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Small Company Suffers Massive Embezzlements

The discovery of alleged fraud at Koss Corporation highlights some of the potential dangers that can lead to fraud within a company and demonstrates how small companies can be susceptible to massive losses.

Koss Corporation is a relatively small, reasonably profitable, and mostly family-owned company with about a quarter of its shares listed on NASDAQ (ticker symbol: KOSS). The almost unbelievable story that continues to unfold around this Milwaukee-based company is that an employee used a large number of unauthorized transactions to embezzle mind-boggling amounts of money from her employer. The fraud exceeded the reported earnings in some years at a cost to the company of $31.5 million over five years. This case provides ethical lessons of value to all organizations.

Sujata "Sue" Sachdeva, Koss's trusted, long-serving vice president of Finance, corporate secretary, and principal accounting officer, faces a six-count indictment accusing her of wire fraud for embezzling money for a lavish lifestyle and extravagant shopping sprees.

The sequence of events was rapid. American Express blew the whistle on the scheme because of the huge transfers from Koss's bank to pay Sachdeva's credit card bills. Within days, on December 21, 2009, trading in KOSS on NASDAQ was halted as the company reported the unauthorized transactions. Sachdeva was terminated on December 23, 2009. On December 24, 2009, the Koss audit committee published word that the financial statements for 2006, 2007, 2008, 2009, and first quarter of 2010 "should no longer be relied upon." Baker Tilly Virchow Krause was appointed as the new independent audit firm on January 5, 2010, and on January 11, 2010, Koss's stock resumed trading on the NASDAQ, with the price plunging 24%. On January 18, 2010, Koss announced the hiring of a new executive vice president, CFO, and principal accounting officer.

A Koss Securities & Exchange Commission (SEC) filing made on January 11, 2010, showed preliminary estimates of the amounts of the unauthorized transactions (see Table 1).

According to wire service reports, the indictment alleges that Sachdeva authorized numerous wire transfers of funds from bank accounts maintained by Koss to pay for her American Express credit card bills. In addition, Sachdeva used money from Koss's bank accounts to fund numerous cashier's checks, which she also used to pay for clothing, furs, purses, shoes, jewelry, automobiles, china, statues, household furnishings, travel expenses for herself and others, renovations and improvements to her home, and to compensate individuals providing personal services to her and her family. She faces a maximum penalty of up to 120 years in prison and fines of up to $1.5 million, plus restitution.

Failure to regularly instill new thinking and perspective into the board governance structure as well as the resulting complacency of board meetings has long been considered a likely factor for enabling fraud to occur within a company, and the long tenures of Koss's board members suggest that this might have been a contributing factor to the apparent breakdown of board oversight to detect the large-scale fraud that occurred. The Koss proxy statement for the 2009 annual meeting of shareholders shows that the board met four times during the year. Two of the six board members have the name Koss. Except for a relative newcomer elected to

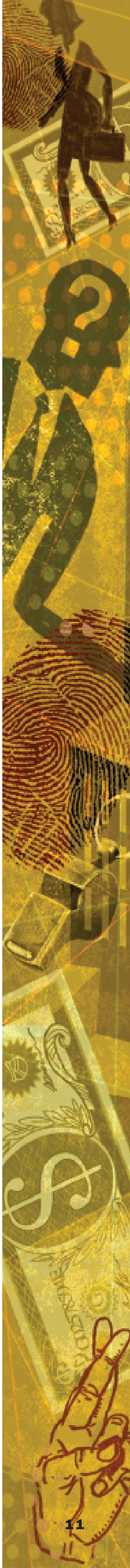

Table 1. Preliminary Estimates of the Unauthorized Transactions

Date	Unauth. Trans.	Earnings before tax	Percent
FY 2005	$2.2 million	$7.4 million	29.7%
FY 2006	$2.2 million	$10.2 million	22.2%
FY 2007	$3.2 million	$8.3 million	37.9%
FY 2008	$5.0 million	$7.4 million	30.0%
FY 2009	$8.5 million	$2.9 million	293.9%
First Qtr 2010	$5.3 million	$900,000	574.7%
Second Qtr 2010	$4.9 million	Not yet released	

the board in 2006, the length of service for the remaining five averaged 32 years. Excluding founder John Koss from the calculation, the average length of service was more than 27 years.

The 2009 proxy statement reported that the audit committee consisted of all four non-Koss board members and met three times during fiscal 2009. The chair, who has been a director since 1987, is the president of a holding company established for the purpose of acquiring established companies involved in distributing products to industrial and commercial markets. The designated financial expert on the committee is the retired president of a manufacturer and seller of portable household appliances. In relating the background of committee members, the proxy statement includes no mention of specialized accounting or financial experience.

It appears that the audit committee may have relied heavily on the internal control work of Grant Thornton, according to the committee's report contained in the proxy statement. The report notes that the committee "meets twice a year with the Company's independent accountants to discuss the results of their examinations, their evaluations of the Company's internal controls, and the overall quality of the Company's financial reporting." This report also states that the audit committee "oversees the audit work performed by the Company's internal accounting staff," hinting that there may have been an internal auditing function.

Grant Thornton has somewhat disputed the conclusion that they were involved in evaluation of Koss's internal controls. In the January/February *CFO Magazine*, a spokesperson for the firm says that Koss "did not engage Grant Thornton to conduct an audit or evaluation of internal controls over financial reporting." Audit fees paid to Grant Thornton were $151,000 in 2009 and $71,000 in 2008. Fees amounting to $97,000 in 2009 and $118,000 in 2008 were paid to PricewaterhouseCoopers for tax compliance, tax advice, and tax planning services.

Koss's 2009 Annual Report on Form 10-K contained various assertions that Koss "maintains a system of internal control to provide reasonable assurance that assets are safeguarded and that the books and records reflect the authorized transactions of the Company." Further assertions are made that management, namely Michael Koss, president, CEO, COO, and CFO, had evaluated internal controls over financial reporting (ICoFR) and believed they were effective. Because of its size, Koss isn't yet subject to the Sarbanes-Oxley Act (SOX) requirement that this control assertion by management be attested to by its independent auditor.

The Koss Code of Conduct, published in 2004, sets forth procedures for employees to follow in reporting misconduct, including that Koss "may" implement a corporate compliance hotline for employee, supplier, and customer use. The Code also notes that "when a report relates to an accounting or auditing issue, the complaint procedures adopted by the Audit Board supersede these provisions." The Audit Board could refer to the audit committee of the board.

The only provision in the audit

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Ethics

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committee charter published in 2006 dealing with ethics is that the committee should "receive, investigate, and retain complaints regarding accounting, internal accounting controls, and auditing matters, including concerns that employees have about questionable matters." Two accountants were terminated because they failed to report the unauthorized transactions to top management or the audit committee.

In summary, the Koss case provides an excellent example of the dangers of:

- Massive weaknesses in internal controls,
- Poor financial oversight by the board of directors and audit committee,
- An apparently obsolete and ineffective ethics and compliance program,
- The external audit firm misunderstanding or not fulfilling expectations of the senior management and audit committee, and
- Failure to report wrongdoing. **SF**

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