Five Types of Fraud Dealership Can Prevent With Better Internal Controls

The U.S. District Court for the Western District of Pennsylvania recently indicted the former controller of a car dealership, who subsequently pleaded guilty to the charges. The indictment details several ways in which the controller stole $10.2 million over a six-year-period and highlights the importance of proper internal controls in a dealership. Many dealers likely are wondering whether something like this could happen in their dealership.

In the Pennsylvania case the controller siphoned $10.2 million over a six-year period by shifting money between accounts, creating fictitious journal entries, and making fraudulent automated clearinghouse (ACH) transfers to the controller's personal account. The fraud involved more than 800 such transactions that could have easily been discovered, or better yet, prevented, had some basic internal control policies and procedures been in place and monitored. Below are five specific types of fraud committed in this case and what dealerships can do to help prevent the same thing from happening to them

1. Electronic Transfers

The controller in this case transferred funds electronically via ACH transactions from the dealership's payroll bank account into the controller's personal bank account.

Related Controls:

To address fraudulent ACH transactions, dealerships should have a call-back procedure in place with their bank for all ACH transactions. In a call-back procedure, when one person in the dealership authorizes and initiates an ACH transaction, the bank calls back another individual at the dealership to confirm the ACH transaction is proper.

Another control is to have someone other than the person initiating the ACH transaction independently review the payroll amounts submitted for payment. Individual department heads typically review and approve the payroll for their departments, but a different individual should then review all of the departments' payroll to verify they've been reviewed and appear to be reasonable.

A third control is to complete an independent review for reasonableness of year-to-date wages in the payroll register. A dealer can look at the year-to-date wages on a periodic basis to reconcile the employees in the payroll register and the amount of wages those individual are receiving.

2. Bank Statements

The controller altered the dealership's bank statements to eliminate references to the fraudulent ACH transfers from the dealership's payroll account.

Related Controls:

If a dealership is still receiving hard copies of its bank statements, the statements should be received unopened by someone independent of the bank reconciliation process. Bank statements could be mailed directly to the dealer's home so that the dealer has the opportunity review the bank statement unaltered. Many dealerships access their bank statements online and should have someone independent of the bank reconciliation process review the statements for reasonableness.

Another basic control is to segregate the functions of writing checks or initiating ACH transfers from the duties of preparing the bank reconciliation. An independent preparation of the bank reconciliation provides the opportunity to raise questions and investigate unusual items.

Finally, the monthly bank reconciliation should be a part of the monthly reporting package that the accounting office provides to the dealer for review. The dealer can then ask questions about items that he or she does not understand

3. General Ledger

The controller inflated the general ledger inventory account via journal entries and added previously sold vehicles back to the dealership's inventory database.

Related Controls:

Journal entries commonly are used to hide fraud. Someone other than the preparer of the journal entry should review all general journal entries. Each general journal entry should include a detailed description of the reason for the entry and a reference to supporting documentation so the reviewer can confirm the accuracy and purpose of the journal entry.

Another inventory control is for a dealership to take a monthly physical inventory of its new and

*(See **Five Types of Fraud** on page 2)*

used vehicles. The inventory should be taken by someone independent of the new and used vehicle inventory departments and can be done at any time during the month.

4. Floor Plan Loan

The controller fraudulently reduced the general ledger floor plan loan amount and altered the floor plan loan documents.

Related Controls:
Dealerships should reconcile monthly the floor plan bank statement with the general ledger. This reconciliation should be prepared by someone independent of the bank reconciliation and inventory functions. A copy of the reconciliation and the floor plan statement should be a part of the monthly reporting package the accounting office provides to the dealer.

5. Reserve Accounts

To conceal the fraud, the controller made false and fictitious increases in reserve accounts as well as fraudulent expense offsets

Related Controls:
Controlling journal entries by having separate individuals perform the preparation and review of each entry will also help prevent this type of fraud. In addition, a month-end summary of all reserve accounts explaining what the reserve is for and how it was determined should be a part of the monthly reporting package submitted to the dealer each month. Another control to address this type of fraud is reviewing financial statements. Looking for month-to-month trends and fluctuations in the detailed financial statements might help a dealer identify unusual items that require further investigation.

Prevention Is Key

The Pennsylvania case should remind dealers to periodically review and monitor their internal control policies to make sure they are being followed and are working. Having a good internal control policy that incorporates "inspect what you expect" can help dealerships prevent costly fraud.

TAX TIP

THE BENEFIT OF TREATING PERSONAL GOOD WILL AS PROPERTY

Most practitioners are aware that substantial tax savings are possible if a portion of the acquisition price of a business can be attributed to the owner of the business for "personal goodwill." The characterization of the payments from the acquirer to the selling shareholder for personal goodwill, could result in one level of taxation, and at more favorable capital gains rates.

Buying or selling a company may be summarized into three types of payments:
- Sale/Purchase agreement required for the assets
- Payments required to be allocated to the consulting agreement, and
- Payments required by and allocated to the goodwill agreement.

Personal goodwill attaches to an individual rather than a business. Personal goodwill is present when the unique expertise, reputation, or relationships of an individual give a business its intrinsic value. For example, consider a mom and pop grocery store. Customers, would more likely find better selections and prices at the new Wal-Mart in town. Customers, however, may continue to shop at the grocery store because they are loyal to mom and pop. If mom and pop were to retire, the business would lose, its customers, and much of its value. In essence, mom and pop are the business, and the business derives its intrinsic value from them. Mom and pop possess personal goodwill.

Courts have likely been more open to recognize personal goodwill in a professional setting because it is easier to see how a professional, such as the lawyer or new surgeon, gives a business its return on value. This, however, does not mean that the law should afford different treatment to non-professionals, such as mom and pop or auto dealers, provided that they too are shown to own personal goodwill. Instead the fundamental inquiry is whether a business or its owner, professional or non-professional, possesses the value sought after by a buyer.

Courts have held that personal goodwill or at least professional goodwill is property that can be bought and sold. The two cases focused on most is, Martin Ice Cream (MIC) and Norwalk v. Comm. (Norwalk), both adopted a view that personal goodwill is property that can be transferred. Both of these cases found that the shareholders owned personal goodwill, and this personal goodwill was intangible property. TAM 200244009 provides additional guidance on the ability to sell personal goodwill by indicating that goodwill cannot be transferred or sold separately, when an employment contract and a non-compete agreement are in existence. Ownership of these intangibles cannot be attributed to MIC because the shareholder never entered into a covenant not to compete or any other agreement not even an employment agreement with MIC. In the Court's view the fact that the shareholder of MIC never entered into a non-compete or employment agreement with MIC indicated that the shareholder had never transferred his rights to any relationships or expertise he may have had and, therefore they remained his personal property.

The Tax Court pointed out in Norwalk that even when a corporation is dependent on a key employee, the employee cannot own the goodwill if the employee has entered into a covenant not to compete (or similar agreement) under which the employee's personal relationship with clients may become property of the corporation. Norwalk had a covenant not to compete which ceased after seven years when the employment agreements expired and he was no longer a shareholder and, thus, no longer obligated to the corporation after it ceased to operate upon its termination and liquidation.

The IRS seeks to characterize personal goodwill as future earnings potential of the company. It is taxed as ordinary income, and thus, at a much higher rate than the capital gains treatment that would likely result under the property view.
What is evident from the above analysis is that personal goodwill is property belonging to the professional which can be transferred or sold separately, as long as no employment contract or a non-compete agreement are in existence between the professional and the business. Ownership of this intangible cannot be attributed to the employer as the shareholder retains ownership of this property and can be separately bargained for when negotiating the sale of a business.

When negotiating the sale of a business always be aware of the above and consider whether personal goodwill maybe treated as property separately negotiated and sold outside of the business. You should always discuss this with your ATA representative.