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AN EMPIRE BUILT ON A LIE – THE PEREGRINE FRAUD: A CASE STUDY ON CONFIRMATIONS AS AUDIT EVIDENCE

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CASE DESCRIPTION

This study examines the real world case of the Peregrine fraud. In this fraud, the CEO Russell Wasendorf, Sr. duped the auditors and the public for years. Wasendorf was able to carry out a fraud using an unsophisticated scheme involving falsified bank statements and falsified audit evidence. Only when an electronic confirmation services was used by the auditors did the fraud unravel. This case provides interesting discussion points for an auditing, fraud detection and deterrence, forensic accounting or ethics class. Students typically need one to two hours of time outside of class to complete the case and instructors should budget approximately one to one and a half hours of class time to discuss the case after the students have completed it.

JEL: M42

KEYWORDS: Audit Evidence, Confirmations, Fraud

CASE INFORMATION

Background Information and Introduction

Recent massive high profile financial frauds such as Madoff and MF Global, the economic crisis and recession in this country as well as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 have all caused an increased scrutiny of external auditors and questions about auditor skepticism. A recent financial fraud at the company Peregrine Financial Group highlights the implications for the auditing profession. The CEO and Chairman of the Board Russell Wasendorf, Sr. was able to build the Peregrine empire on a lie, dupe the auditors and steal approximately $200 million over the course of 20 years with an unsophisticated scam using Photoshop to forge "documentation" and setting up a bogus bank address at a post office box. He stole from his customers' accounts for years in order to finance a new $24 million headquarters for Peregrine, personal shopping binges, a private jet and other luxuries. The fraud went undetected for approximately 20 years and Wasendorf stole approximately $200 million during this time. What regulators and investors are asking is, "Why didn't the auditors catch this fraud?" The failure of the auditors to catch this blatant fraud has regulators demanding to know why it was not detected. In addition, regulators are asking why the bank did not notice that Wasendorf was using client funds for personal use.

Russell Wasendorf, Sr. came from a modest upbringing. He founded Peregrine Financial Group (also known as PFG or PFGBest) in 1992. Peregrine Financial Group was an independent futures brokerage, also known as a futures commission merchant (FCM). An FCM "solicits or accepts orders to buy or sell futures contracts, options on futures, retail off-exchange forex contracts or swaps and accepts money or other assets from customers to support such orders" (NFA, 2016). "All customer funds for trading on designated contract markets (exchanges) must be kept apart ("segregated") from the futures commission merchant's (FCM's) own funds—this includes cash deposits and any securities or other property deposited by such customers to margin or guarantee futures trading" (CTFC, 2016). The CFTC requires FCMs to provide customers with monthly statements as well as next business day confirmations of transactions executed including gains/losses from any offsetting positions. All FCMs must be members of the NFA. The NFA is a non-profit independent self- regulatory organization for the derivatives market in the US. The NFA conducts a rigorous screening of registrants as well as having a comprehensive set of compliance rules. Supposedly the NFA performs periodic examinations of its members to ensure compliance. (See https://www.nfa.futures.org/NFA-about-nfa/who-we-are/how-NFA-fights-fraud-and-abuse.HTML). The question is, why did the NFA fail to discover the Peregrine fraud?

This is not the first fraud of this type. MF Global's CEO, Jon Corzine, was involved in similar fraudulent activities of comingling customer accounts with other company transactions. MF Global was deemed to have an outdated compliance system that contributed to the ability of the company to engage in risky transactions. Controls were lacking regarding both risk and how to keep separate customer trading accounts from other firm activities (Fox Business, 2011). To the public, Wasendorf grew PFG into what appeared to be a very successful trading business. Wasendorf lived a lavish lifestyle with two luxury homes, extravagant vacations, a $100,000 wine collection, his own high-end Italian restaurant and a private jet. However, in violation of regulations, customer funds were not kept segregated, so PFG had access to customer money and Wasendorf was able to misappropriate it. The auditors and regulators failed to detect this for years. Changes in technology in recent years have significantly altered the audit process. Audit confirmations used to be sent via regular mail. However, the use of electronic confirmation services has increased in the past few years. The NFA auditors started using an electronic confirmation service, Confirmation.com and pressured Wasendorf to agree to the use of it in the audits of PFG. Wasendorf resisted at first. In 2012, twenty years after he formed PFG, Wasendorf, called the regulators and agreed to use of the electronic confirmation service. The next day, he was found in his car in an attempted suicide. In the car was a note to his wife and a confession letter that said he had been committing fraud for twenty years. Wasendorf Sr.'s son, Russell Jr., who was the President and COO of PFG, arrived at work that day and found a suicide note addressed to him as well as an exact copy of the confession letter that was in the car. Wasendorf Sr. wrote in the letter, "I have committed fraud." (To view a copy of the indictment, go to: http://www.jdsupra.com/legalnews/jdsupra-00183/).

<u>How the Fraud Was Perpetrated</u>

A normal procedure in generally accepted auditing standards (GAAS) is for the independent auditor to obtain and examine bank statements. Wasendorf simply used software such as Photoshop to create phony bank statements showing heavily inflated balances. According to Wasendorf's confession, he was the "sole individual with access to the US Bank accounts held by PFG. No one else in the company ever saw an actual US Bank statement." When the bank statements arrived in the mail, they were delivered to Wasendorf, who opened them and then made phony bank statements, passing the phony statements on to the accounting department. Wasendorf also made sure that he was the only person with online access to PFG's bank account. Another standard auditing procedure is to send confirmation requests directly to the bank and obtain confirmation of balances and other information directly from the bank. Wasendorf simply set up a phony bank address at a post office box and tricked the auditors into believing it was a legitimate address for the bank. Wasendorf would then intercept all confirmation requests from the auditors, fill in the information with fictitious amounts, and send them back to the auditors. The Wall Street Journal has made copies of the falsified bank statements available at http://www.documentcloud.org/notes/print?docs[]=398920_. Copies of the falsified confirmations are available at http://www.wsj.com/news/interactive/pfgbestcftc .

Auditing standards call for maintaining professional skepticism throughout the planning and performance of an audit, describing professional skepticism as, "an attitude that includes a questioning mind, being alert to conditions that might indicate possible misstatements due to fraud or error, and a critical assessment of audit evidence" (Arens et al., 2014). In Auditing Standard No. 15, the Public Company Accounting Oversight Board details standards for audit evidence. AU 316 describes the procedures for consideration of fraud in an audit. (PCAOB, 2016). Previous frauds at Parmalat and Olympus illustrate the problems with relying on paper confirmations. Only after Parmalat defaulted on a $185 million bond payment did the auditors uncover the fraud. "Some 38% of Parmalat's assets were supposedly held in a $4.9 billion Bank of America (BAC) account of a Parmalat subsidiary in the Cayman Islands. But on Dec. 19, Bank of America reported that no such account existed" (Bloomberg, 2004). Managers simply forged documents over a15 year period and eventually put the company in bankruptcy. Similarly, an investigation in to the Olympus scandal uncovered evidence that a company executive sent a fake confirmation letter to the auditor to perpetuate the fraud (Vanderford, 2013).

Electronic Confirmation Services

Electronic confirmation services are relatively new to the field of auditing. These digital confirmations significantly reduce the amount of time it takes to receive confirmations back and can significantly reduce the potential for fraud. Reducing delays and the need for follow ups can reduce audit costs. Electronic confirmation services ensure that both the requestors (auditors) and the responders are vetted and verified. According to their website, Confirmation.com users can initiate and receive confirmations in as little as 24-48 hours. Using old-fashioned paper confirmations can take weeks or even months. The night before he attempted to take his own life, Wasendorf agreed to let the regulators use Confirmation.com. The next morning, while Wasendorf was found in his car with a suicide note, the auditors began to receive electronic confirmations noting that the balance in PFG's US Bank account was approximately $7 million, a long way off from the $220 million that was supposed to be there. PFG was subject to audits by the NFA and also to an annual audit by an independent accounting firm. The audits by the NFA were to test whether the financial statements were fairly presented in all material respects according to Generally Accepted Accounting Principles and also to make sure that PFG was in compliance with NFA regulatory requirements. PFG's outside accounting firm, Veraja Snelling & Company, was a small, one-person firm. The CTFC later determined that this accountant did not follow Generally Accepted Auditing Standards, failed to adequately plan and staff the audits, and failed to exercise due care (CTFC, 2013). The CTFC noted that the accounting firm did not appropriately review and test internal controls and procedure for safeguarding customer assets (CTFC, 2013).

The Aftermath

PFG was forced to close its doors. More than 200 employees lost their jobs. More than 13,000 customers suffered major financial losses. Russell Wasendorf, Sr. pleaded guilty to mail fraud, making false statements to regulators and embezzlement of customer funds. He is currently serving a 50 year prison sentence for fraud (the maximum term). Wasendorf has insisted that he acted alone. U.S. Bank was sued by the U.S. Commodities Futures Trading Commission for failure to follow rules requiring the bank to segregate customer accounts. The two parties agreed to settle the suit and they have not disclosed the terms of the settlement. The CTFC has permanently barred PFG's external accounting firm from practicing before the commission (Tadena, 2013) and the firm is no longer registered with the PCAOB.

QUESTIONS

1. Explain the role of professional skepticism in an audit and in your opinion, why wasn't this fraud detected sooner?

2. What internal controls were deficient or lacking at Peregrine? What red flags existed?
3. Explain the fraud triangle. Detail how all elements of the fraud triangle were present in this case.
4. How can the use of electronic confirmation services help to prevent fraud?
5. Why did the NFA fail to discover the fraud?

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TEACHING NOTES

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GENERAL COMMENTS

This case describes a real world, multi-million dollar fraud that was able to go undetected for twenty years. Students find this case interesting because it actually happened and many of them recall hearing about it in the news. Completing the case study allows the students to go beyond traditional textbook learning and apply what they have learned in class to a real world situation. Concepts such as *professional skepticism* should become more salient. The authors usually assign this case as an individual assignment. We allow the students approximately one week to complete the case questions outside of class. Then, on the day the case questions are due, we spend the entire class period (one hour) discussing the case and questions.

QUESTIONS

Question 1: Explain the role of professional skepticism in an audit and in your opinion, why wasn't this fraud detected sooner?

Solution 1: Instructors may find this a good place to have students research the authoritative literature and discuss how it translates into the "real world" in an actual audit. The PCAOB website is a good starting point. AU 230 states, "Due professional care requires the auditor to exercise *professional skepticism*. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor uses the knowledge, skill, and ability called for by the profession of public accounting to diligently perform, in good faith and with integrity, the gathering and objective evaluation of evidence." (PCAOB, 2016)

Question 2: What internal controls were deficient or lacking at Peregrine? What red flags existed?

Solution 2: This is an excellent spot for the students to point out huge red flags and blatantly missing internal controls. An obvious red flag is the autocratic CEO. Students may note that the characteristics of the Peregrine CEO are similar to those of the WorldCom CEO Bernie Ebbers. Another red flag is that the company used a small, one person outside accounting firm, similar to both Madoff and Allen Stanford. The most blatant missing internal control is basic separation of duties. Wasendorf should not have had access to bank statements, customer records, customer funds and accounting records. In addition, having a whistleblower hotline may have improved internal controls.

Question 3: Explain the fraud triangle. Detail how all elements of the fraud triangle were present in this case.

Solution 3: Incentives or pressure is what motivates the fraudster. It seems like Wasendorf felt pressure to succeed. He indicated that he felt he had the choice of go out of business or commit fraud. The opportunity to commit the fraud was there because of the lack of separation of duties, coupled with lax oversight. The rationalization piece of the triangle may be that Wasendorf felt that is was not his fault, it was the fault of the regulators who had it out for him. Instructors may find it helpful to refer their students to the ACFE website for an interactive explanation of the fraud triangle at http://www.acfe.com/fraud-triangle.aspx.

Question 4: How can the use of electronic confirmation services help to prevent fraud?

Solution 4: AU 505 covers the use of external confirmations. When auditors use external confirmations, they are only valuable audit evidence if they are completed by a reliable third party source. By using an electronic confirmation service, the auditor should be able to improve the likelihood of the appropriate third party completing the confirmation and also shorten the time it takes for the confirmation to be returned. In addition, if a client does not want to use an electronic confirmation service, as in the case of Peregrine, this alone could be a red flag.

Question 5: Why did the NFA fail to discover the fraud?

Solution 5: The NFA is an independent self-regulatory agency financed exclusively from membership dues and assessment fees. It could be argued that the independence of the NFA is in questionable because the organization is funded by its members – those it monitors. The Commodities Futures Trading Commission (CFTC) set regulations requiring FCMs to be registered with the NFA. Does the NFA have enough resources to carry out a thorough audit of its members? What real power does the NFA have over the FCMs? These are discussion points for the class. The class could also look at other self-regulatory bodies and draw parallels. For example, the FASB is funded primarily by the publicly traded companies that it sets standards for. Is this a similar conflict of interests? The FASB is also a self-regulated organization. Even the PCAOB, created by the Sarbanes Oxley Act of 2002 to oversee the audits of publicly traded companies, is funded by accounting support fees from the companies they monitor.

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BIOGRAPHIES

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