

Asset misappropriation and the death of a mayor

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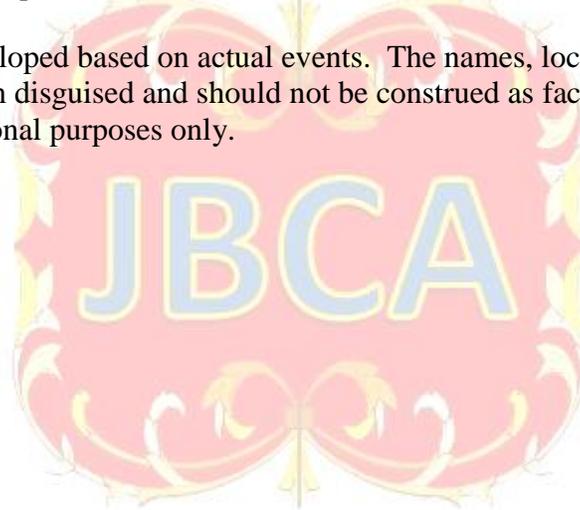
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ABSTRACT

This case discusses the misuse of a city-issued procurement card. The case allows students to examine internal control processes and discuss the role of internal controls within an organization. The case addresses issues applicable to courses in Auditing, Government/Non-profit Accounting, and Strategic Management which emphasizes internal controls.

Keywords: Asset misappropriation, Audit, Fraud, Internal controls

Note: This case was developed based on actual events. The names, locations, policies, statements, etc. have been disguised and should not be construed as factual. The case should be used strictly for instructional purposes only.



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BASIC FACTS OF THE CASE

It was a storybook wedding in Florida in 1989 for Rachel and David Lawson. Two years later the couple gave birth to a beautiful baby girl, Ashton. In 1995 the family decided to move from Florida to Texas. They settled in a small very affluent city with a population of about 40,000. They purchased a home valued at nearly \$500,000. They seemed like the ideal family.

David was an engineer earning a lucrative six figure salary. Rachel was a contract software developer primarily working from home. Their lifestyle afforded Rachel the ability to become a very active community leader. She served as the President of her daughter's Parent Teacher Association for three years. She was also an executive director on the board of the local Chamber of Commerce. Rachel was known for her commitment to her family and community. It was no surprise when she ran for the position of City Council Member and won. A spirited and loyal public servant, Rachel served as a council member for 10 years. As Rachel was actively serving her community, her husband became ill.

David was diagnosed with an aggressive form of cancer. The family expended significant resources for doctors, medicine and the best possible care for him. After taking out a second mortgage on their home, it appeared that David was doing better. Rachel decided to run for mayor. Just as she made her intentions known, David died. The family and community mourned his loss. After several weeks Rachel decided to continue with her mayoral efforts. She won her mayoral bid unopposed. It appeared that she and Ashton were rebuilding their lives, despite their loss. Ashton was preparing to go to college. She gleefully shared with friends her excitement about being accepted to one of the more prestigious universities in the state. As a gift to her, Ashton's mom gave her a new car.

As mayor, Rachel did not receive a salary, but was given a city credit card to use for business related expenditures. Her primary source of income was derived from her contract work as a software developer. Her work however was not consistent. Although David had a lucrative career, they had never planned for the loss of his income. The life insurance policy that he had was less than adequate to cover the monumental medical costs that the family had incurred. Rachel was experiencing increased financial pressure particularly with the prospect of her daughter's additional college costs.

It seemed that no one was privy to the financial strains that Ms. Lawson was experiencing. She had serious financial problems which included a foreclosure notice on her home and a lien for non-payment of homeowner's association dues in excess of \$1,200. To sustain minimal living standards and maintain the respect that she had earned in the community, Rachel began to use the city-issued credit card to supplement her income and pay for certain living expenses.

The city has a process by which purchases made on the city-issued card are reviewed periodically, monthly. Figure 1 (Appendix) shows the general process by which purchases should be made, approved and paid. The cardholder is required to periodically and/or upon request submit detailed itemized reports with supporting receipts. Additionally, the Purchase Policy states that a cardholder is not allowed to use the city-issued card for more than five (5) transactions per day. Each cardholder signs the Purchase Policy when a card is issued. Thus they are aware of the policies. The policy specifically states that the following are non-appropriate expenses:

- Any item costing more than \$1,000
- Items of personal use

- Alcoholic beverages
- Cash advances, money orders, or other cash/capital outlays
- Maintenance and repair items
- Payments for services

During Rachel's first nine months as mayor she used the city-issued card for both personal and city related purchases. During three reconciliation cycles, the charges were brought to the City Manager's attention. He followed up by speaking to Rachel about the charges that seemed personal in nature. When questioned during this time, she responded by reimbursing the city for those personal purchases. The purchases included fees for a rental car, clothing, and purchases from a "big box store" for household items.

Subsequently, Rachel used the card again for more purchases that seemed personal. When questioned about the purchases by the City Manager, Rachel promised to make the reimbursement payments for the personal items and provide receipts for the remaining charges (presumably city related). However the payments were not made and reconciliation reports were not provided. During the following months additional charges were billed to the card which seemed personal. In particular there were charges for: \$1,938 for car rental, more than \$500 for gas, \$700 for groceries, \$425 for telephones and \$958 for restaurants. The City Manager increased his persistence. The mayor however began to evade him with a myriad of excuses, some seemingly very plausible. The City Manager conceded to the Mayor's multiple requests for postponements. After five months of postponements, no reconciliations and no accompanying receipts, the City Manager became increasingly concerned. The Mayor began requesting additional copies of statements, claiming her reconciliation could not be completed because she lacked source documents necessary to provide the requested receipts. The Finance Manager's assistant hand delivered the statements to the Mayor's office. For six months the City Manager unsuccessfully tried to discuss the charges with the Mayor; charges which totaled approximately \$6,500. For six months the Mayor avoided providing a detailed reconciliation of the questionable charges. Finally, on the afternoon of July 12th, the City Manager informed the Mayor that the unresolved issue would be turned over to the City Attorney for further investigation.

On July 13th the regularly scheduled City Council meeting was held. The Mayor had never missed a meeting and was typically punctual, but not on this day. She did not call to state that she would be late which raised concerns. When Ms. Lawson failed to appear at the meeting, police were dispatched to her home. A note found at her home read in part, "..... Please forgive me. Rachel." There were several other notes left in the home where the Mayor's body and that of her daughter were found.

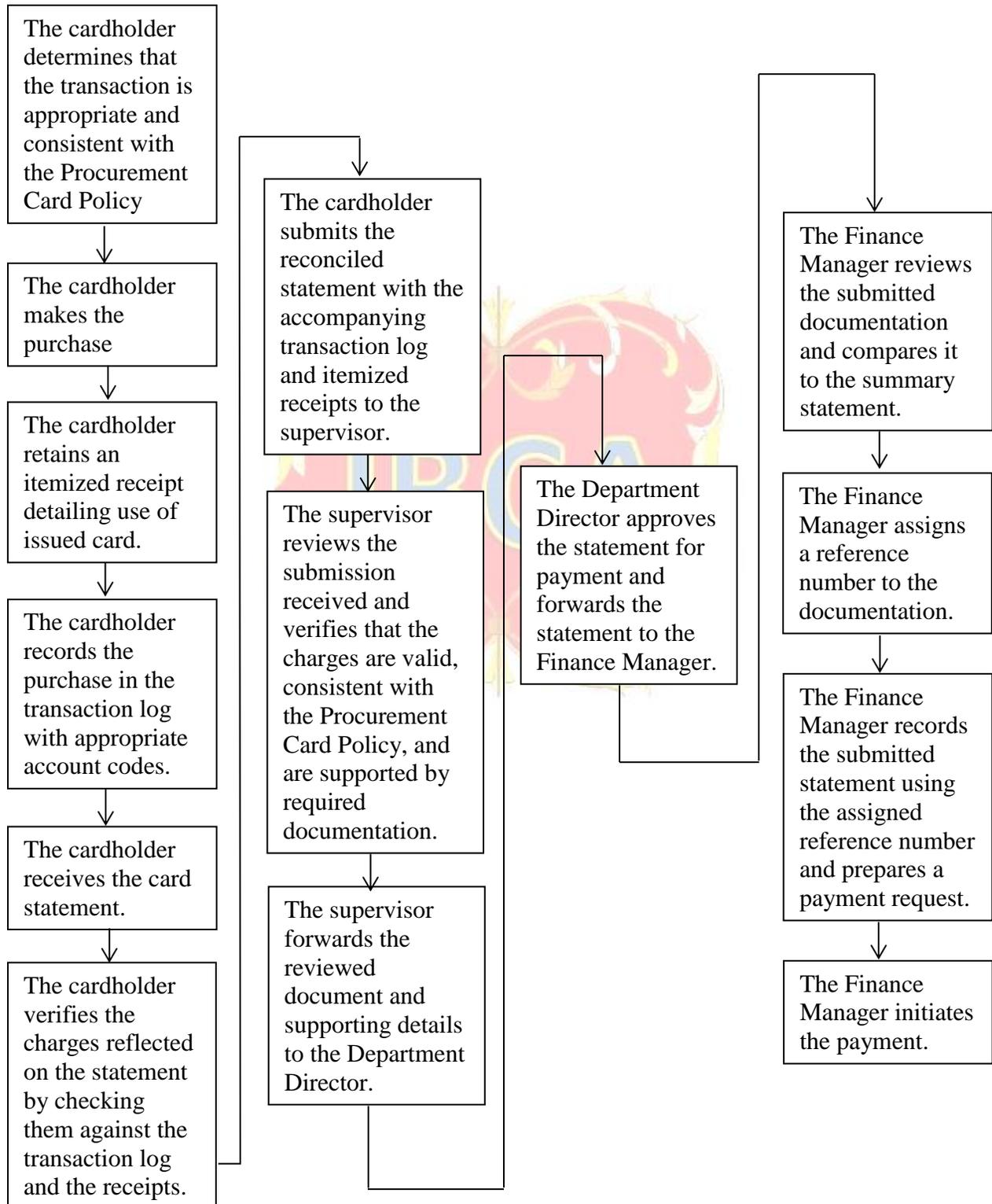
QUESTIONS FOR DISCUSSION

- 1) The City has an outlined Purchasing Process for holders of a city-issued Procurement Card. Is the Purchasing Process adequate?
- 2) Were there internal control weaknesses at the City?
- 3) Was this a case of fraud?
- 4) The fraud triangle identifies three elements that must be present in order for fraud to occur. Which of the elements of the fraud triangle are present?
- 5) Was the City Manager negligent by not uncovering the misappropriation sooner?
- 6) Could anything have been done to prevent these events?

APPENDIX

Figure 1.

Purchasing process for Procurement Cardholders



TEACHING NOTES

Following are suggested solutions to discussion questions:

- 1) The City has an outlined Purchasing Process for holders of a city-issued Procurement Card. Are the control activities related to the Purchasing Process adequate?

The Purchasing Process described in Figure 1 outlines the duties of the purchasers and the process by which the resulting purchases are approved. Students should rely on Figure 1 to help assess the adequacy of the Purchasing Process. This question allows the students to examine the Control Activities that should be present in an organization. The discussion below is presented based on the five control procedures outlined by the Committee of Sponsoring Organizations of the Treadway Commission (1992). It addresses whether or not the specific control is in place at the city. Students should also consider how the controls can be improved.

- 1) Segregation of duties

In the case of the City, the person incurring the charge is not also the person responsible for paying the bill.

- 2) Authorizations

The cardholder, by virtue of having a city-issued card, has agreed to use the card for purchases outlined in the Purchase Policy Agreement. The agreement outlines the spending limits and the number of allowable transactions that are permitted during a single day. The written Purchase Policy Agreement serves as the authoritative document that allows the cardholder to initiate and make purchases, thus prior authorization of transactions exists as a result of the agreement. The city relies on the cardholder to uphold the policies of the agreement. There is currently no mechanism in place to prevent the cardholder from violating the guidelines of use.

- 3) Independent checks

Two statements outlining the card activities are sent, one to the cardholder and one to the city (finance department). The city's process contains a way by which the purchaser's transactions are verified by personnel from two different departments. Original supporting documentation is required in order to process payments for charges made on the card. Although the charges are independently verified the obligation to pay the charges rests with the city, i.e. it is a city-issued card. What are the repercussions to the cardholder if the charges made are not business related?

- 4) Physical safeguards

The information in this case does not indicate that the process of safekeeping the city-issued card is an issue. The cards are issued to authorized personnel including Council Members. Each cardholder is responsible for ensuring the safekeeping of his/her card. Lost cards should be immediately reported.

- 5) Documentation and recordkeeping

Documents and records require receipts and documentation that allows the transactions to be audited. The city has a process by which documentation was required for purchases

made on the city-issued card. Throughout the process there is a requirement for supporting documentation which is verified by sources outside of the purchaser.

2) Were there internal control weaknesses at the City?

Weaknesses in internal control can relate to weakness in the 1) design or the 2) operation of internal controls. The design of the internal control processes related to the city-issued card, as outlined in the Figure 1 and discussed in Question 1, is adequate.

The issues related to the internal control weaknesses for the City are operational deficiencies. The process of submitting documentation that supports charges made on the city-issued card requires reconciliation on a regular basis (at the end of each month). The reconciliation process related to the Mayor did not occur with the frequency outlined by the City's process. The weaknesses related to the process provide opportunities to explore additional questions. Are there ever times when is it acceptable to obfuscate internal control processes? Should managers (executives or leaders) be held to the same standard as other employees, i.e. should managers be allowed additional time, more than 30 days, to provide required information? If cardholders are not complying with the monthly reconciliation process, what mechanisms are in place to stop cardholders from making additional purchases? This question allows students to see how a well-designed process can be ineffective if it is not supported by corresponding actions.

3) Was this a case of fraud?

Fraud includes a variety of acts intended to cheat another. The basic elements of fraud require an intentional material misrepresentation which is believed or relied upon by others resulting in actions that cause damage to a victim. An interesting aspect of this case is the relative size of the total unauthorized purchases, less than \$10,000. Students may want to interject ethical or social considerations. The following questions may arise. Is it acceptable to take a small amount to sustain one's livelihood? Is it acceptable if the amount will be paid back? Should the amount be overlooked because it is immaterial? These questions elicit an interesting discussion about whether fraud is ever acceptable.

There are two types of fraud 1) fraudulent financial reporting which results from the manipulation of accounting records and 2) misappropriation of assets which causes misstatements in the financial statements. This is a case of misappropriation of assets. Students should be challenged to examine whether all of the elements of fraud present?

- 1) A false statement of a material fact
- 2) Knowledge that the statement was false
- 3) The intention is to deceive
- 4) The false statement was relied on
- 5) Injury resulted from relying on the false statement

4) The fraud triangle identifies three elements that must be present in order for fraud to occur. Which of the elements of the fraud triangle are present?

Statement on Auditing Standards No. 99: Consideration of Fraud (SAS 99) describes three elements that increase the possibility of misappropriation of assets and fraudulent financial

reporting. The three elements are: Incentive/pressure, Opportunity, and Rationalization/Attitude.

1) Incentives or pressure may result from a variety of sources including increasing personal debt and other financial pressures. The loss of the mayor's spouse and his income caused the family to experience financial pressure.

2) Opportunities exist when the ability to commit fraud is available perhaps because of the lack of controls or ineffective monitoring. Opportunity to support fraud is supported when the organization has an inadequate record keeping process or a lack of timely reconciliations.

3) Rationalization/attitude is not necessarily visible but may be inferred by observing the communication habits (or lack thereof), perceived disregard for controls and a willingness to override or ignore existing controls, and changes in personal behavior or lifestyles.

Ex post it is clear that the all of the elements of the fraud triangle are present. The challenge of detecting fraud is the ability to see the elements at the time the events occur.

- 5) Was the City Manager negligent by not uncovering the misappropriation sooner?
The City Manager became increasingly concerned about the Mayor's inability to provide reconciling documentation. Although increased concern may not connote a concern about fraudulent behavior, the prolonged process should have signaled "red flags".

The City Manager has a duty to follow the organizational protocols to help ensure that the resources of the city are used appropriately and appropriately accounted for. Typically, expenditures related to the procurement card require a monthly review and reconciliation. The process of review in this instance was protracted and did not occur in a manner consistent with the organization's guidelines. Latitude is often granted to high ranking officials or executives of organizations. Indeed the City Manager did not receive the required information in a timely manner. He was however consistently requesting the information. Ignoring organizational processes and guidelines however serves to negate the purpose for which the guidelines are designed to serve. There should be safeguards that allow suspension or revocation of a city-issued card based on clearly outlined objective standards.

- 6) Could anything have been done to prevent these events?

Although protecting the organization's resources is a primary responsibility, it is not the only one. Organizations have a vested interest in ensuring the well-being of their employees. An organization that provides and Employee Assistance Program (EAP) helps to ensure that employees have access to counseling that helps maintain mental/emotional balance. Although EAP programs historically had a limited focus, drug and alcohol abuse, today EAP programs extend to personal issues that potentially impact the employees' behavior, health and mental state.

Many city governments have Health and Wellness programs for employees (Benivides and David, 2010). Through the EAP process employers can similarly encourage employees to utilize the counseling and mental health services provided through the EAP. Employers should identify at risk situations and individuals including those effected by: 1) recent traumas, loss/death of a loved one, displacement due to natural disasters, domestic violence, etc. An active EAP program that encourages and reminds employees to utilize the program services helps to maintain balance for employees. The organization may further have guidelines that require counseling for high risk individuals.

Processes which are effective, well-organized, and routinely monitored do not provide an unassailable guarantee for organizations. However, processes must be established and implemented to help minimize the occurrence unwanted events.

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