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## CASE STUDY 5:

# American Food Suppliers Inc.: A Case Study in Fraud and Forensic Accounting

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## LEARNING OBJECTIVES

After completing and discussing this case, you should be able to

- Understand the basics of accounting for vendor rebates.
- Understand the dangers of over relying on third party confirmations as an audit procedure.
- Understand the responsibilities of the external auditor for detecting fraud.
- Appreciate the importance of professional skepticism.
- Understand the difference between a financial statement audit and a forensic audit.
- Appreciate the importance of ethical behavior in the accounting profession.

## INTRODUCTION

American Food Suppliers was acquired by the company Barnacle in 2000. American Food Suppliers was the largest distributor of food to restaurants, hotels, schools, hospitals, and Barnacle's extensive chains of U.S. grocery stores. A material portion of American Food Suppliers' balance sheet was promotional allowances receivable from vendors (vendor rebates). As part of their normal audit procedures for American Food Suppliers, Barnacle's independent auditors, Doodle Auditors LLP, sent confirmations for these receivables. Confirmations were mailed to vendors' salespeople and were returned without exceptions. For the first two years after the acquisition, the auditors issued unqualified opinions. During the 2002 audit, however, Barnacle's independent auditors discovered problems and promptly withdrew their audit opinions for 2000 and 2001, and suspended their 2002 audit. On February 28, 2003, Barnacle announced that it would restate earnings downward for the fiscal years 2000 and 2001, and for the first three quarters of 2002 by a combined total of at least \$500 million and

that a forensic accounting investigation would be launched, mostly because of irregularities at Barnacle's subsidiary American Food Suppliers.

The company's stock price lost nearly two-thirds of its value on the day of the announcement. Barnacle's chief executive and chief financial officers resigned when the announcement was made, and subsequently other high-level managers at both the parent company and American Food Suppliers also stepped down. On March 28, 2003, Barnacle's audit committee ordered investigations at the parent company and at 22 Barnacle subsidiaries to look for accounting errors, irregularities, and other issues as well as assess internal controls and management integrity. After a forensic audit, Barnacle eventually reported that the overstatement of American Food Suppliers' earnings was more than \$900 million. A large component of the overstatement resulted from improper recognition of promotional allowances. Several American Food Suppliers' employees and vendors either admitted to or were convicted of playing a role in the fraud.

In this case, students will gain insights into the proper accounting for and disclosure of promotional allowances and also the risk of over-reliance on third party confirmation as an audit procedure. Students will also distinguish between a financial statement audit and a forensic audit.

## SOME BACKGROUND

Accounting for cash consideration from vendor rebates, also known as "promotional allowances," was at the center of the American Food Suppliers's earnings restatement. Rebates of this type are common in the grocery and foodservice industries and are frequently material in amount, sometimes exceeding 5% of sales. Vendors can offer rebates to customers in exchange for favorable display space in stores, or they may give volume rebates to provide an incentive to a retailer to increase sales of the vendor's products, with the rebate percentage increasing as the retailer's sales volume increases. However, these rebates are problematic in several respects. At the time of American Food Suppliers's accounting irregularities, there was no standardized accounting treatment of these rebates. Companies have accounted for them differently, and there have been differing levels of disclosure regarding their amounts. The investigation at American Food Suppliers revealed that determination of rebates receivable can be problematic.

Even before the investigation into American Food Suppliers's accounting practices, supplier rebate issues have come under scrutiny and have even resulted in regulatory action against other retailers. The Securities and Exchange Commission (SEC), as an example, alleged that among the accounting irregularities that occurred at Rite Aid in the late 1990's was how the company accounted for its vendor rebates. In June 2002, the SEC's Accounting and Auditing Enforcement Release No. 1581 indicated that Rite Aid improperly recognized \$75 million in vendor rebates, which represented 37% of the company's pre-tax income in 1999 (SEC, 2002). Kroger Co. of Cincinnati had to restate its earnings from 1998 to 2000 as a result of how one of its acquired companies had accounted for such

rebates. Similar irregularities and allegations of impropriety regarding recognition of vendor rebates have led to earnings restatements and/or regulatory actions at other companies, including Just for Feet, Fleming Cos., and Great Atlantic & Pacific Tea Co. More recently, the SEC filed a suit with Penn Traffic grocery stores in which the SEC alleged that Penn Traffic intentionally inflated income by prematurely recognizing income from promotional allowances (SEC, 2008).

## GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR VENDOR REBATES

Prior to 2002, there was no standardization regarding the accounting for or disclosure of these vendor rebates. Companies often "buried" the rebates in their financial statements, even though they were frequently material in amount, particularly for retailers such as American Food Suppliers. In August 2002, the Financial Accounting Standards Board (FASB) released Emerging Issues Task Force (EITF) Issue No. 02-16, *Accounting by a Reseller for Cash Consideration Received from a Vendor*, which addressed the accounting for and disclosure of these rebates. In the EITF, the FASB outlined three possible views of these rebates. Depending upon the circumstances under which it is being offered, a vendor rebate may represent: 1) a reduction in the cost of sales to the reseller; 2) a reduction in some other expense, e.g., advertising; or 3) a type of revenue for the reseller. Generally, cash consideration from a vendor is presumed to be a reduction of the price of the vendor's products or services and should, therefore, be a reduction in the cost of sales when recognized in the reseller's income statement. That presumption can be overcome, however, under two different sets of circumstances: 1) if the cash consideration is intended to reimburse the reseller for costs incurred (e.g., advertising), then the consideration received by the reseller should be recorded as a reduction in that expense; or 2) if the cash consideration is primarily payment for the reseller's expertise and efforts in a particular endeavor (e.g., market research), then the consideration should be recognized as revenue by the reseller (FASB, 2002).

Additionally, the Task Force concurred that if the cash consideration is primarily an incentive for the reseller to achieve certain sales levels, or to remain a customer of the vendor for a specified period of time, then the consideration should reduce the reseller's cost of sales. This reduction in cost of sales should be systematic and rational, reflecting the underlying progress of earning the incentive, assuming that the reseller's progress is probable and reasonably estimable. If the progress is not probable, or it cannot be reasonably estimated, the consideration should reduce the reseller's cost of sales as the relevant milestone is achieved (FASB, 2002).<sup>1</sup>

As an example, assume that retailer ABC Company is entitled to a 10% rebate of the purchase price of merchandise purchased from vendor XYZ Company if ABC Company is able to sell \$1,000 of XYZ Company's products during the

<sup>1</sup> This EITF has been codified into FASB ASC 605-50.



coming year. If it is probable that ABC will meet the \$1,000 target and the company can also reasonably estimate its progress towards achieving the milestone, ABC should recognize the 10% rebate in a systematic and rational manner. If, on the other hand, the probability of ABC achieving the \$1,000 sales level is uncertain or if ABC cannot reasonably estimate its progress in reaching the milestone, ABC should recognize the entire 10% rebate as a reduction in cost of sales only upon reaching the \$1,000 target. The Task Force's position was clear that *immediate* recognition of cash consideration as a reduction of cost of sales or as revenue was *not* acceptable. American Food Suppliers appears to have been recognizing the vendor rebates as it *purchased* the product not when it was sold. Additionally, federal authorities alleged that American Food Suppliers deliberately booked vendor rebates to which they were not entitled. Thus, not only is this an accounting issue with respect to the *timing* of recognition of the rebates, but it is also an issue of fraudulently recognizing rebates that did not exist.

## WHAT HAPPENED AT AMERICAN FOOD SUPPLIERS

During their 2002 audit of Barnacle's financial statements, as part of their confirmation process at American Food Suppliers, Doodle Auditors LLP discovered that certain accrued vendor allowance receivable balances were overstated. Doodle uncovered a series of accounting irregularities at American Food Suppliers and other Barnacle subsidiaries. Doodle immediately withdrew their audit opinions for 2000 and 2001 and suspended work on the 2002 audit.

There appeared to be a confluence of economic conditions, managerial "inventiveness," and failures of internal controls that led to the accounting irregularities at American Food Suppliers. Company sales for the year 2002 had been decreasing. In last quarter of 2002, upper management held a conference call with its divisional managers advising them that their annual bonuses were at risk if sales were not boosted. According to testimony provided by those inside the company, in that conference call, the company's chief operating officer described an "initiative" that would increase the likelihood of managers receiving their bonuses and help the company achieve its sales target for the year. Quite simply, the strategy was to order large amounts of inventory and immediately recognize the vendor rebates that accompanied them. The rebates were in many cases substantial and, according to some sources, ranged from 8.5% to 46% of the purchase price. Divisional managers stated that they were told by upper management that if they did not place orders for additional inventory, then it would be done for them. These managers reported that it was made clear that if they did not go along with the "initiative," not only were their bonuses in jeopardy, but perhaps their jobs were as well.

Soon the warehouses at American Food Suppliers were overflowing with inventory of food-related items and paper products. The amount of inventory the company purchased was so large that it had to rent additional space and refrigerator trucks to store it. As purchases increased, the vendor rebates to which

American Food Suppliers were entitled also increased. Supplier rebates increased from approximately \$150 million in 2000 to about \$800 million in 2003. These rebates were recognized immediately as products were purchased in an attempt to boost earnings. The excess inventory was so immense; however, that even after the announcement of the earnings restatement, it was questionable whether the company would be able to sell it. In an effort to unload the massive amount of product in its warehouses, the company had to reduce its selling price below its original cost in some cases.

During the audit of American Food Suppliers, third party confirmations of rebates receivable had been provided by the vendors' salespeople, not their accounting departments. According to complaints filed by the SEC, employees at American Food Suppliers urged their vendors to complete and return to the auditors false confirmation letters with dollar amounts intentionally overstated, sometimes by as much as millions of dollars. Some vendors were pressured, some were provided with secret "side letters" assuring the vendors that they did not owe the amounts listed on the confirmations.

In a span of several months, the "initiative" proposed by the company's COO unraveled. Rather than helping the company out of its economic doldrums, the scheme instead resulted in earnings restatements, plunging stock price, several high-level managers losing their jobs, regulatory investigation of the company's accounting practices, and allegations that company officers had criminal intent to deceive and defraud the investing public. In September 2003, officials raided Barnacle's headquarters and began a criminal probe. One year later, U.S. officials announced that three former American Food Suppliers executives were being formally charged with conspiracy, securities fraud, and making false filings. Prosecutors also announced at the same time that four other American Food Suppliers managers had admitted to their roles in the same alleged scheme of overstating earnings.

## THE FORENSIC AUDIT

After the irregularities were uncovered by the external auditors, a criminal investigation was launched by the U.S. Department of Justice. In addition, Barnacle appointed a team of forensic accountants to work alongside the SEC. The forensic accountants had to sort through tens of thousands of documents.

The forensic audit revealed fraud at American Food Suppliers totaling over \$900 million, with over \$150 relating to 2000, over \$300 million relating to 2001 and the rest relating to 2002. The fraud related to fictitious and/or overstated vendor allowance receivables and improper or premature recognition of vendor allowances and an understatement of cost of goods sold. Numerous American Food Suppliers employees were involved in the fraud, and it was discovered that the fraud went back as far as 2000. American Food Suppliers employees were found to have been using inflated recognition rates for vendor allowances and intentionally misapplying GAAP. Doodle's audit testing using third party

confirmations failed to detect management's misrepresentation of the reduction in cost of sales resulting from these manufacturer rebates.

The probe of American Food Suppliers expanded to investigate several of the company's suppliers to determine if they might have been complicit in American Food Suppliers' intent to misrepresent certain financial statement assertions. The investigation revealed that American Food Suppliers employees asked salespeople at their vendors to sign false documentation for Doodle and that some vendors cooperated with this fraudulent scheme. Four salespeople at Vendor A admitted that they had signed off on, and forwarded to American Food Suppliers external auditors, erroneous documents that reflected inflated amounts owed to the company by Vendor A. Similarly, at Vendor B, three salespeople also admitted to signing off on inflated amounts for manufacturer rebates due to American Food Suppliers. Vendor B claimed, however, that the erroneous confirmation amounts were discovered and that American Food Suppliers' external auditor was notified before news of the accounting scandal broke. The forensic examination at American Food Suppliers also revealed numerous weaknesses in internal controls, including failure to properly record and track vendor allowances, inadequate accounting and financial reporting systems for vendor allowances, and failure to follow GAAP.

The investigation revealed fraud at not only American Food Suppliers, but also at several other Barnacle subsidiaries and the parent company. It was discovered at one subsidiary that fictitious invoices were used to conceal payments, and in some cases, payments were improperly capitalized rather than expensed. It was also discovered that the consolidation of certain joint ventures into Barnacle's financial statements was in error and that secret side letters had been concealed from Barnacle's audit committee and external auditors. Further, accounting irregularities and earnings management were uncovered at other subsidiaries and at the parent company.

Overall, more than 800 separate items related to internal control weaknesses and accounting issues were identified at Barnacle and its subsidiaries. This extensive forensic examination led to a lengthy delay in the announcement of 2002 audited earnings numbers. Barnacle's 2002 annual report was released on December of 2003, which included restatements for the years 2000 and 2001.

The total fraud at Barnacle was revealed to be over \$1.2 billion. Of this, approximately \$925 million related to American Food Suppliers. Upon conclusion of the forensic investigation, Barnacle announced the creation of a task force reporting to the audit committee to address the internal control weaknesses and improper accounting practices uncovered during the investigation. Barnacle announced in their 2002 annual report that the internal audit department would now report directly to the CEO and the audit committee, rather than solely to the CEO, as was the case previously.

According to press releases from Barnacle, after the accounting scandal, American Food Suppliers made substantial improvements in the company's financial systems and controls, as well as its financial organization, to strengthen financial

monitoring and reporting. They also established a new office of governance, ethics and compliance.

## LESSONS LEARNED: AUDIT CONFIRMATIONS

In designing the tests to be performed during an audit, an auditor must obtain adequate assurance to address audit risk. The greater the risk of a particular financial statement assertion (e.g., the existence and amount of vendor rebates), the more evidence an auditor should gather to support the assertion. Statement on Auditing Standards (SAS) No. 67 states that, "confirmation is the process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions" (AICPA, 1992, SAS 67.06, AU 330). According to SAS No. 67, confirmation from an independent source is generally viewed as having greater reliability than evidence obtained solely from client personnel. Confirmation with a third party helps the auditor assess the financial statement assertions with respect to all five of management's assertions: existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure. The auditor may design a third party confirmation to address any one or more of these assertions (AICPA, 1992). However, existence is usually the primary assertion addressed by confirmation of receivables.

Even though evidence obtained by a third party confirmation is generally viewed as being more reliable than evidence provided by the entity being audited, SAS No. 67 cautions that an auditor should maintain a healthy level of professional skepticism. The auditor should consider information from prior years' audits and audits of similar entities. Further, an auditor has an obligation to understand the arrangements and transactions between the audit client and the third party so that the appropriate confirmation request can be designed. SAS No. 67 states that "[i]f information about the respondent's competence, knowledge, motivation, ability, or willingness to respond, or about the respondent's objectivity and freedom from bias with respect to the audited entity comes to the auditor's attention, the auditor should consider the effects of such information on designing the confirmation request and evaluating the results, including determining whether other procedures are necessary" (AICPA, 2002, SAS 67.27). The statement allows for the possibility that the party responding to the confirmation may not be completely objective or free from bias and requires the auditor to use other evidence to confirm financial statement assertions in such cases (AICPA, 1992).

Confirming accounts receivable is a generally accepted auditing procedure and is required unless the amount involved is immaterial, a confirmation would be ineffective, or if the auditor can substantially reduce the level of audit risk of the financial statement assertion through the use of other substantive and analytical tests. Accounts receivable, for the purpose of SAS No. 67 (AU 330), represent claims against customers that have arisen in the normal course of business and loans held by financial institutions (AICPA, 1992). The Statement does

*not* specifically address confirming a receivable that arises when a vendor owes a rebate to a reseller, a situation that differs substantially from the typical trade accounts receivable from a customer. Confirming vendor rebate receivables give rise to different risks that likely were not envisioned when the Statement was adopted in 1992.

In adopting SAS No. 67, two (of the seventeen) Board members, while assenting to the Statement, expressed a reservation that the language used in the Statement usurped the freedom of the auditor in exercising professional judgment in how best to confirm accounts receivable and that the language might also lead auditors to place undue reliance on third party confirmation when circumstances might suggest that the auditor choose a more effective test (AICPA, 1992). With the benefit of hindsight it is clear that the auditors of American Food Suppliers could have, and should have, designed a more “effective test,” one that would have helped overcome the inherent weakness that existed in this situation where parties providing the confirmation may have either been uninformed about the existence and/or amount owed to the retailer or may have had a vested interest to overstate the amount that was owed to American Food Suppliers. While some practitioner literature has made reference to biases of confirmation respondents, scant attention has been given to this particular concern regarding responses to auditor confirmations by vendors’ sales personnel.

## THE AFTERMATH

- Three former purchasing executives for American Food Suppliers pleaded guilty to participating in the scheme and to conspiring with suppliers to mislead the company’s auditors. They later agreed to pay approximately \$400,000 in civil penalties.
- U.S. courts approved a \$1.3 billion global class action settlement between Barnacle and shareholders.
- The former CFO of American Food Suppliers pleaded guilty and was sentenced to eleven months of home detention and five years’ probation.
- Fifteen American Food Suppliers vendors pleaded guilty from 2003 to 2006 to criminal charges related to the fraud, admitting that they submitted false confirmations to the auditors.
- Former American Food Suppliers CEO reached an agreement with Barnacle in which he agreed to pay \$10 million but did not acknowledge liability.

- 3) What mistakes were likely made by auditors of American Food Suppliers and what responsibility does the auditor have to uncover fraud?
- 4) The FASB has reduced the wide latitude that companies once had in accounting for vendor rebates by issuing EITF Issue No. 02-16. What recommendations would you suggest to the FASB for further improving the accounting and auditing guidance in the area of vendor rebates?

## REFERENCES

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