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How an Embezzler Stole Millions from a Small Company

More details have emerged regarding the fraud committed at Koss Corporation by Sue Sachdeva. A former senior accountant has been charged for assisting Sachdeva in the cover-up of the fraud, and Koss has filed a lawsuit against its auditor for failing to discover the embezzlement.

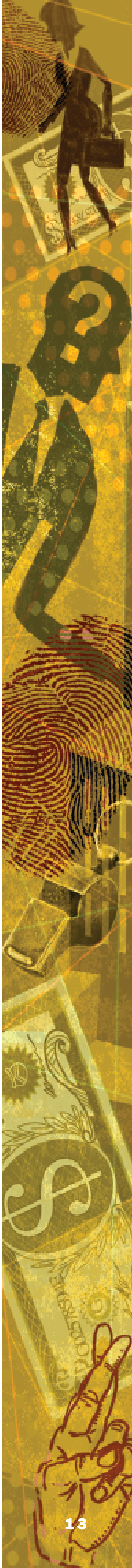
New details have emerged on the methods used and the outcomes following the case of 47-year-old convicted embezzler Sujata "Sue" Sachdeva (see "Small Company Suffers Massive Embezzlements," *Strategic Finance*, June 2010). Sachdeva was the trusted 15-year veteran VP of Finance, secretary, and principal accounting officer of Koss Corporation. During a span of more than five years, she stole nearly half the company's pretax earnings. The scheme was uncovered when American Express noticed her credit card balances were being paid through large wire transfers originating from a company bank account. Koss is the Milwaukee-based, mostly privately held small company that's a prominent global designer and marketer of stereophonic headphones.

Sachdeva's criminal case concluded after she pleaded guilty to embezzling $34 million from her employer, an increase of $2.5 million over earlier estimates. The six felony fraud counts carried a maximum penalty of 120 years in jail, but 15 to 20 years is appropriate under federal sentencing guidelines. Because she cooperated with authorities from the very beginning of their investigation, the judge limited her sentence on November 17, 2010, to 11 years in federal prison plus restitution to Koss of $34 million. Her physician husband filed for divorce after the sentencing hearing. Federal officials have seized most of her assets, including a 2007 Mercedes-Benz, timeshares, jewelry, shoes, furs, and other luxury items—some that were never worn because they were put into storage for lack of space. Sachdeva's attorney claims she has a bipolar disease of compulsive shopping disorder and is an alcoholic.

Countering the defendant's plea for a lenient sentence because of mental illness, Koss CEO Michael Koss asked the judge to sentence Sachdeva to the maximum 15 to 20 years, writing that she "stole from the hardworking employees of the company and their families, and ultimately the stockholders of the company." In a presentencing letter, he stated, "The full extent of the damage to the reputation of the company and its employees caused by Ms. Sachdeva's criminal acts cannot be expressed in words." He added that the damage will continue to tarnish Koss and subject it to ridicule long after her sentence ends.

In addition to Sachdeva, the Securities & Exchange Commission (SEC) has charged Julie Mulvaney, former Koss senior accountant, with assisting Sachdeva to conceal the theft on Koss's financial statements by overstating assets, expenses, and cost of sales and by understating liabilities and sales. The SEC accuses both of them in a civil case of maintaining fraudulent records so that Koss filed materially false current, quarterly, and annual reports with the Commission over a period of years. The theft was accomplished through a variety of means, including fraudulent cashier's checks, fraudulent wire transfers, and unauthorized payments from petty cash. A third person, Tracy Malone, a Koss accountant who was fired because she knew about the theft but said nothing, hasn't been charged.

The SEC's August 30, 2010, complaint provides details of the means used by Mulvaney and Sachdeva to get cash by circumventing the internal controls of



the corporation. Sachdeva admitted stealing $15 million by authorizing issuance of more than 500 cashier's checks to pay her personal expenses. Cashier's checks were issued directly to retailers, such as Nieman Marcus and Saks Fifth Avenue, and other vendors. Sometimes acronyms were used, like N-M and S.F.A. In addition to using cashier's checks, Sachdeva fraudulently authorized and directed numerous wire transfers, including wiring company funds to American Express to pay for personal purchases on her credit card. From 2008 through December 2009, Sachdeva fraudulently authorized more than 200 bank wire transfers totaling more than $16 million to American Express.

Other methods of fraudulently misappropriating cash for personal use described in the SEC complaint include misuse of petty cash. Sachdeva issued checks payable to "petty cash," had Koss employees then negotiate and return the money to her, which she then used to pay personal expenses. Sachdeva also converted unused traveler's checks that the company had purchased for use by its employees travelling on company-related business and fraudulently used them for herself.

It appears that Mulvaney didn't receive any of the benefits of the massive embezzlements, and she hasn't been charged with theft. But she did materially participate in the cover-up of the fraud and was therefore charged with civil fraud. According to the SEC complaint, the pair were able to hide the huge amounts of missing cash by means of top-side general journal entries. Mulvaney maintained a "red book" containing numerous false journal entries to the company's accounting books and records. She wrote the false journal entries in the red book and then entered them in the company's accounting books and records. By means of those entries, Mulvaney purported to adjust or reclassify the amount of company cash without supporting documentation or any legitimate explanation.

The rainbow files included more than 100 fraudulent transactions on the company's books and records.

The complaint notes that Mulvaney also prepared falsified accounting books and records and maintained them in a series of colored folders, called the "rainbow files." The rainbow files consisted of seven folders covering fiscal years 1995-2000 (green folder), 2004 (orange), 2005 (blue), 2005 (orange), 2006 (blue), 2007 (yellow), and 2008 (green). The rainbow files included more than 100 fraudulent transactions on the company's books and records.

The rainbow files also reflected a scheme to conceal the receipt of funds by the company through a debit/credit wipe (DC Wipe). A DC Wipe made it appear that a certain transaction (e.g., a sale to a customer and the receipt of funds by the company) never took place. For example, in December 2007, Koss received funds totaling more than $100,000 from an overseas customer. Mulvaney falsified the books and records to make it appear that the company never received the funds. In an attempt to avoid detection, she reduced five separate sales accounts by different amounts that collectively totaled the exact amount—instead of reducing a single sales account by the whole amount.

The fraudulent accounting cover-up also involved the company's sales over the Internet and at its retail outlet. From fiscal year 2006 through the time the fraud was discovered during the second quarter of fiscal year 2010 (December 2009), Sachdeva and Mulvaney didn't record in Koss's books any sales made over the Internet or at the company's retail outlet, totaling $1.8 million.

Although Sachedeva's fate seems settled, at least for several years, no punishment for Mulvaney has been revealed yet. In a November 17, 2010, *Milwaukee Business Journal* article titled "Sachdeva throws Mulvaney under the train," additional details emerged from the sentencing hearing that show Mulvaney's enabling role in the fraud. Apparently, each year Sachdeva would review the company's cash position a few weeks prior to a scheduled visit from Koss's outside auditors, Grant Thornton. She would presume the difference between the cash in the company's bank accounts and the related ledger accounts was because of her theft of company funds. In a panic, Sachdeva would then call Mulvaney into her office and show her the numbers. Mulvaney would respond by saying, "Let me look at everything and get back to you, and don't worry" and then appar-

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ently make the journal entries that no one questioned.

There are other unanswered questions, such as how it was possible that Grant Thornton didn't discover such a massive defalcation. Answers may be forthcoming in the lawsuit Koss has filed against the firm in Cook County, Ill. The complaint alleges that "Grant Thornton, the company's auditor, failed to properly perform audits of the company's financial statements and failed to properly assess the company's internal controls, thus allowing the embezzlement to continue and the damage to the company to escalate." Surprisingly, the lawsuit claims specifically that "Grant Thornton repeatedly assured Koss' management and its board that the company's internal controls were effective and that Koss could rely on those same internal controls and Grant Thornton's work."

Koss's attorney, Michael J. Avenatti, said, "Grant Thornton was paid hundreds of thousands of dollars to properly audit the company's financial statements, and they failed miserably. This failure included repeatedly assuring the company and its board that the company's internal controls were effective. A company should be able to rely on its auditors." For its part, the firm has stated it was not engaged to provide a separate opinion on internal controls. Sarbanes-Oxley Section 404(b) doesn't apply to Koss because it is too small.

The many lessons to be learned from this case seem obvious, especially that smaller companies need to be particularly aware of the possibility of fraud. **SF**

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