudulent statements issued, not for the purpose of obtaining credit but for defeating the Government out of taxes. I have an instance in mind which I dealt with personally in the city of Glasgow, Scotland. During the period in which the British Government levied an Excess Profits Duty Tax, most business houses were making enormous profits. A perpetual inventory was not maintained by this particular concern, but on approximating the inventory was on the basis of gross profit, it appeared that the amount reported was rather low. After repeated questioning, the proprietor admitted that he had intentionally omitted a considerable portion. Whether or not this was ever discovered by the Internal Revenue, I am not aware, as we took no responsibility and did not sign any statements. In order that the profit from the sale of the inventory omitted would not be disclosed in the following year, as sales were made of the particular items, no entry was made on the books, but the amount realized was divided amongst three salesmen who alone knew what had taken place, and the proprietor himself. The proprietor deposited his share to the credit of a brother-in-law in an out-of-the-way town and received an I. O. U. in exchange.

A further precaution which might be taken is in the quality and calibre of the personel in addition to the treatment to be meted out to them. The reference presented should be originally investigated. Salaries paid should be in accordance with usual living standards and becoming to a particular position of the employee. Should any doubt arise regarding the integrity of any trusted member of the staff, the fidelity company should immediately be communicated with.

Let us touch on the subject of stock frauds. The losses incurred by the people of the United States through the purchase of spurious securities since the close of the World War aggregate the colossal sum of three billion dollars. Such losses generally arise from the broadcasting of circulars advertising the sale of corporate stocks which if real have no potential value. It is often the case that the corporation mentioned does not exist. Bucket shops and such other illegal forms of trading in securities have for long been a menace to the financial world, and have threatened to discredit reputable houses in the eyes of the investing public. More so in the case of poorer class of investor. Laws have been enacted in every state for the purpose of penalizing those guilty of such fraudulent transactions but these it seems do not protect investors from further loss owing to their gullibility nor do they restore such losses. With reference to such sufferers, The Honorable Joab H. Banton, District Attorney of New York County says:

"The prosecution of the thief and putting him in prison does not restore to the defrauded person his money; the person who was defrauded in this way, usually, was poor and was striving to make his life savings earn more than savings bank interest."

You have all heard of the recent case involving the Union Food Stores Company which has resulted in the incarceration of some of the higher officials in addition to heavy fines being imposed. There are no signs, however, of any of the credulent investors ~~recovering~~ any part of the loss incurred. (recovering)

The legal investigation into the fraud perpetrated by the officials of the Union Food Stores Company which was originally the Waukagen Tea Company disclosed various subversive means resorted to for the purpose of obtaining permission from the Wisconsin Securities Division, to sell capital stock. In submitting statements for this purpose the assets and liabilities were converted in such a way as to show a healthy financial condition. These statements were accepted at face value by the commission who forthwith granted permission to sell. Had these statements been audited by accredited public accountants, it is certain that no loss to investors would have occurred, and the Union Food Stores would possibly have been put out of business.

Many cases might be cited of fraudulent security sales, but no doubt you are all more or less aware of the principal cases and the harassing results they have had on the public generally.

Many fields, gentlemen, may be covered on this subject of the tendency toward crime, but I trust that I have said sufficient to impress upon you some of the outstanding crimes which are perpetrated in the financial world today. Apart from the introduction by way of mechanical devices bonding of employees and investigating personnel, I have tried to show you the propriety of cooperating with public accountants towards the successful solution of your problems to the end that your business may be conducted without loss.

When the necessity arises for you to require the services of a public accountant, I would suggest that you outline to him exactly the information which you require and leave him to determine how he shall obtain such information. It is unwise to dictate to an accountant just how and what he should do and how he should report thereon.

I Thank You.