

MAYBERRY BANK & TRUST: A CASE STUDY

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On September 14, 2017, news that Barton Ward, a highly respected banker, had been charged with committing a long-running bank fraud rocked residents of Hazzard County. Astonishingly, the reported fraud involved a theft of almost \$1.5 million that occurred over nineteen-years. In executing a search warrant at Ward's residence, police located bank statements, deeds, IRS, and tax returns, including fake identities.

Ward, a senior vice-president of commercial lending at Mayberry Bank & Trust, was charged with 1st-degree Forgery, Filing an Illegal Lien, Possession of a Forgery Device, and Identity Theft. These charges carry a 30-year maximum sentence. The news shocked banking employees, residents of the close-knit community, and banking regulators. Less than one year after the fraud was detected, Big City Bank acquired Mayberry Bank & Trust.

BACKGROUND

Growing up in Hazard County, Georgia, Barton Ward was best friends with Drew Phife. The two, often inseparable, attended the same school and church and played together on the same local ball teams. At suppertime, you would find the two together at one family's home or the other. Unlike the many passing friendships of youth, their friendship only deepened with time. So, when it was time for college, it was little surprise to anyone in Mayberry that the duo settled on the big state university. At college, the two roommates only differed in major. While his friend decided on pre-med, Ward had a mind for business and finished with his Business Administration and Management degree.

Rather than returning to Mayberry after graduation, Ward continued the banking job that he had begun during his sophomore year of college. For Ward, this was a great option on all fronts. He still got to enjoy the atmosphere of college town life

and also remain close to Drew, who was just beginning med school. The bank also appreciated his talent and drive and promoted him into their management training program.

After seven years, Barton felt the tug of home. It was time to return to Mayberry. His banking success had landed him multiple offers over the years, and his work in lending was still exciting to him. However, Barton finally received an offer that he could not refuse when his hometown bank's president came calling. Mayberry Bank & Trust (MB&T) had an excellent reputation in the community, and when they made an offer in commercial lending, it was too good to turn down. Of course, it did not hurt that the offer came from his old friend's father, Andy Phife, who considered Barton a second son.

Back in Mayberry, Ward immersed himself into work at the bank and within the community. He joined several local community organizations, became a regular at the high school athletic events, attended and coached youth sports, and organized fund-raising events for the local boys and girls club. He was Mr. Hazard County. The relationships Ward developed through these activities led to innumerable lending opportunities. As a result, Ward received several promotions before ultimately becoming Senior Vice President over commercial lending.

THE PLOT

In 1998, Ward decided it was time for a raise, but he took a shortcut rather than going through proper channels. Ward made a loan to a fictitious individual and deposited the money into his personal account. The loan was well below Ward's loan limit established by the bank's loan policy. Because of his close connection to Andy Phife, Ward routinely bypassed the secondary approval process required for other loan officers. In other words, he was able to make the loan without obtaining approval from another individual or loan committee. Plus, Ward routinely originated loans exceeding hundreds of thousands of dollars. Given his reputation and stature in the community, no one gave the loan a second thought. This loan was the beginning of a fraud lasting 19 years. From 1998 through 2017, Ward funded vacations, a new house, boats, and children's education at private schools by originating loans to fictitious companies and individuals and depositing the loan proceeds into accounts under his control.

Examples of the fraudulent loans originated by Ward include Steven Austin and Jet Tech. Steven Austin was a wholly fabricated person created by Ward. According to documents prepared by Ward, Austin was a small business owner, the owner of multiple rental properties, and a long-term employee of Acme Inc. Jet Tech was a fictitious business operated by Steven Austin. To perpetuate this fraud, Ward prepared and falsified all necessary paperwork, including federal tax records. By

transferring some of the proceeds from one fraudulently obtained loan to pay on the debt service of other fraudulent loans, Ward was able to conceal his theft for almost two decades.

As the need grew for additional loans to service the outstanding fraudulent debt, Ward continued to originate fraudulent loan after fraudulent loan to fictitious individuals and companies. While the names of the fabricated companies and individuals were confirmed to be fraudulent, the social security numbers and dates of birth were real, belonging to actual Georgian residents.

Throughout the 19-year fraud, Barton Ward obtained loans totaling approximately \$1,440,502, utilizing his position as a loan officer to make loans to fake individuals and illegally acquire money for personal benefit. As part of his scheme, Ward created all necessary documentation to originate the loans, including fake tax returns, credit reports, applications, brokerage account statements, property deed filings, certificates of insurance, and Uniform Commercial Code filings.

THE BILL CAME DUE

In September 2017, a new internal auditor arrived at MB&T, who was unaware of Ward's privileged position at the bank. Caroline Bragg was not content to take things at face value. Instead, she dove into the details of her work and one of Ward's most recent loans. Although the loan paperwork seemed in order, Bragg still could not track down the loan recipient. As an experienced auditor, Bragg knew something was off and alerted her superiors. When Andy Phife heard the news, he immediately reached out to a friend who just also happened to be a Mayberry Police Department detective. From the start, Andy suspected that this was only a single indiscretion by a trusted employee and friend who had perhaps fallen upon hard times or bad habits. In an attempt to keep everything quiet, Andy allowed undercover detectives to assess the situation at MB&T. When they uncovered the depths of Ward's schemes, MB&T's management immediately notified the FBI and the FDIC. They, together with local law enforcement, conducted a thorough investigation. During a night-time search of Ward's residence, authorities discovered a trove of bogus bank statements, counterfeit deeds, forged and falsified loan documents, and fraudulent tax returns used to secure the loans made to MB&T's fictitious customers. As one Mayberry officer who was involved in the search later observed, "Once we got ahold of his files, we saw what he was doing. It fell apart like a house of cards."

At Ward's arraignment, an MB&T representative told the local press that the matter was discovered earlier that week through the bank's internal controls. They immediately reported their suspicions to the authorities. A criminal investigation was immediately launched into the matter by local authorities, the FBI, and the

Federal Deposit Insurance Corporation (FDIC). The representative also stated, “This brilliant fraud perpetrated by a trusted member of the MB&T family was discovered as the result of our effective internal control system and the remarkable efforts of compliance and audit personnel.” The representative attempted to relieve customer fears by stating, “...no customer information or accounts were compromised.”

THE PLEA

With Ward facing a 30-year maximum sentence, it took little effort from his attorney Saul Coleman to persuade his client to take a plea deal. In December 2017, Ward pled guilty to one count of bank fraud in U.S. District Court. In his plea deal, Ward acknowledged his scheme began in May 1998 and continued through July 2017. The agreement listed fifteen fraudulent loans ranging from \$20,000 to \$245,000. Of these loans, the ones with current remaining balances dated from 2005 to 2017. Coleman offered that his client’s scheme began as a “bad decision” to take out the initial loan before ultimately spiraling out of control. The court ordered Ward to make restitution of \$1,440,502 (the total amount of losses experienced by MB&T. On April 30, 2018, Ward was sentenced to 51 months in federal prison by U.S. District Judge Charles H. Thrash.

AFTERSHOCKS

Ward’s wife, children, and extended family were devastated to learn of his long-running deception. Following his conviction, his wife filed for divorce, and his children refused to visit him in prison. As Mayberry’s town began to slowly recover from the shock of the fraud and life at MB&T started to settle into a new norm, things were far from settled concerning the bank’s future. In fact, more waves were on the way. In July 2018, MB&T’s board unanimously approved a merger with Big City Bank, such that Big City Bank would be the surviving institution. The acquisition of Mayberry Bank & Trust had an aggregate deal value of \$95 million.

Appendix A

GENERIC CREDIT PROCESSES FOR A COMMUNITY BANK

Commercial lending requires experience, expertise in making different types of loans, and knowledge of the customer and their business. Commercial banks must have a lending policy reviewed by the Board of Directors and provided to the lenders to give them guidance and rules for making different types of loans. Some of the items included in the loan policy include:

- Customer requirements for the loan such as an application and financial statements
- A list of documents needed by the lender for loan approval
- Requirements for perfecting the loan (ex. Filing a mortgage with the county or an auto title with the State)
- Required loan covenants
- Lending authority levels
- Loan review administration

The loan policy will state approval limits for each level of lenders, loan committees, and the board of directors. Junior lenders may have the authority to approve loans up to \$100,000, and senior lenders may have the authority to approve loans up to \$250,000. Loans from \$250,000 to 500,000 may require the approval of a loan committee consisting of junior and senior lenders. Any loan over \$500,000 will require board approval.

Loan review administration is a vital department separate from the lenders and reports directly to the board of directors. The loan review officers' function is to analyze and assign a grade to the loan based on the loan risk after making sure the lender followed the loan policy. The loan review administration will track the loan to ensure all the loan requirements continue to comply.

The purpose of the loan policy and loan review administration is to provide checks and balances to reduce fraud. In some cases, the loan review process is unsuccessful because the reviewers are too comfortable with the lender and fail to follow up on loan issues. A strong relationship can develop over time between the lender and the loan review officers, and the loan review department trusts the lender will correct any problems with the loan. Fraud in lending will sometimes occur when the lender knows loan review is slack in assessing the loans booked, and if the lender has a too high level of access to the processing system, which allows system changes to loan by the lender.

The loan policy and the audit policy should support each other to limit the opportunity for fraud. Both policies should clearly describe the checks and balances

required, have a continuous review process, and make policy adjustments when conditions change. When lenders have too much lending authority, access to incompatible functions within the bank's processing system, the bank faces an increased risk of fraudulent activity.

Appendix B

INTERNAL CONTROL BACKGROUND

Early audits consisted of detailed tests of transactions, with near 100% coverage. As audits transitioned from detailed testing of almost all transactions to testing a sample of transactions, it became necessary for auditors to consider a company's internal control system as part of the audit of a company's financial statements. As a result, in 1941, the Securities and Exchange Commission adopted amendments to Rules 2-02 and 3-07 of Regulation S-X that formally codified the requirement that auditors consider internal controls as part of the audit of a company's financial statements (*Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238, n.d.*).

Companies subject to the Securities and Exchange Commission (SEC) are required to disclose material weaknesses³ in internal controls over financial reporting (ICFR). These requirements result from Congress enacting a series of laws in response to corporate governance failures requiring companies to design, implement, and maintain effective ICFR. Beginning with the Foreign Corrupt Practices Act (FCPA) in 1977, Congress has slowly increased companies' ICFR requirements, and as a result, the cost of compliance has increased as well. Before 1977, there were no regulatory requirements that companies design or implement an effective system of ICFR. We present a brief history of internal control regulation in the United States in the following paragraphs.

Foreign Corrupt Practices Act. Congress enacted the FCPA in the wake of the Watergate political scandal and the discovery that hundreds of U.S. companies had paid bribes to foreign officials and falsified their corporate records to conceal the payments (Breuer & Khuzami, 2012). The FCPA established the first legal requirement that a company devise and maintain a system of internal accounting

³ A material weakness in ICFR is defined as: "...a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis (*AS 2201, 2007 Paragraph A7*)."

controls and established civil and legal penalties for a company that failed to comply with the FCPA's accounting requirements. It did not, however, require companies or their auditors to identify and report deficiencies in internal control systems (Section 13(b)(2)(A) of the Exchange Act, 15 USC § 78m(b)(2)).

Federal Deposit Insurance Corporation Improvement Act. Following the savings and loan crisis of the 1980s, Congress enacted the FDIC Improvement Act of 1992 (FDICIA). FDICIA applied to all financial institutions with deposits insured by the Federal Deposit Insurance Corporation and required companies to evaluate the effectiveness of companies' system of ICFR by comparing it to an established framework, disclose the framework used, and disclose any material weaknesses in internal control (MWIC)⁴ identified during the evaluation of the system of ICFR.

Sarbanes-Oxley Act of 2002. SOX was the third law enacted by Congress relating to ICFR and was developed in response to significant corporate failures such as Enron and WorldCom. Sections 302 and 404 of the Act are two of the Acts most contentious provisions because of the requirement for management to assess the effectiveness of the firm's ICFR and the auditor to express an opinion on management's assessment of ICFR (Alexander et al., 2013; Ge et al., 2017). Section 302 requires, among other things, that management must disclose in a company's quarterly and annual report an acknowledgment that they are responsible for ICFR and their conclusions about the effectiveness of the company's ICFR (Sarbanes-Oxley Act of 2002 § 302(a)(4)). SOX Section 404 requires that each annual report explicitly state management's responsibility for ICFR and contain an assessment as of the end of the most recent fiscal year of the effectiveness of the internal control structure and procedures (Sarbanes-Oxley Act of 2002 § 404(a)). Therefore, SOX provides the first legal requirement that companies publicly disclose M.W. and that an independent auditor attest to management's assessment of ICFR.

Following the enactment of the Sarbanes-Oxley Act of 2002 (the Act or SOX), practitioners and academics primarily focused on internal controls over financial reporting (Ashbaugh-Skaife et al., 2008, 2009; Chan et al., 2008; Doyle et al., 2007; Ge et al., 2017; Ge & McVay, 2005; Goh, 2009; Lawrence et al., 2018).

⁴ According to the Public Company Accounting Oversight Board (PCAOB), a company's ICFR is effective if no material weaknesses exist (AS 2201, 2007).

Internal Control Framework

The COSO framework is the most widely used framework for assessing internal control effectiveness in the U.S. (Lawrence et al., 2018). In 1985, several key stakeholders in the financial reporting process, including the American Accounting Association, the American Institute of Certified Public Accountants, Financial Executives International, the Institute of Internal Auditors, and the Institute of Management Accountants formed the Committee of Sponsoring Organizations (COSO) to sponsor the National Commission on Fraudulent Financial Reporting (the Treadway Commission). COSO published its initial internal control framework in 1992 and updated the framework in 2013.

COSO defines internal control as “...a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance” (Landsittel & Committee of Sponsoring Organizations of the Treadway Commission. COSO, 2013). COSO’s framework includes three objectives (operations, reporting, and compliance) and five components (environment, risk assessment, control activities, information and communication, and monitoring). The objectives and components relate to all levels of the organization (Landsittel & Committee of Sponsoring Organizations of the Treadway Commission. COSO, 2013). Therefore, improvement in one of the internal control components, such as the control environment, should improve the controls related to compliance, operations, and financial reporting.

Beyond COSO’s broad definition of internal controls, suggesting that an effective internal control system reaches beyond financial reporting, more effective ICFR leads to higher quality information for management decisions, which leads to better decisions and better-operating results (Feng et al., 2009; Li et al., 2012).