H.S. Grace & Company, Inc.

Embezzlement: Bank Liability
Role of Governance and Control Processes

Allegations

X Bank was sued in connection with an embezzlement in which X Bank had permitted the embezzlers to open a fictitious corporate account at X Bank. FLY, Inc. (FLY), the firm at which the embezzlement occurred, sued X Bank for direct and consequential damages. FLY had filed for bankruptcy subsequent to discovering the theft.

H.S. Grace & Company, Inc. (HSG) was retained by X Bank and its counsel to analyze the business aspects of the litigation and to provide expert testimony. Certain results of our analysis are set out below along with graphics prepared for trial.

Analysis

The Petition stated that, in August of 2001, Smith and Jones, without the knowledge, consent or authority of anyone at FLY, opened a bank account at X Bank under the name of Forwarding Services, Inc. (FSI). The Petition also stated that "Beginning on or about August 2001 while employed by FLY, Smith and Jones devised a scheme to embezzle funds from FLY and deposit said funds into the FSI Account for their personal use; this scheme continued during the entire time that Smith and Jones remained employed by FLY." The Petition went on to state that as a result of the actions and inactions of X Bank, FLY sustained significant consequential damages.

HSG initiated a review of Smith's activities during his employment by FLY as well as the activities of Smith and Jones during their respective tenures. This review indicated a lack of controls in many areas of the operations of FLY as the result of a highly unusual and inappropriate delegation of responsibilities by FLY's owner. HSG found that Smith employed a wide range of techniques and utilized a number of bank accounts and related vehicles in his personal embezzlement of funds and, subsequently, in his and Jones's embezzlement of funds from FLY. HSG found that the FSI Account at X Bank was only one account employed at one point in time. That point in time was the latter stages of what was a lengthy period of embezzling funds which began literally at the outset of Smith's employment, and involved three others banks prior to X Bank.

Smith was hired on or about July 6, 2000 according to the earliest W-4 found. FLY granted him check-signing and wire transfer authority sometime during the month of July 2000. Smith, a low-level employee, was granted these authorities although it appears that no one had done a background check or employment history verification. It is unusual that any employee would be hired, given the responsibilities that Smith was given, without so much as a phone call to previous employers.

HSG reviewed Smith's personal bank accounts and established that Smith began to embezzle from FLY within several weeks of joining FLY, as his first theft appeared to have occurred at least as early as July 25, 2000. HSG's findings indicated that Smith made his decision about his ability to embezzle (and presumably not to get caught) within a few days or weeks of starting to work at FLY, and this decision appeared to have been based on his determination that the internal controls at FLY were so weak that he could embezzle at will. Smith was correct as he embezzled and avoided detection for two and one half years. Interestingly, even when FLY detected the embezzlement, the entire amount of the fraud appears not to have been uncovered. The Petition states that the fraud commenced in August of 2001, whereas HSG established the actual thefts started as early as July of 2000.

HSG found that part of the reason that Smith was able to commence his fraudulent activities so soon after being hired was that there were problems with the production of financial statements at the time of Smith's hire. These were in addition to the serious questions regarding the integrity of the systems and controls in place.

HSG's findings established that Smith used several methodologies to embezzle before the FSI account at X Bank was opened. Initially, Smith had someone approve fraudulent vendor invoices, prepared the checks in payment of these fraudulent invoices and had someone sign the checks, and then Smith would deposit the checks into his personal accounts at banks other than X Bank. Smith continued this activity from July 2000 through October 2000. From November 2000 through August 2001 Smith fraudulently wire transferred funds from various FLY accounts to his personal accounts, none of which were at X Bank.

In the summer of 2001, Jones, in his new role as Controller, discovered Smith's embezzlement activities. Smith persuaded Jones to join him. Together they opened the FSI account at X Bank. Smith and Jones did not require the use of the FSI account in order to continue the embezzlement of funds. They could have continued to use one of Smith's existing accounts. This was supported by the fact that Smith wired four transfers from FLY into his personal accounts in March of 2002. These wires did not go through the FSI account.

HSG's findings pointed out that, because the vendors of the bogus invoices were either current or fictitious vendors, FLY knew or should have known the invoices were fraudulent. HSG pointed out that either the approver did not properly review the invoices or Smith was able to set up vendor invoices for payment without appropriate approval. In either instance, the HSG findings indicated the internal controls at FLY were such that Smith was practically invited to embezzle.

Further, HSG findings revealed the absence of a proper review of monthly financial statements, and a breakdown in the review of monthly bank reconciliations. Either of these could have alerted management to the possibility that fraud was occurring.

Graphics

Graphic #1 sets out certain HSG findings. X Bank was the fourth bank to be utilized by Smith, as opposed to being the only bank connected to the embezzlement. The timeline on Graphic #1 shows that X Bank became involved fourteen (14) months after Smith had initiated his fraud in July 2000. Graphic #2 focuses on FLY's internal control weaknesses and employs the same timeline as Graphic #1.

Result

The matter went to trial. X Bank had liability in permitting the fictitious FSI account to be opened, and FLY had been damaged by the embezzlement. FLY sought direct and consequential damages in excess of $10 million. HSG testified regarding its findings on this matter and its experience with such matters. The jury found that X Bank was liable for none of FLY's alleged

Consequential Damages and less than one percent of FLY's alleged Direct Damages, approximately $5000.

H.S. Grace & Company, Inc. is a team of senior executives who diagnose and resolve critical corporate problems in business governance, operations, finance and control. With more than 1,000 years of experience, our goal is to help companies enhance shareholder value, protect reputation and their long-term ability to succeed, avoid and manage litigation, and navigate major changes such as mergers and acquisitions or bankruptcies. We often serve as consulting and testifying experts, identifying and analyzing critical business issues.

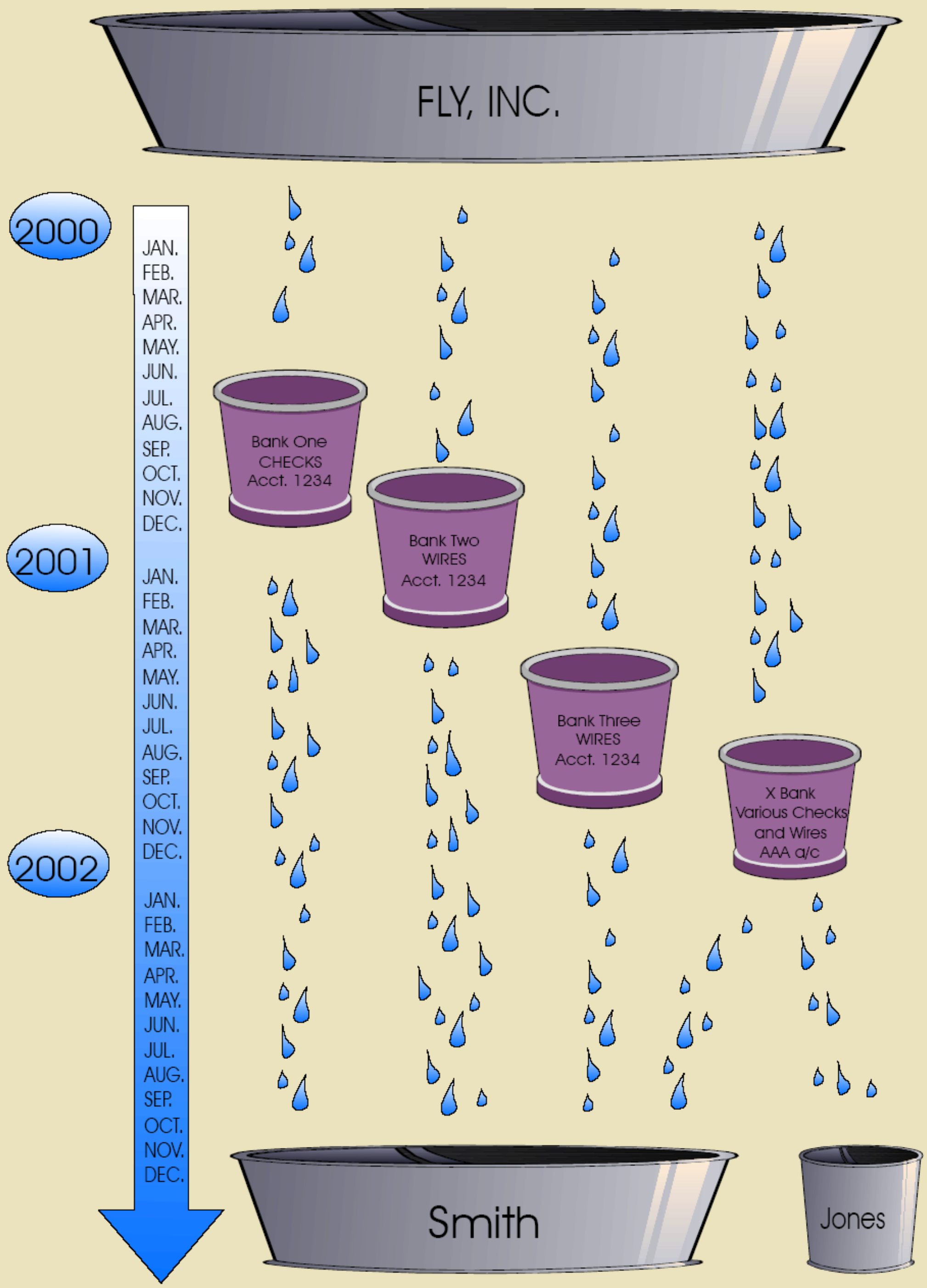
Houston: 4615 Southwest Freeway, Suite 625, Houston, TX 77027
(713) 572-6800 • FAX (713) 572-6806

New York: 300 E. 57th Street, #18A, New York, NY 10022
(212) 644-8620 • FAX (212) 813-1779

Email: hsgraceco@hsgraceco.com
Visit us at: http://www.hsgraceco.com

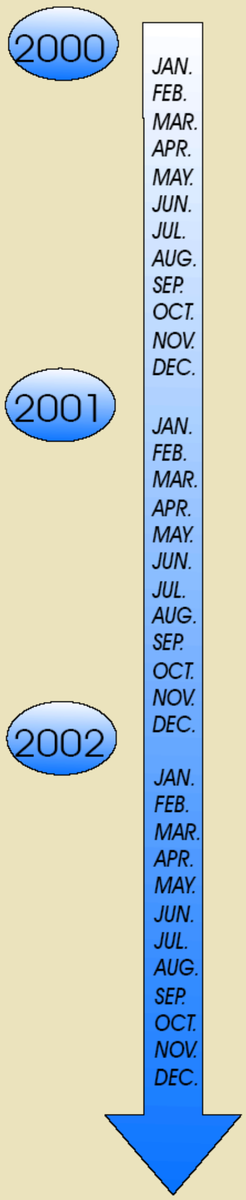
FLY, INC.

SMITH EMBEZZLEMENT ACTIVITIES



FLY, INC.

Apparent Internal Control Weaknesses 2000-2002



Inadequate Hiring Procedures

Failure to Segregate Duties

Lack of Financial Controls

- Deterioration of Bank Reconciliations
- Excessive Year-end Journal Entries to CASH
- Failure to Oversight Cash Flows
  - Operations
  - Damage Model Calculations
- Financial Statements' Weaknesses
  - Timeliness
  - Do not track from Month to Month
  - Do not track from Year to Year
  - Do not agree with Tax Return
  - Fluid, never closed, continual adjustments
  - Monthly Statements Y-T-D totals did not tie to total of individual months
  - Monthly Statements appear to differ considerably from trial balances used to develop tax returns

Lack of External Oversight

Consideration: Employees do not attempt to embezzle unless they believe they will be successful.