

Absolute Trust: The GlobalClean Case

Ebenezer K. Lamprey
Tarleton State University

Bilal Makkawi
Morgan State University

ABSTRACT

Occupational fraud threatens the survival of businesses. The Association of Certified Fraud Examiners estimates that a typical organization loses 5% of its revenue to fraud each year. An audit report has just exposed the head of the accounting department of GlobalClean. He had pilfered \$45,000 from the company's account and had been lapping accounts receivables to cover-up his activities. The main issue bordered on fraud and lack of internal controls. Chris Kline, the president, and general manager of GlobalClean, needed a loan from a bank to finance the acquisition of a competitor. The bank requested audited financial statements from GlobalClean. The audit, performed by Colorado Accounting, Audit, and Tax Services, uncovered fraudulent activities. The case is intended to help students understand occupational fraud, be able to identify the indicators of fraud, understand how the lack of internal control influences the likelihood of fraud, identify internal controls that could prevent the fraud described in the case, and provide an insight into the ethical issues underlying the case.

Keywords: Occupational fraud, Lapping, larceny, internal control, business ethics

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INTRODUCTION:

Lapping is the fraudster's version of "robbing Peter to pay Paul." It is the extraction of money from one account to cover shortages in another account (Wells, 2002). Lapping has also been described as "a scheme where an accounting clerk incorrectly classifies cash receipts from one customer to another in order to cover up the diversion of funds from a customer for personal gains" (Johnson & Wiley, 2022.p.11-31). Lapping is one form of occupational fraud and has threatened the survival of many businesses. This case presents the discovery of lapping in a janitorial company, GlobalClean, during an audit of financial statements. A trusted accountant had been manipulating the books by lapping accounts receivables. The case shows the impact that the absence of a robust internal control system may have on an institution's financial position.

Chris Kline, the president, and general manager of GlobalClean, needed audited financial statements to secure a loan for the acquisition of a competitor, CrystalClean. He contracted Colorado Accounting, Audit, and Tax Services (COAATS) to perform the financial statement audit. The auditors noted during the audit that some customers were not receiving statements, or the statements did not indicate payments. The auditors also pointed out that some payments were not readily recorded, and reconciliation of accounts receivable was not performed at month's end. Charles, a trusted accountant, was responsible for preparing and depositing payments received from customers, but he typically made the deposit a week or so late. Given the issues above, the auditors suspected irregularities in the accounting department.

BACKGROUND:

GlobalClean is a janitorial company based in Aurora, Colorado owned by Chris Kline and Kristine Kline. GlobalClean is a closely held corporation that has made a valid election to be taxed under Subchapter S of Chapter 1 of the Internal Revenue Code. GlobalClean's income or losses are divided between and passed through to Chris and Kristine Kline who must then report the income or loss on their individual tax returns. The business model of the company is based on solicitations of janitorial contracts and outsourcing to independent contractors. Global Clean generates revenue by subcontracting its cleaning contracts at 80% of the original contract fee to independent contractors.

Additionally, GlobalClean sells janitorial equipment and supplies to independent contractors and the general public. The customers could purchase materials and supplies on credit. GlobalClean provided janitorial services to over 80 clients including services for 35 office buildings, 28 restaurants, 10 car dealerships, and seven banks. GlobalClean had equipment for sale of \$90,000, inventory of cleaning supplies of \$125,000, and accounts receivable estimated at \$68,000.

The company had a calendar year fiscal period. The financial statements prepared at the end of each year are not audited. GlobalClean has performed very well and has reported significant profits annually since its inception. Charles had responsibility for all accounting-related issues, and he reported directly to Chris. Chris did not closely supervise Charles. The company's policies require that the accounting department reconcile all payments received from customers and post all payments to the customer's account. It is GlobalClean's policy to send monthly statements detailing all transactions to customers.

Chris Kline was born and raised in Denver, Colorado. Except for the six years he served as a United States Marine; he had spent his entire life in Denver, Colorado. He attended Colorado State University in Boulder, Colorado, where he studied Psychology, joined the Reserve Officers Training Corp. (ROTC), and graduated Magna Cum Laude. Chris joined the United States Marine Corps and did two tours in Iraq and Kuwait. As a young man, Chris had always wanted to own a business. Therefore, he invested all his savings and took a loan from a bank to build GlobalClean. As a war veteran, Chris transferred his military diligence and commitment to his business. He was always the last to go home after the day's work. Chris was always on the go securing new business. He is married to Kristine Kline who is a graduate of the University of Denver and is a mathematics teacher at the local middle school in Aurora, Colorado. Chris and Kristine have a son, Josh Kline, who is a sophomore at the University of Denver, where he majors in Computer Science.

Charles Kilpatrick was born in Cheyenne, Wyoming. Charles was the son of a cattle rancher, and he attended the local elementary, middle, and high schools in Cheyenne. Charles saw the difficulties his father encountered with his accountant, and his father always lamented that he wished one of his three sons would become an accountant. Charles wanted to spend his college years away from home, so he attended Colorado State University in Boulder, Colorado where he studied accounting. It was during his time at Colorado State University that he met and became friends with Chris Kline and Will Stevens, who also studied Psychology. Chris, Charles, and Will maintained their friendship after they graduated from Colorado State University. Charles had worked as an accountant for a car dealership before he joined GlobalClean. Charles is married to Ann Kilpatrick who is a Licensed Practical Nurse and worked at the Centennial Hospital. Ann graduated from Aurora Community College. The couple have a son, Rush Kilpatrick, who is a freshman at Colorado State University. Rush was studying towards a degree in Petroleum Engineering. Ann had been diagnosed with breast cancer two years earlier, and it appeared that she had survived the disease. Charles had spent virtually all their savings on medical bills that were not covered by insurance. However, he was happy that his wife was free of the disease.

The Acquisition:

It was 5 PM on Friday, and Chris Kline was just about to leave for the Pepsi Center to watch his favorite basketball team, the Denver Nuggets, host the Cleveland Cavaliers in game seven of the playoffs when his office telephone rang. The number displayed on the caller ID belonged to one of his friends Jim King. Jim and Chris had been friends since elementary school, and they regularly played golf. Jim was the owner of CrystalClean in Colorado and PureClean in Dallas, Texas. He introduced Chris to the janitorial industry when Chris retired from the United States Marine Corps. Jim called to inquire from Chris whether Chris would be willing to acquire CrystalClean. The conversation unfolded as follows;

Chris: "Did you want a rematch on nine holes since you lost the last one?"

Jim: "I sure do, but something else is up. I want to move to Texas, and I wanted to inquire if you would be interested in acquiring CrystalClean."

Chris: "Sure, I will be if you tell me why you are moving, leaving me here in the snow while you move to warm Texas."

Jim: "I have decided to be close to Mom and Dad, they are both 90 now."

Chris: "It is a good idea to be close to your parents, but must you sell CrystalClean?"

Jim: "I want to concentrate on PureClean."

Chris "Is PureClean doing well?"

Jim: "Well, it is picking up, and I know that when I give it some more attention, it will be better."

Chris: "Why don't we meet and talk this over on nine holes next week?"

When they met the following week, Jim provided the following information about CrystalClean. He stated that CrystalClean had seventy-five clients of which CrystalClean provides services for 27 office buildings, eight car dealerships, 10 banks, and 30 restaurants. Additionally, CrystalClean had equipment for sale of \$200,000, an inventory of cleaning supplies totaling \$80,000, and accounts receivable estimated at \$6,000. The company had been appraised at \$305,000.

Chris was very excited about the possibility of expanding his business. He thought about how he would raise the money to finance the acquisition of a rival business that would make GlobalClean the largest Janitorial Company in Colorado. After he had performed his due diligence on CrystalClean, he was happy that all seventy-five customers had agreed to work with him. After a lengthy but successful negotiation, GlobalClean acquired CrystalClean for \$310,000. While he was negotiating to acquire CrystalClean, Chris was also holding discussions with his bankers to finance the acquisition.

The Loan:

GlobalClean had a strong relationship with its bank for many years. Accordingly, the bank was eager to fund the acquisition of CrystalClean. The loan process required audited financial statements. It was at this point that Chris told Charles of his intention to purchase CrystalClean and the request by the bank that GlobalClean provide audited financial statements before the loan application would be approved. Chris also told Charles that the bank had recommended COATS to audit the company's financial statements and that the auditors would start work the following week. Charles appeared fretful when Chris told him that the company accounts were to be audited.

The Incident

It all started during a celebration at the GlobalClean office after winning a major contract. Charles received a phone call from Ann. Her physician had just informed her that her cancer had resurfaced, and she needed emergency surgery. A visibly disturbed Charles walked towards Chris and mentioned to Chris that Ann needed to get another surgery. As Charles was driving home, he thought about where he would get money for this surgery. Under intense financial pressure, Charles started questioning how he was not paid enough for all the work and sacrifices that he had made for the survival of GlobalClean. Then it dawned on him that he managed the accounts of the company. He asked himself whether he should take the money from the company's account to save his wife and pay later. Eventually, Charles took the \$25,000 he needed from the company's account. He planned to pay the money back but was not able to do so six months later. He devised a strategy to keep postponing the payment.

Charles decided to take the money received from some credit customers who were making monthly payments to GlobalClean to cover up for the money he had taken. He used the payments from other customers to pay for those customers whose money he had taken. The scheme had been so successful that he expanded his "operations" to other customers including

the largest customer such that by the end of the fourth month of operating the scheme, he had embezzled an additional \$20,000. In the fifth month, since he implemented his strategy, the customers started complaining to Chris that they had not been receiving statements and Chris had a discussion with Charles about the statements, but Charles indicated that he had been quite busy and could not send statements as previously, but he was working on doing so. Charles decided to send statements to those customers who were not receiving their statements, but because he had not been sending the statements for four months, he mistakenly sent statements that did not reflect the payments and balances of the accounts of some of the customers. Those customers who received statements with discrepancies visited Chris armed with the statements and their records of payments. It was clear to Chris at this point that something had gone wrong. It was around this time that COAATS was performing the audit on the finances of GlobalClean. This cycle continued until the end of the sixth month when COAATS completed the financial statements audit and uncovered the fraudulent act perpetrated by Charles.

The Findings:

The audit report presented by Mike Miller, the audit partner, contained information that sent shockwaves through the spine of Chris Kline. Mike explained the details of the audit report to Chris. Mike stated that the audit uncovered an amount of \$45,000 that could not be accounted for. He indicated that this had been the case for the past six months. Mike explained that some credit customers' payments were not immediately recorded and no statements for these customers were sent either. Those comments from Mike made Chris furious.

After Chris had time to ponder over the information he had received from Mike, his fury abated. Chris called Charles to his office to discuss the audit report and provide explanations and responses to the issues raised by the audit. The conversation unfolded as follows in that meeting.

Chris: "I have just received the audit report from the auditors, and some issues are of grave concern. What did you do with the \$45,000? Why are statements not being sent to our customers?"

Charles: "Chris, I am just going to tell you the truth. When Ann was required to undergo another surgery, I did not have the money so I took it from the business account and planned on paying it back, but I could not."

Chris: "Why did you not ask me?"

Charles: "You have already done so much for me that it's hard to ask you for further assistance."

Chris: "I am irritated, and I do not know what to tell you at this time."

Charles: "Chris, I did not mean to do any harm to this business, forgive me, it will not happen again."

As Chris was going home that day, he thought about how well the company would have performed but for the fraudulent activities of Charles and the fact that he had trusted Charles exceedingly and left the company's accounting in the hands of a fraudster.

EPILOGUE

Because of the continuous growth that GlobalClean has experienced over the years coupled with the good relationship between Chris and the bank, GlobalClean obtained the loan and

acquired CrystalClean. Charles resigned from GlobalClean because he was ashamed of his actions, and Chris decided not to press charges against Charles.



INSTRUCTORS' MANUAL

Case Overview

An audit report has just exposed the head of the accounting department of GlobalClean. He had pilfered \$45,000 from the company's account and had been lapping accounts receivables to cover up his activities. The main issue bordered on fraud. Chris Kline, the president, and general manager of GlobalClean, needed a loan from a bank to finance the acquisition of a competitor. The bank requested audited financial statements from GlobalClean. The audit, performed by COAATS, uncovered fraudulent activities that required Chris to decide on the status of the perpetrator of the fraud.

Suggested Teaching Approach

Students must have introductory knowledge in accounting and auditing, specifically on accounts receivable, fraud, and internal controls. The case is designed for a 50-minute class session. The cases should be assigned to the students at least one week in advance to enable students to acquaint themselves with the issues involved. For the sake of time, the class could be divided into groups of about five students and the questions assigned to each group.

The session could be conducted as follows:

1. List some common fraud schemes in the case. (5 Minutes)
2. Identify the elements of the fraud triangle in the case (10 Minutes)
3. Describe how Charles Kilpatrick used accounts receivable as a tool to commit the fraud (10 Minutes)
4. Propose internal control procedures that could have helped to prevent the fraud scheme discussed in the case. (15 Minutes)
5. What recommendation would you make to deter fraud in GlobalClean? (10 Minutes)

Level of Difficulty

This case will require students to understand different concepts such as account receivables, internal controls, and issues related to fraud. Students should also be required to identify the ethical issues embedded in the case. The case has been presented in a format that omits some important situations and includes information that will not necessarily be useful to students in making decisions.

Class / Target Audience

The case is developed for teaching audit in the final year of an undergraduate class. The case will better serve students who have basic accounting and auditing knowledge.

Broad Learning Goals.

The case is designed to help students understand the problems that can arise as a result of the absence of strong internal controls. It is intended to encourage students to think about ways to

prevent fraud in an organization. After analyzing the case, students must understand the following.

1. The indicators of occupational fraud.
2. How the absence of strong internal controls can influence the likelihood of fraud in an organization.
3. Describe internal control procedures that could prevent the fraud described in the case.
4. Identify any ethical issues in the case.

Suggested Discussion Questions

1. List some common fraud schemes in the case.
2. Identify the elements of the fraud triangle in the case
3. Describe how Charles Kilpatrick used accounts receivable as a tool to commit the fraud
4. Propose internal control procedures that could have helped to prevent the fraud scheme discussed in the case.
5. What recommendation would you make to deter fraud in GlobalClean?

Suggested Responses

1. List fraud schemes identified in the case.
 - Lapping
 - Larceny
2. The elements of the fraud triangle in the case. See the Appendix for the fraud triangle.

Pressure:
Charles Kilpatrick's inability to pay his bills was due to the huge amount of money he spent during his wife's illness.

Opportunity:
The absence of supervision of the accountant at GlobalClean created the opportunity for Charles to commit fraud. Additionally, the lack of internal controls provided the environment needed to commit fraudulent acts. Also, Charles took advantage of his relationship with Chris which created the needed space for him to perpetuate this fraudulent behavior.

Rationalization:
Charles justified his actions by the thought of him being underpaid, and also that he was borrowing the money and would pay it back.
3. Describe how Charles Kilpatrick used accounts receivable as a tool to commit the fraud
What is account receivable/trade receivables?
 - Basic Definition: Money that a business has a right to receive after it has provided goods or services to others.
 - Charles Kilpatrick resorted to lapping where he concealed larceny by applying funds subsequently paid by a second customer to cover the deficiency in the first customer's account.
4. Propose internal control procedures that could have helped to prevent the fraud scheme discussed in the case.

- Segregation of duties. GlobalClean should hire another accountant to record payments received from customers to the accounts receivable sub-ledger. A different person should post the payments received to the cash receipt journal. The same person who prepared the deposit slip should not make the deposits.
- Have customers send payments directly to the company's depository bank.
- Proper recording of payment receipt procedures where check numbers and amounts are properly tied to customers' accounts must be implemented.
- Monthly reconciliations of all accounts must be performed and inspected.

Suggest alternative disciplinary actions available to Chris Kline and explain why you recommend that Chris choose a particular action.

- a. Firing Charles will not be an easy decision for Chris to make. Chris and Charles have been friends for a very long time, and Charles has contributed immensely to the success of GlobalClean. Firing a loyal employee may send the wrong signal about loyalty.
- b. Chris may demote Charles to perform non-accounting related functions such as quality supervisor for the cleaning accounts; this may only be a gesture to help Charles stay employed. But here again, this will send the wrong signal to the rest of the workers.
- c. Do nothing. Allow Charles to continue to perform the accounting functions, however, not firing him and allowing him to maintain his position will indicate to other employees that Chris does condone fraudulent activities at GlobalClean, and other staff may be tempted to do the same.

CONCLUSION:

The case attempts to reconcile what students have studied at school with real-world situations and enforces students' understanding of fraud and fraud-related activities. For confidentiality, the case has been modified to disguise the company names and names of the characters involved in the case. Familiarity with any names is purely coincidental. The case seeks to provide students with an understanding of fraud, and the importance of internal controls, and highlight ethical issues in an institution that can impact financial performance. For instance, the case provides students with insight on how an employee can lap accounts receivable. Students have the opportunity to design internal control structures that could have prevented the fraud from occurring. The ethical issues involved in the cases provide examples of what ethical issues are and dilemmas that can be posed by such ethical issues.

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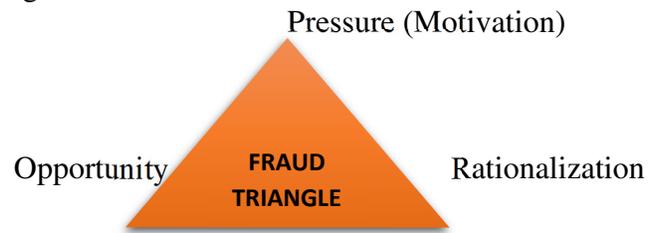
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APPENDIX:

The Fraud Triangle¹:



¹ (To explain the factors that lead people to commit fraud, Donald Cressy in his book titled 'Other People's Money': A Study in the Social Psychology of Embezzlement (Montclair, NJ Peterson Smith, 1973) p.30, developed this model to be known as the Fraud Triangle. The particular elements that influenced Charles Kilpatrick to commit the fraud have been identified above).