Follow the Money

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Although the names have been changed, this case is based on actual events that occurred at a small college between 1987 and 2003. The college operates a child development center under the auspices of its Child Development Department. A faculty member whose child is at the center discovers that her checks are not being cashed on a timely basis and complains. The college accountant discovers that funds are being misdirected and deposited in an unauthorized bank account. She also discovers that the program revenues are $12,000 short out of a budget of just over $50,000. It is further uncovered that a long term employee of the college opened an unauthorized bank account over 15 years ago and has embezzled almost $200,000 over that period. This employee kept records of all transactions and the methods and extent of the fraud are explained in the case. The issues of internal control and adequacy of policies and procedures are presented. Students are asked to present their analysis of the current accounting procedures, along with recommendations for improving the procedures to prevent future fraud. Students are also asked to address the responsibilities of the college's auditors.

This case is suitable for undergraduate classes where the topics of internal control and accounting systems are presented. Safeguarding of assets, separation of duties and employee theft are possible topics for discussion. Students will analyze the current flow of accounting information and address inadequacies in the current system.

THE PROFESSOR

Abby Young was not having a good day. She was juggling motherhood, marriage, and a career at St. Agnes College, and one more thing was stressing her out. How did it make sense that she taught accounting and couldn't get her checking account to balance?

Abby had given birth to her first child in December, 2001, and had taken a leave of absence in the spring semester to bond with her son. She went back to full time teaching at the end of August and had placed her son in the child development center on St. Agnes campus. The center was expensive, $825 per month, but she was confident that her son received excellent care and he was just a five minute walk from her office. For $825 per month, Abby expected excellent service in all matters, and her checking account reflected that the child development center had not cashed her checks for October, 2002, or March,

2003. Abby ran into Lauren Davis, St. Agnes' controller, as she was walking back to her office. "Lauren, I'm really worried about this day care situation. They aren't cashing my checks. Do you think they'll say I haven't paid them, or that I was late in paying? There is a huge waiting list at the center, and they only allow 7 children. I can't risk losing my son's placement in the day care center because someone else was inefficient. What should I do?" Lauren was at a loss as to how to advise Abby and she wondered if she should review the college's internal control procedures. Perhaps there was something missing in the process that merited investigation. "No," Lauren said to herself, "All of the employees in the child development center have been with us for a long time and I know them well. There's just some mix up."

Abby asked the director of the child development center if she knew anything about the missing checks, but she was told that the checks had been sent for deposit as usual. Abby followed the trail by going to Mary Turner, the departmental assistant for the Department of Child Development, which included the child development center. Mary was a 62 year old woman who had been at the college since 1986. She was well liked and easy to talk with and Abby felt that she might finally get some answers. Mary just shook her head when she heard about the problem and told Abby that the accounting office tended to be pretty inefficient and suggested that Abby check with them. Abby was not surprised when the accounting office didn't immediately solve her problem.

A SHORTFALL IN REVENUE

In the summer of 2003, St. Agnes' Vice President for Finance, Bob Williams, noticed that revenues for the child development center were significantly under budget. He had been told by the director that the child development center had been operating at full capacity with an extensive waiting list. The total budget for the center was just over $50,000 per year, and the revenues appeared to be $12,000 short. He asked the Head of the Department of Child Development if she had any information. She was baffled, but was concerned because if the center wasn't self-supporting, it would have to be closed or subsidized from other departmental funds. Neither option was acceptable to her since students needed the center to enhance their studies and she didn't have sufficient funds from other sources to subsidize the child development center by $12,000. She discussed the problem with Mary Turner, her departmental assistant, and became even more discouraged when Mary told her of the inefficiencies in the accounting office. Bob Williams' staff seemed to have lots of problems and they were making problems for her. She was lucky to have good employees like the director of the child development center and Mary Turner. She knew that Mary was approaching retirement age and couldn't imagine having to train her replacement with so little support from accounting.

Bob Williams decided that he needed more information about the shortfall in revenues in the child development center and asked his controller, Lauren Davis, to investigate. Lauren was a graduate of St. Agnes and was well-respected on campus. She also knew almost everyone on campus and Bob reasoned that it would be easy for her to get information and cooperation to resolve any problems. Lauren called Mary Turner and asked for copies of her deposit slips. Her plan was to compare the deposit slips with records in the accounting office to determine if some of the deposits were posted to the wrong accounts. A comparison indicated that something was wrong and Lauren decided to do some research and verify procedures for handling funds from the child development center.

THE PROCEDURES

The accounting procedures for the child development center documented by Lauren included the following. Parents paid the director of the child development center $825 per month for each child. Funds were usually paid in check, although occasionally a parent would pay in cash. The director kept a log of all payments, photocopied each check and prepared a deposit slip. She took the funds and the deposit slip to Mary Turner, who took them to the college's accounting office for deposit to the child development center account.

Mary handled funds for student clubs within the department as well as for the child development center. Mary took the deposit slips and funds to the accounting office and got a receipt. She filed all the receipts according to which club or activity was depositing the funds.

Each month a detailed printout of deposits and disbursements for each department was sent to the department head. The Head of the Department of Child Development received these reports, but had delegated to Mary's the reconciliation of the accounts. Each month Mary got a printout from the accounting office which detailed all deposits and disbursements from the various departmental accounts. She reconciled these printouts with her records and reported any unusual items to the Head of the Child Development Department.

THE PROBLEM

Lauren was unable to reach Mary by telephone and was anxious to get on with her "investigation." She reasoned that the director of the child development center was the originator of the deposits, so she called the director of the center and asked for copies of her documents. Since the director's deposits were taken to Mary, Lauren reasoned that it shouldn't matter which was the source of her deposit slips, since the records from the

Child Development Center and Mary's records should be identical. Lauren planned to compare the director's records with the deposits in the accounting office and was looking for missed or lost deposits. Lauren thought that deposits might have been keyed to the wrong accounts and that everything could probably be straightened out easily. Lauren found unusual differences in 3 different months. In each of these cases, the director's deposit slips didn't agree with actual deposits. Lauren again asked for copies of Mary's records so that she could compare the records from the child development center, the accounting office, and Mary's records.

The Child Development Department was housed in temporary space because their permanent space was being renovated. Mary told Lauren that the records she wanted were in a box which was locked in the old building, but that she would get them as soon as she could. Repeated calls to Mary went unanswered. Lauren thought this was very unusual since Mary was a friend of hers and was generally very responsive to requests. When Lauren finally called the Head of the Child Development Department, she learned that Mary had been out sick for several weeks with a serious illness. Lauren was sorry to hear that Mary was sick, but was relieved to know that Mary wasn't avoiding her. Mary finally brought information and documentation to Lauren, but the three requested months weren't among the information delivered. Lauren wasn't unduly concerned about the delay because by now the Child Development Center was closed for the summer and would not reopen until mid August.

Lauren searched the information and found that Abby Young's checks were on two of the child development deposit slips that included checks from another employee with whom she was friendly, Jody James, the Dean of Students. Lauren had searched the accounting records for the deposits in question and couldn't find them deposited to any other account. Thinking that the deposit might have been lost, Lauren called Jody to see if her checks had been cashed. Jody told Lauren that her checks had cleared the bank and Lauren asked to be allowed to examine the cancelled checks. How could some of the checks on a deposit have cleared, while others did not?

When Lauren inspected Jody's checks, the checks were revealed to have been deposited to a St. Agnes College account at B&S Bank. This presented a real problem for Lauren, since St. Agnes had no accounts at B&S Bank. Lauren went to Human Services and found that Mary's personal checking account was at B&S Bank. Fearing that Mary might be depositing the checks to her personal account, Lauren got direct deposit information for Mary's account at B&S Bank. The funds were not going to Mary's personal account.

Bob Williams instructed Lauren to contact B&S Bank and get additional information. Lauren called B&S Bank Customer Service and was assisted by a Customer Service

Representative who was a St. Agnes graduate. When she realized the depth of the problem, the Customer Service Rep wouldn't give information to Lauren because she wasn't a corporate officer. Bob Williams was required to appear personally at the bank with official St. Agnes authorization in order to get information. He was told that there was a St. Agnes, but there wasn't a corporate resolution or signature card on file for this account. Mary Turner had opened the account in 1988 and promised to return with both a corporate resolution and a signature card, but she had never done so. Mary Turner was the only authorized signer for the account. Bob requested copies of the bank statements, checks, and deposits for the past three months. The deposits included amounts that appeared to be club account funds as well as child development center funds. The majority of the checks were made payable to Mary and were also signed by her. The checks were always for random amounts and had a notation in the memo area – e.g., $37 stamps, $102 supplies, $437 travel reimbursement.

At about the same time as the investigation was progressing, Mary applied for retirement. Although she was of retirement age, her retirement plans were rather sudden and the Department of Child Development employees were disappointed that she was leaving. Planning began for a retirement party to honor Mary for her many years of service to the College. The party was scheduled for Friday, October 10.

THE CONFRONTATION

After obtaining information from B&S Bank, Bob and Lauren talked with the Vice President for Academics, since the Department of Child Development was in his area. Bob also notified the President of St. Agnes, since there was a distinct possibility that the media might hear something about this. Bob next called the Head of the Department of Child Development and asked her to join him in his office. As she was leaving for Bob's office, she said to Mary, "There must be something important going on, I've never been invited to Bob Williams' office before." Bob explained what they had found and asked her if she had any information which might explain the situation. She knew nothing about the problem and was visibly shaken. Mary had been a long time employee and was a trusted friend. The Department Head decided not to return to the office for the day.

On the same day, Bob and Lauren met with Mary. Bob showed Mary what Lauren had found – a total of $2,400 in missing funds. Mary quickly admitted she had taken the $2,400 and was immediately terminated. The termination occurred three days prior to the scheduled retirement party. Mary asked for permission to clean out her office, but Bob denied the request, instead escorting her to her office to get her purse and then escorting her off campus.

MORE FACTS ARE UNCOVERED

The next day, Lauren went to Mary's former office and found a checkbook and bank statements with entries dating back to 1986. All checks written to Mary were entered in pencil, while checks to other parties were in ink. The shredder was full of shredded checks. Lauren discovered that there were not one, but two bank accounts and that the misappropriations had been going on for over fifteen years. The first bank account had been closed in 1988 when Bob Williams first came to St. Agnes as Controller. In an attempt to control access to all funds, College policy was changed in 1988 and no clubs or departments were allowed to have bank accounts except through the accounting office. The first account controlled by Mary was legitimate and was closed when the policy changed in 1988.

The second account was opened within two or three weeks of the closing of the first account and was at a different bank. Mary had access to St. Agnes' federal ID number from the first account and opened the second account without the required signature card or corporate resolution. The second account was used for a mixture of legitimate organizational purposes as well as for her own unsanctioned purposes. Mary kept excellent records and the checkbook for the account had information on every check written on the account since it was opened in 1988. Checks for legitimate purposes had the entry and data entered in ink. Checks written to Mary or to cash had the date and amount written in pencil and there was no payee entered on the stub.

THE TIP OF THE ICEBERG

Closer inspection of the two accounts maintained by Mary revealed that the problem was much larger than $2,400. Mary maintained that the checks written to herself on the first account were for legitimate purposes. She said that she would cash checks and give the funds to students for legitimate purposes. She admitted that checks written to herself from the second account were "probably" not given to students. After lengthy analysis, Lauren discovered that almost $200,000 was missing. Because the total amount of the misappropriated funds was well over the $100,000 amount which would constitute a felony, the college decided not to contest the checks to Mary written on the first account. Mary was charged with two separate incidents of embezzlement, as the law pertaining to embezzlement was changed in late 1997.

Lauren and Bob verified that each year the independent auditors for the college sent confirmations for all college bank accounts. Standard auditing procedures require that confirmations are sent to all banks where St. Agnes has accounts, but not to banks where no accounts were supposed to exist. Occasionally a confirmation would reveal that a club or department had opened an account in violation of college policy. In these cases, the employee was unaware of college policy and the accounts were closed immediately. No official sanctions were taken in these situations.

The Vice President for Finance and the College Accountant are both CPAs and have many years experience. St. Agnes has been audited each year by an excellent accounting firm. Each year, the auditors' opinion had not disclosed any unusual circumstances.[See Appendices A and B for additional information.]

Lauren saw the Vice President for Finance who asked her "What have you learned, Lauren? And what is your suggestion about how to proceed?" Lauren was thoughtful and then responded, "Well, I've learned a lot. As a beginning, we need to review our policies and procedures. Let's meet next Monday."

REFERENCES:

AICPA Statement on Auditing Standards (SAS) No. 82, "Consideration of Fraud in a Financial Statement Audit," February 1997.

AICPA Statement on Auditing Standards (SAS) No. 99, "Consideration of Fraud in a Financial Statement Audit," November 2002.

AICPA website, October 28, 2004
http://www.aicpa.org/antifraud/educators_students/Understanding_SAS99/Requirements_of_SAS99_edupkg_classroom_use/93.htm

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Appendix A
Overview of AICPA Statement of Auditing Standards SAS No. 99 "Consideration of Fraud in a Financial Statement"

The following are highlights of the content of SAS No. 99, Consideration of Fraud in a Financial Statement Audit.

- According to the guidance in SAS No. 99, Consideration of Fraud in a Financial Statement Audit, an audit should be planned and performed to obtain reasonable assurance that the financial statements are free of material misstatements. Audits require due professional care.

- Financial misstatements may be caused by error or fraud. Fraud encompasses both a) fraudulent financial statements, due to false records or omission of transactions and b) misappropriation, which includes theft and unauthorized expenditures.

- Audits should be approached with professional skepticism. This means the auditor has a questioning mind that seeks to critically assess audit evidence. The auditor recognizes the possibility of material misstatement due to fraud and looks for persuasive evidence.

- The conditions that can lead to fraud – and that make up the "fraud triangle" – are incentive or pressure, opportunity and rationalization.

- Steps involved in considering the risks of fraud in an audit include:
    1. Staff discussion.
    2. Information gathering.
    3. Risk identification.
    4. Risk assessment.
    5. Responses to results of the assessment.
    6. Evaluation of audit evidence.
    7. Communicating about fraud.
    8. Documenting consideration of fraud.

AICPA website, October 28, 2004
http://www.aicpa.org/antifraud/educators_students/Understanding_SAS99/Requirements_of_SAS99_edupkg_classroom_use/93.htm

Appendix B

The following email was sent by the Vice President for Finance at St. Agnes College prior to its most recent audit in July, 2004. This email presents evidence that St. Agnes and its auditors are following current AICPA requirements.

"As you are likely aware, our independent auditors are in the process of conducting their annual examination of our financial statements and records. The purpose of this annual examination is to provide assurance that we maintain our records and prepare our financial statements based on policies and procedures prescribed by certain regulatory bodies. As a result of their examination, the auditors express to our Board of Trustees their opinion regarding our financial statements.

Two regulatory bodies play a significant role in the audit process. The Financial Accounting Standards Board (FASB) provides rules and regulations about financial record keeping, appropriate accounting methods, and financial statement presentation including required financial statement disclosures. The Auditing Standards Board (ASB) provides guidance to the auditors regarding the audit procedures they use in their examination. From time to time, to adjust to changing times and environments, new rules and regulations will be announced. To comply with these new rules and regulations we will adjust our financial statement presentation or our accounting procedures or the auditors will adjust their audit procedures.

In November 2002, in response primarily to a good number of well publicized cases of corporate fraud and financial statement misrepresentations, the ASB issued Statement of Auditing Standards (SAS) Number 99 - "Consideration of Fraud in a Financial Statement Audit". Although it has never been (and still isn't) the auditor's responsibility to detect fraud that does not result in material misstatements of financial statements, this new Statement does prescribe additional audit procedures the auditors must use to look for areas where fraud, or the opportunity for fraud, might exist.

One of the new procedures required by SAS 99 is for the auditors to interview certain individuals outside the direct Accounting or Business Office function to identify potential problem areas. You have been selected as the individuals that they would like to interview to comply with this new procedure. You were selected based on the responsibility and authority of your position, and/or due to your access to College resources, records, and/or data.

Someone from the independent accounting firm will be contacting you directly to schedule a time (probably 30 - 45 minutes) to talk with you. Please be very open and honest with them in answering their questions. We welcome these conversations as an opportunity to identify areas where we might need to modify policies and procedures to protect both the College and our employees.

Thank you for your cooperation with this process and let me know if you have any questions."