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SOX EXEMPTION AND THE TRUE COST OF INTERNAL CONTROLS IN SMALL COMPANIES: THE CASE OF KOSS

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ABSTRACT

This case discusses the potential consequences when small public companies are exempted from Sarbanes-Oxley Section 404(b) requirements for internal control audits. Students are presented with the real world case of Koss Corp., in which a large fraud was perpetrated over the course of five years by circumventing the company's internal controls. This case is appropriate for use in an auditing or fraud/forensic class. Students will examine the various facets of fraud and its prevention and detection, including the role of the external auditor, as well as appreciate the importance of internal controls in small companies.

Key words: SOX, Section 404(b), Koss, Auditing Case, Fraud and Forensic Accounting

KOSS HISTORY AND BACKGROUND

Koss Corp. is a consumer electronics company recognized as the pioneer and leading U.S. manufacturer of stereo headphones and related accessory products. It offers speaker-phones, computer and telecommunication headsets, active noise cancelling stereophones, wireless stereophones and other products. Originally founded as a television rental business in 1953, the company's founder, John Koss, and his partner, Martin Lange, subsequently pioneered the stereo headphone, which created an audio revolution in 1958. The timing of the invention was propitious. The baby boom generation of the 1960s and 1970s created a huge demand for loud music and high quality stereo sound as the rock and roll era took off. The company's sales increased dramatically during this period.

John Koss ran the company with a simple hierarchy, no significant controls and little formal planning, instead concentrating on producing high quality headphones and marketing them through innovative billboards and commercials in media outlets. Despite some competition from Japanese firms in its early years, Koss' focus on product quality proved successful and sales grew at an annual rate of 15-20%. In 1967, the company went public with approximately $1 million of annual sales. The company expanded internationally in the 1970s, and by the mid-1970s, the company had manufacturing subsidiaries in Italy and Ireland, and international sales and marketing centers in London and Canada. By this time, the Koss brand controlled between 25 to 40 percent of the stereo headphone market worldwide. However, while the company achieved record sales, its profits were hit by unfavorable exchange rates and labor unrest in the Italian manufacturing facility, which it subsequently closed. Nevertheless, the company continued to expand in the 1970s. Departing from its strategy of marketing its products only through high end audio outlets, the company started distributing its headphones through Sears Roebuck and Company in 1976 and subsequently through other mass merchandisers, competing on both price and quality with Japanese imports.

By the end of the 1970s, increasing market competition along with changing market demographics, as baby boomers got older, resulted in a maturing of the business and decreasing profitability. In 1979, with annual sales of $25 million, future growth seemed uncertain. Recognizing the need for professional management, Koss brought in James D. Dodson as president and chief operating officer. Dodson created formal systems for planning and control, as well as internal rules and documentation procedures. He also spearheaded a shift in strategy by diversifying away from stereo headphones and expanding into several related electronics areas.

Dodson's expansion strategy proved disastrous for the company. Consumer demand for headphones declined about 50% in 1983-84, and Koss' market share plunged from a peak of 50% of the U.S. market to around 25% in mid-1980s. Competition from Japanese manufacturers, like Sony with its top selling "Walkman," and cheap imitators that seemed ubiquitous proved fatal to the company's portable devices. Sales declined from $25.2 million in 1981 to around $20 million with a net loss of $6 million in 1984. Additionally, the expansion had resulted in the company going heavily into debt.

As a consequence of its dire financial situation, Koss entered a restructuring plan after filing for Chapter 11 bankruptcy protection in December, 1984. Dodson was fired and John Koss retook control of the company, hiring a new Executive Vice-President James Dorman to see Koss through its bankruptcy proceedings. The company closed its European operations, laid off employees, instituted pay cuts, renegotiated debt and secured a $1.2 million loan to see it through the holiday season. Focusing on its core business, Koss put out a new line of mass market headphones selling for $10 to $20 at retailers such as Target, Zayre and Kmart, while repackaging its high end line. The asset sales and loans enabled the company to pay off the banks and emerge from bankruptcy in December, 1985. It started to develop stricter management standards and focused on efficiency in producing and marketing its products.

In 1991, Michael Koss, the founder's son, took over as President and CEO. The company stayed close to its core headphones business servicing both the mass market and high-end consumers with prices ranging from $10 to $2000 a pair in the early 1990s. Innovations also focused on this segment and included headphones that changed color with exposure to light and headphones designed specifically for computer games. The company's revenues increased from around $25 million in the early 1990s to record sales of $40 million in 1997. The company's success came in the face of stiff competition from Sony and other Asian manufacturers as its new lean domestic structure allowed it to respond quickly to new trends. Koss made headphones with enhanced features such as noise suppression, collapsible and cordless models, and headphones with interchangeable components. It licensed its name to makers of car speakers and stereos, and made headphone equipment for the telecommunications industry.

The decade of the 2000s also saw growth with revenues of almost $49 million in 2008. However, the company saw significant revenue decreases in 2009 ($42 million) and 2010 ($40 million) reflecting the severe global recession.

The economic crisis, however, paled in comparison to a huge scandal uncovered at the company. It was during the 2000s that Sujata "Sue" Sachdeva, Vice President of Finance and Principal Accounting Officer for Koss, embezzled more than $30 million from the company, circumventing the firm's internal controls as well as monitoring by Grant Thornton, Koss' external auditors. The fraud is described in the next section.

THE FRAUD

During the course of about five years, Sachdeva was able to defraud Koss of approximately $31.5 million. The amount embezzled each year increased significantly over the period (Exhibit 1).

It was a simple fraud: she racked up millions of dollars of personal expenses on her personal American Express credit card and then simply paid the American Express bills with wire transfers from Koss bank accounts. Before her arrest, Sachdeva's spending was nearly $600,000 per month.

Sachdeva's lavish purchases included designer clothes, furs, handbags, jewelry, cars, travel and more. She paid for these items largely by fraudulently authorizing and directing wire transfers

EXHIBIT 1

Koss Corporation Estimates of the Unauthorized Transactions since Fiscal Year 2005

FY 2005:	$2,257,079
FY 2006:	$2,284,124
FY 2007:	$3,509,861
FY 2008:	$5,099,900
FY 2009:	$8,498,434
Q1 FY 2010:	$5,324,164
Q2 FY 2010:	$4,962,824

Source: Koss Corporation 10-K/A dated 6/30/2009; filed 6/30/2010

from Koss bank accounts to American Express. She also used Koss bank accounts to fund cashier's checks, which she then used for personal expenses. In addition, she issued checks payable to "petty cash," and then had Koss employees negotiate these checks for cash. She used traveler's checks, which Koss had purchased for employees' business travel, for her personal use. In her deposition, Sachdeva admitted to embezzling money from Koss through "cashier's checks, traveler's checks, wire transfers and some petty cash." When asked how the fraud started, Sachdeva stated that, "… a bill [American Express] would come through that would just shake me to the core, and I would take the money in the forms I've told you before and in the beginning with full intentions to pay it back."

In the deposition, Sachdeva stated that she had single signature authority on all Koss bank accounts (meaning that she could move as much money as she wanted, without anyone else's signature or approval). She noted that the external audit firm, Grant Thornton, knew this, and that Grant Thornton never expressed any concerns over the internal controls at Koss. She testified that Grant Thornton never questioned any disbursements or wires from any of the bank accounts and never made any inquiries relating to payments to American Express. Sachdeva noted that Grant Thornton "… always thought we were a smaller company but run well and a good training ground for all the new auditors that they brought on" and "…every year we'd have at least one or two new auditors come through, and I know Michael and I both objected to that – getting kids right out of college and had to explain the business to them every time, and they said, well, you guys are such a good company, a well-run company and small company, it's a good training ground for us."

Sachdeva testified that she never falsified or altered documentation for Grant Thorton, and that she provided all documentation requested by the auditors. She also testified that neither she nor anyone else ever attempted to select or choose the transactions that Grant Thorton would audit or review. She said, though, that she was afraid that the auditors would catch her "From the moment they walked into the building… I thought it was imminent." She also said that she felt that the CEO, Michael Koss, was going to catch her and that she was afraid "Every time he called me into his office." She said, "I was so ashamed of what I did that I thought that he [Michael Koss] would catch me any day from the beginning."

Sachdeva testified that Michael Koss, the CEO, would never review the bank statements; rather, he would rely on Sachdeva and others in the accounting department to do so. She also said that Michael expected the auditors to review bank statements.

Sachdeva started by using cashier's checks to pay her bills. Sachdeva testified that she used cashier's checks as part of the embezzlement because they would be returned directly to the bank and not come back to the company. She noted that both she and her assistant, Julie Mulvaney, could have cashier's checks issued without anyone else's approval. Sachdeva or Mulvaney would simply call the bank, tell the bank that she wanted a cashier's check generated in X amount, and would like to pick it up in an hour. Then Mulvaney would send an employee over to the bank to pick up the check. Sachdeva testified that she was never asked for any sort of authorization, identification or confirmation of signing authority before a check was issued.

Some of the cashier's checks were made out to initials, rather than company names. For instance, some checks were made out to NMI, and then Sachdeva sent them to Neiman Marcus, Incorporated, SFA for Saks Fifth Avenue, etc. There were more than 500 cashier's checks issued in connection with the embezzlement.

In her testimony, Sachdeva said that she was originally using a lot of cashier's checks. Then, her assistant Julie Mulvaney suggested that it would be easier to just use wire transfers because then no one would have to go to the bank to physically pick up the checks. Sachdeva testified that she would instruct Julie Mulvaney, her assistant, to send wire transfers from Koss accounts to American Express. She said that Mulvaney never asked where the money was going and never asked for any documentation relating to the American Express bills. When the cash left Koss Corp. in the form of a wire transfer or cashier's check, no journal entry was made. Accordingly, the cash balance per ledger was much higher than the true cash balance.

The fraud appears to have continued for so long because Sachdeva's superiors were not reviewing the accounting data closely. Sachdeva testified that close to the company's June 30 fiscal year end, she would start to have a "panic attack" about how much cash she had taken, and that the year-end financial statements would reflect the missing cash. She testified that Mulvaney said that "she'd take care of it" and that Mulvaney would not post money that came in during June to accounts receivable. Sachdeva would compare the cash ledger balance to the bank statements to see how much was missing, and then tell Mulvaney. Mulvaney would then make up the difference by depositing June cash receipts into the cash accounts but not posting them to accounts receivable. As such, accounts receivable would be overstated at year-end to cover up the embezzlement. The cash that came in during June was deposited into the bank, but no journal entries were made to debit cash (or to credit accounts receivable). Then after the June 30 fiscal year end, Mulvaney would apply the monies to the customers' accounts receivable balances and again there would be a difference between the amount of cash per the ledger and per the bank. Customers were not sent statements, so they were not aware that payments to their balances were not posted in June. This created the appearance that the accounts receivable aging was approximately 30 days longer than it was in reality. Sachdeva testified that Grant Thornton never asked her or anyone else about the accounts receivable aging and that Grant Thornton never asked why June's receivables were so different from those of other months.

Sachdeva also testified that, in addition to delaying the credits to accounts receivable, she wrote a number of journal entries to cover up the embezzlement and that Mulvaney assisted with this. The entries consisted of a debit to an expense and a credit to cash. Sachdeva said that as part of the audit each year, Grant Thornton was provided with documentation showing all journal entries and adjusting journal entries for the year, along with the general ledger, and that the documentation included the journal entries prepared as part of the embezzlement. She testified that the majority of the fraudulent entries were in even dollar amounts, such as $20,000, $200,000, etc. Sachdeva testified that Grant Thornton never asked any questions about specific entries on the general ledger. According to Sachdeva, it was her own responsibility to review the year-end trial balances from the general ledger and that these were also provided to Grant Thornton during the year-end audit as well as during their quarterly reviews. Sachdeva testified that although there were hundreds of thousands of dollars in wire transfers from Koss bank accounts to American Express each year, Grant Thornton never asked any questions about the American Express bills and never asked for copies of the statements from American Express.

Interestingly, the fraud was ultimately detected when American Express notified Michael Koss, CEO of Koss Corp., that Koss Corp.'s corporate funds were being used to pay Sachdeva's personal credit card bill. After Michael Koss was notified, he entered Sachdeva's office and found piles of expensive women's clothing, some with price tags of more than $2,000 still attached (Ramde, 17 Nov 2011).

In 2010, Koss filed amended financial statements, restating results for fiscal 2009 and prior comparative periods (Form 10K/A). The restated financial statements are presented in Exhibits 2, 3 and 4. The amended filings also contained disclosures in the footnotes detailing the causes of and the company responses to the fraud.

According to Koss Corp.'s 2010 form 10-K/A, Sachdeva was able to conduct the fraud by circumventing the company's internal controls. The internal controls in place at the time over wire transfers and cashier's checks were as follows: all invoices over $5,000 were required to be submitted and approved by Michael Koss, the CEO, all accounts payable checks generated from the company's accounts payable system were to be signed by the CEO, and wire transfers for inventory and other expenses were to be approved by several employees including authorized Vice Presidents. According to the 10-K/A, Sachdeva circumvented the internal controls by ordering cashier's checks directly from the bank and processing wire transfers from Koss' bank accounts directly so that the payments would not be submitted through Koss Corp.'s accounts payable system.

EXHIBIT 2

Koss Corporation and Subsidiary
Consolidated Statement of Operations Information

Year Ended June 30,	2009 (as previously reported)	Adjustments	2009 (as restated)
Net sales	$38,184,150	$3,532,964	$41,717,114
Cost of goods sold	24,917,013	(1,748,591)	23,168,422
Gross profit	13,267,137	5,281,555	18,548,692
Operating Expenses:			
Selling, general and administrative expenses	10,653,243	(262,891)	10,390,352
Unauthorized transactions	—	8,498,434	8,498,434
Total operating expenses	10,653,243	8,235,543	18,888,786
Income (loss) from operations	2,613,894	(2,953,988)	(340,094)
Other Income (Expense)			
Royalty income	258,333	(49,583)	208,750
Interest income	15,503	—	15,503
Interest expense	—	(216,751)	(216,751)
Total Other Income, net	273,836	(266,334)	7,502
Income (loss) before income tax provision (benefit)	2,887,730	(3,220,322)	(332,592)
Income tax provision (benefit)	911,062	(986,496)	(75,434)
Net income (loss)	$1,976,668	($2,233,826)	($257,158)
Earnings (loss) per common share			
Basic	$0.27	($0.30)	($0.03)
Diluted	$0.27	($0.30)	($0.03)
Dividends declared per common share	$0.26	—	$0.26

Source: Koss Corporation 10-K/A dated 6/20/1009; filed 6/30/10

EXHIBIT 3

Koss Corporation and Subsidiary
Consolidated Balance Sheet Information

As of June 30,	2009 (as previously reported)	Adjustments	2009 (as restated)
ASSETS			
Current Assets:			
Cash and cash equivalents	$1,664,407	($165,531)	$1,498,876
Accounts receivable, less allowance for doubtful accounts of 1,588,923	8,679,606	(4,018,879)	4,660,727
Inventories	9,763,158	(1,054,323)	8,708,835
Prepaid expenses	179,549	(28,212)	151,337
Deferred income taxes	720,121	665,376	1,385,497
Total Current Assets	21,006,841	(4,601,569)	16,405,272
Equipment and leasehold improvements, net	4,076,198	(1,835,626)	2,240,572
Other Assets:			
Product software development costs	—	1,727,040	1,727,040
Deferred income taxes	1,237,727	5,073,555	6,311,282
Cash surrender value of life insurance	—	2,917,223	2,917,223
Other assets	2,149,586	(2,124,586)	25,000
Total Other Assets	3,387,313	7,593,232	10,980,545
Total Assets	$28,470,352	$1,156,037	$29,626,389

(continued)

EXHIBIT 3 (continued)

As of June 30,	2009 (as previously reported)	Adjustments	2009 (as restated)
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current Liabilities;			
Accounts payable	$1,810,466	$1,312,255	$3,122,721
Accrued liabilities	1,153,089	936,965	2,090,054
Dividends payable	479,876	—	479,876
Income taxes payable	175,568	4,228,814	4,404,382
Total Current Liabilities	3,618,999	6,478,034	10,097,033
Long-Term Liabilities:			
Deferred compensation	1,095,961	445,279	1,541,240
Derivative liability	125,000	—	125,000
Other liabilities	—	725,000	725,000
Total Long-Term Liabilities	1,220,961	1,170,279	2,391,240
Total Liabilities	4,839,960	7,648,313	12,488,273
Stockholders' Equity			
Common stock, $0.005 par value, authorized 20,000,000 shares; issued and outstanding 7,382,706 shares	2,049,384	(2,012,470)	36,914
Paid in capital	—	1,056,975	1,056,975
Retained earnings	21,581,008	(5,536,781)	16,044,227
Total Stockholders' Equity	23,630,392	(6,492,276)	17,138,116
Total Liabilities and Stockholders' Equity	$28,470,352	$1,156,037	$29,626,389

Source: Koss Corporation 10-K/A dated 6/20/1009; filed 6/30/10

EXHIBIT 4

Koss Corporation and Subsidiary
Consolidated Statement of Cash Flow Information

Year Ended June 30,	2009 (as previously reported)	Adjustments	2009 (as restated)
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	$1,976,668	($2,233,826)	($257,158)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Provision for doubtful accounts	77,007	168,530	245,537
Provisions for obsolete inventories	—	12,358	12,358
Loss on disposals of equipment and leasehold improvements	—	224,286	224,286
Depreciation of equipment and leasehold improvements	817,957	(89,903)	728,054
Stock-based compensation expense	399,996	42,664	442,660
Provision for deferred income taxes	(107,000)	(2,648,314)	(2,755,314)
Increase in cash surrender value of life insurance	(195,463)	136,899	(58,564)
Deferred compensation	48,479	166,063	214,542
Net changes in operating assets and liabilities (see note 10)	(639,018)	4,488,763	3,849,745
Net cash provided by operating activities	2,378,626	267,520	2,646,146
CASH FLOWS FROM INVESTING ACTIVITIES:			
Maturity of investments	75,000	—	75,000
Life insurance premiums paid	—	(348,503)	(348,503)
Purchases of equipment and leasehold improvements	(2,147,866)	1,129,809	(1,018,057)
Product software development expenditures	—	(1,053,738)	(1,053,738)
Net cash used in investing activities	(2,072,866)	(272,432)	(2,345,298)
CASH FLOWS FROM FINANCING ACTIVITIES:			
Dividends paid to stockholders	(1,920,586)	1	(1,920,585)
Purchase of treasury shares	(43,640)	20	(43,620)
Net cash used in financing activities	(1,964,226)	21	(1,964,205)
Net decrease in cash and cash equivalents	(1,658,466)	(4,891)	(1,663,357)
Cash and cash equivalents at beginning of year	3,322,873	(160,640)	3,162,233
Cash and cash equivalents at end of year	1,664,407	(165,531)	1,498,876

Source: Koss Corporation 10-K/A dated 6/20/1009; filed 6/30/10

In the 10-K/A, Koss Corp. lists several remediations to internal control over wire transfers and cashier's checks, including disallowing the use of any cashier's checks, enforcing that all wire transfers are initiated within the financial function and electronically approved by the CEO, and performing an enhanced review, reconciliation and reporting of cash activities.

The 10-K/A also notes that $600,000 was misappropriated by violating the company policies over petty cash, manual checks and traveler's checks. As a remedy, the company responded by eliminating the petty cash fund so that all reimbursements run through the normal accounts payable system and also by eliminating the use of manual checks and traveler's checks.

The 10-K/A notes other improvements to internal control including improved controls and procedures related to journal entries and account reconciliations with improved segregation of duties, review and approval of reconciliations, and approval of all manual journal entries.

THE AFTERMATH

Koss' external auditors, Grant Thornton, were terminated days after the fraud was uncovered. Koss Corp. as well as its shareholders sued Grant Thornton for failing to uncover the fraud. In August, 2011, the shareholder class action lawsuit against Grant Thornton was dismissed (Hajewski, 2011). The U.S. district judge in the case, Lynn Adelman ruled that the occurrence of fraud and subsequent failure to detect it does not imply willful, knowing or reckless behavior on the part of Grant Thornton; rather, the firm was found to be negligent. Koss' case against Grant Thornton for negligence was finally settled when the company collected $8.5 million from the accounting firm on July 3, 2013 (Spivak, 2013).

Koss shareholders also filed a lawsuit against Michael Koss and Koss Corporation. Judge Adelman dismissed claims of willful or reckless behavior on the part of Michael Koss. The case against the company and Michael Koss as the person in control of the company is still open.

On July 16, 2010, Sachdeva pleaded guilty to six counts of wire fraud. On November 17, 2010, she was sentenced to 132 months in prison and ordered to pay restitution of $34 million. On March 8, 2011, she was suspended from appearing or practicing before the SEC.

The SEC has also filed suit against Julie Mulvaney, a former assistant to Sachdeva. The SEC is charging Mulvaney with aiding and abetting in the fraud. A trial date is schedule for 2012. In her deposition, Sachdeva testified that Mulvaney assisted with the embezzlement.

Koss Corp. sued American Express, alleging that American Express waited too long to report the wire transfers to Koss. The suit against American Express was dismissed, but Koss has the option to appeal. Koss Corp. has also sued several banks for failing to discover the fraudulent transactions – these suits are pending.

In an unusual move, the SEC initiated enforcement action against Michael Koss. Michael Koss settled with the SEC in October, 2011. As part of the settlement, Michael Koss must pay back bonuses of $450,000 cash and also 160,000 options.

CASE QUESTIONS

1. Exhibit 1 provides annual estimates of fraud committed by Sachdeva. What can you conclude by examining this trend?
2. Examine the originally reported and restated financial statements for fiscal 2009 (Exhibits 2, 3 and 4). What do the restatements tell you about how Sachdeva concealed her fraud?
3. In general, auditors perform substantive testing to uncover balance sheet errors. What steps could the auditor in this case, Grant Thornton, have taken to verify various balance sheet items? Assuming that the auditors performed receivable confirmations, what possible methods could Sachdeva have used to circumvent audit checks?
4. Who are the various stakeholders in this case?
5. Who is at fault in this case? Discuss the role of the auditor in providing assurance on financial statements.
6. The most controversial aspect of SOX is its requirement of an adequate system of internal control. This requirement was instituted to prevent the type of fraud that Enron and WorldCom symbolized. What internal control elements were missing in this case?
7. In your opinion, should smaller public companies be exempted from SOX 404(b)?
8. Do you think that the auditors' responsibility in auditing small public firms that are exempt from Section 404(b) of SOX is different from their role in auditing large accelerated filers that are subject to SOX 404(b) reporting requirements?
9. The relationship between regulation and ethics is often unclear. Discuss the key ethical issues in this case and speculate on how the SOX regulation possibly played a role in Koss' ethical environment.

TEACHING NOTES

Teaching notes are available from the editor. Send a request from the "For Contributors" page of the journal website, http://gpae.bryant.edu.