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Koss Corporation Corporate Governance, Internal Controls, and Ethics: What Went Wrong?

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INTRODUCTION

Koss Corporation is a Milwaukee company whose principal business is the design, manufacture, and sale of stereo headphones and related accessories. Michael Koss is the CEO; his father, John Koss, founded the company in 1958. The company has trademarks and patents for its products to differentiate itself from the competition. Koss Corp. has a six-man Board of Directors, including Michael and his father. John is 81 years old and serves as chairman of the Board. Michael is 57 years old and serves as vice chairman, president, CEO, COO, and CFO.[1] The other Board members have served 25 years. Neither Michael nor the other Board members have financial backgrounds. Michael graduated college with an anthropology degree.

Although Koss Corp. is a multimillion dollar company, it only employs 73 people, which auditors consider a "small business." Michael has worked for Koss Corp. since 1976, and earns a base salary of $295,000; his total compensation, including options, is over $800,000.[2]

Selected financial data is presented in Table 1.[3]

Table 1: Financial Data from 2008 and 2009

	June 30, 2009	June 30, 2008
Net Sales	$ 38,184,150	$ 46,943,293
Net Income	1,976,668	4,494,289
Basic Earnings per Common Share:		
Basic:	0.54	1.22
Diluted:	0.54	1.22
Total Assets	$ 28,470,352	$ 29,977,077
Cash Dividends per Common Share	$ 0.52	$ 1.52

THE ACCOUNTING FUNCTION

The accounting work was handled by Sujata "Sue" Sachdeva, vice president of finance, secretary, and principal accounting officer—in a small business, employees typically have more than one responsibility. Sue, whose family was from India, had been employed at the company for 17 years.[4] She was a trusted and valued employee and earned about $200,000 per year. She had two assistants: Julie Mulvaney, senior accountant, and Tracy Malone, junior accountant.[5]

Sue told friends and coworkers that her family was very wealthy and held a very high social status in India. She reported that she and her husband spent their wedding night in the Taj Mahal. It was important for her and her family to live in the best area, attend the best schools, and socialize with the recognized society members of Milwaukee. Sue served on several charity boards, organized lavish parties for their events that cost millions of dollars, and purchased all items that did not sell at the charity auctions she organized.[6]

Sue also had a reputation as a demanding boss: Her assistants were required to help her with the charity events, and Sue took them out to lunch almost daily. Julie and Tracy also went to Sue's house to help her unpack and store the many expensive items she purchased. Sue loved designer clothing, shoes, and accessories and purchased over 20,000 items in a five-year period from 2004 to 2009. She purchased so many items that they did not fit in her house. So, she rented a storage unit and a two-office suite to store her unused purchases. In addition, Sue made some purchases that she never picked up from the retailers.[7]

Sue could not pay for all of these purchases with her $200,000 salary or her physician husband's $600,000 salary.[8] Her job at Koss Corp. provided her with an extra opportunity to obtain the funds necessary to support her lavish lifestyle: She committed the fraud over at least a five-year period to fulfill her compulsive shopping disorder.[9]

THE FRAUD

Sue started stealing from the company with relatively small thefts that increased over the years. She partially hid the alleged theft in cost of goods sold (COGS) and indicated the increase in COGS was due to rising material costs. She also overstated assets and other expenses and understated liabilities and sales.[10]

Sue embezzled $34 million over a five-year period beginning in 2004;[11] only the embezzled amounts from 2005 forward were documented, even though she had been allegedly embezzling since 1997. The fraud was uncovered when American Express notified Michael Koss about an unusual, ongoing practice: Sue paid her personal credit card balances with several large wire transfers from a Koss Corp. bank account.[12]

The following amounts represent the fund's embezzled by Sue:[13]

2005 - $2,195,477
2006 - $2,227,669
2007 - $3,160,310
2008 - $5,040,968
2009 - $8,498,434
2010 - $10,286,988 (two quarters)

Sue wired an average of $500,000 per month from Koss Corp. bank accounts to pay for her personal credit card bills.[14] Sue colluded with her senior accountant Julie to embezzle the money. Julie maintained she just made the journal entries and cash transfers based on Sue's orders, noting that Sue was a "powerful, imperious, overbearing, determined, and willful superior."[15]

FRAUDULENT ACTIVITIES

Koss Corp., like most businesses, had a system of internal controls designed to protect the company's assets. The fraudulent activities that occurred included large payments by check or wire transfer, misuse of petty cash, an outdated computerized accounting system, unprepared account reconciliations, and minimal management review of financial statements.

PAYMENTS BY CHECK OR WIRE TRANSFER

Michael approved invoices of $5,000 or more for payment. Yet processing wire transfers and cashier's checks outside of the accounts payable system did not require his approval. This flaw in Koss Corp.'s internal control system allowed Sue and Julie to cover up the embezzlement.[16]

Over the total 12-year embezzlement period, Sue wrote over 500 cashier's checks, totaling over $17.5 million, from Park Bank.[17] Julie did not have the authority to sign checks at Park Bank, although she often ordered and processed the checks for Sue without Michael's knowledge or authorization.[18] So as not to draw attention to these checks, they were often made payable to initials, such as "N-M," for Neiman Marcus or "S.F.A." for Saks Fifth Avenue.[19]

Julie helped Sue initiate and authorize wire transfers of Koss Corp. funds to Sue's personal creditors for over $16.3 million without requiring or obtaining Michael's approval.[20]

PETTY CASH

Most organizations maintain a petty cash fund to facilitate small, incidental expenses. Petty cash balances and transactions are usually small. Given the insignificance of petty cash, management and auditors spend very little time reviewing these accounts. Sue used petty cash as another vehicle to obtain funds: more than $145,000 over five years.[21]

COMPUTERIZED ACCOUNTING SYSTEM

A computerized accounting system and the related software were designed to prevent certain unintentional (or intentional) errors. For example, entering an out of balance entry is not possible in most computerized accounting systems. Koss Corp.'s computerized accounting system, however, was almost 30 years old and did not have sufficient controls. Koss Corp.'s accounting system could not lock out changes made after the end of the month, and there was no audit trail. Sue and Julie made undetected post-closing changes to the accounting records without Michael's approval or knowledge.[22]

Julie covered up Sue's embezzlement by forging entries to match the company cash account balance with the cash on hand balance in the bank and "holding back" receivables to match the amount of the cash shortfall.[23] In addition, Julie did not record Internet sales or sales from the company's retail outlet in order to cover up the cash shortfall.[24]

RECONCILIATIONS

Other checks and balances in accounting systems include account reconciliations that are prepared by the accounting staff. Account reconciliations were not prepared or maintained at Koss Corp. Reconciliations that were performed were prepared by Sue or Julie, so they were not correct; they also initiated or recorded all accounting entries.[25]

MANAGEMENT REVIEW

Sue provided Michael with financial statements and reports that were prepared from the fraudulent accounting records, and Michael did not review them in great detail. Because he trusted Sue, Michael did not fully review the financials before approving them.[26]

THE AUDITORS

Grant Thornton, a national firm based in the U.S., was the auditor for Koss Corp. at the time. Over the five-year period, Koss Corp. paid Grant Thornton $625,000 to audit their financial results. Grant Thornton classified Koss Corp. as a non-accelerated filer. The fraud was never detected during the audit for several reasons: (1) Grant Thornton reviews the company's financials to make sure that every account balance aligns with accounting standards. Because Sue and Julie were balancing the books to counteract the fraud, nothing seemed suspicious. (2) Lax oversight ran rampant at Koss Corp. Because Michael trusted Sue, he believed all her numbers were correct. [27]

Sue knew the questions the auditors would ask and the documents they would review. Because Sue knew the July 1 year-end would bring scrutiny to June's records, she never moved any money in June. Grant Thornton viewed Koss Corp. as a small audit of a well-run company with low risk and an excellent training ground for new auditors.[28]

CONCLUSION

Sue embezzled over $34 million in a five-year span. She betrayed the trust of her boss, Michael, as well as the company's employees and shareholders.

Answer the discussion questions below based on your review of the Koss Corp. case.

DISCUSSION QUESTIONS

1. Review the fraudulent activities. What went wrong? Describe what internal controls were missing or circumvented. Consider the Sarbanes-Oxley Act of 2002 (SOX) requirements, and review the definition of internal controls. Who is responsible for internal controls? What reporting is required?
2. What were the problems in the corporate governance and/or organization structure? What are the major requirements of SOX with respect to corporate governance and/or organization structure? How would corporate management and the accounting function be better organized?
3. What should Julie Mulvaney have done when Sue Sachdeva requested her to assist in the fraud? What would the IMA® Code of Ethics, known as the *IMA Statement of Ethical Professional Practice*, dictate?[29]
4. What were the responsibilities of the following entities or individuals for the fraudulent activities? What are the possible consequences?
   a. American Express
   b. Park Bank
   c. Sue Sachdeva
   d. Michael Koss
   e. Julie Mulvaney

ENDNOTES

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[27]Van de kamp Nohl, 2011.

[28]Hajewski, 2011.

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