Case Study
Fraud at a Public Authority

1. Introduction
This case describes a situation where an accountant working for a public authority stole tens of thousands of dollars over a period of several years. The case illustrates how ineffective internal controls create an opportunity for employees to steal assets. Students are asked to identify the internal control weaknesses that provided the opportunity for the accountant to steal cash, make recommendations to strengthen controls, and discuss how the authority’s auditor should have searched for this fraud. The case is based on a real-life event, although the names of the authorities and individuals have been changed. The case, which effectively meets important learning objectives, can be used in a first auditing or forensic accounting course.

2. Background
From 1998 until 2001, Tom Smith was employed as controller for a public authority (“Old Authority”). A public authority is a type of governmental unit (in some states referred to as a special district) that is separately incorporated for the purpose of acquiring, financing, and operating real properties, such as athletic stadiums, convention centers, water systems, airports, and public transit. The goal of a public authority is to insulate local and state governments from the liabilities related to owning and operating these types of real properties. The board of directors of a public authority, once appointed, acts independently of local and state government.

Old Authority owned and operated a large municipal facility (Old Facility) that was used for major athletic and entertainment events, such as football, baseball, and concerts. The Old Facility was imploded in 1999 and a new public authority (“New Authority”) immediately commenced construction on a new municipal facility that would be used for the same purposes (“New Facility”).

After the Old Facility was demolished, Mr. Smith remained as the sole accounting employee of Old Authority where he continued to provide accounting services on a part-time basis. Although the Old Facility had been demolished, the Old Authority continued to exist to collect rent payments from other properties that it owned and to repay existing long-term debt.

In early 2001, Mr. Smith was hired as the full-time controller for the New Authority, which owned and operated the New Facility. Smith remained employed both as the full-time controller of the New Authority and part-time accountant for the Old Authority until the fraud was detected in the fall of 2003.

3. Duties
Mr. Smith’s responsibilities at the Old Authority included monthly payroll, collecting receipts, making payments, budgeting, making entries into the books of original entry, and preparing financial reports for the Board of Directors of Old Authority. Mr. Smith had access to cash in the Old Authority’s safe and he was authorized to order cash from the Old Authority’s bank in order to provide the monies cashiers needed for an event at the Old Facility (“start-up cash”). Mr. Smith had full access to all of the Old Authority’s computers.

Following concerts at the Old Facility, Mr. Smith was responsible for meeting with the concert’s promoters, counting the event receipts, and returning the start-up cash to the Old Authority’s safe. Mr. Smith was charged with arranging for an armored courier to pick-up the start-up cash the next day for its return to the Old Authority’s bank.

The monthly income statement and balance sheet were prepared with a financial software package utilized by Old Authority. At year-end, Mr. Smith prepared all form W-2’s and 1099s related to compensation and he was responsible for filing all tax reports. Mr. Smith had two employees who performed accounting functions under his supervision. A local accounting firm audited the Old Authority annually. Mr. Smith was responsible for assembling the documents that the auditors requested and answering their questions. Mr. Smith developed a good relationship with the auditors.

Mr. Smith reported to the Chairman of the Board of Directors of the Old Authority. Smith met with the Chairman at monthly meetings where he secured the Chairman’s signature on checks that exceeded $2500.00. The Old Authority’s bank account signature authorization allowed Mr. Smith alone to sign checks up to $2500.00.

From March 1999 until January 2001, while the New Authority was constructing the New Facility, Mr. Smith served as the part-time controller of the Old Authority. The other accounting employees who had reported to him at the Old Authority had been laid off. Mr. Smith and the furloughed employees received a retention bonus payment from the Old Authority equal to one-half of their annual salary. Smith’s office was moved to a remote building owned by the Old Authority. Mr. Smith maintained a check register on a computer at this remote office, but moved all of the checks and other financial documents of the Old Authority to his home in order to make performing his duties more convenient. Mr. Smith went to the remote office to pick up mail and to meet with the local accountants for the Old Authority’s annual audit examination. After the Old Authority’s operations were moved to the remote office, Mr. Smith wrote about 100 checks per year from the Old Authority’s checking account.

In early 2001, Mr. Smith was hired as the full-time controller of the New Authority. He also continued to manage the books and records of the Old Authority. As controller of the New Authority, Mr. Smith had substantially the same duties that he performed for the Old Authority, including the ability to record entries into the
books of original entry, access to cash in the safe, and the authorization to order event start-up cash. New Authority explicitly noted in the employment letter to Mr. Smith that his salary included the bookkeeping services he would perform for the Old Authority.

4. Discovery of the theft
In June 2003, while Mr. Smith was on vacation, an accounting employee from the New Authority picked up the mail from the remote office and noted that the Old Authority’s bank statement contained a $1400 canceled check payable to Mr. Smith. It was determined that the check, which Smith paid to himself for “consulting fees,” was unauthorized.

The New Authority’s financial staff conducted an internal audit and discovered approximately $15,000 in unauthorized checks from April 2002 through March 2003. Soon thereafter, a meeting was called by the Board of Directors of the New Authority where Mr. Smith was confronted with the $15,000 in unauthorized checks. Mr. Smith admitted to writing these checks, but then stated that there were no other unauthorized transactions. Nonetheless, following the meeting further internal audit by the financial staff discovered a total of $70,000 of unauthorized checks, $20,000 in unauthorized retention payments, and $25,000 of unauthorized payments for an insured investment account that was partially owned by Smith. Moreover, an outside agency’s parallel investigation of the New Authority’s cash disclosed a loss of approximately $15,000 in funds which had been recovered earlier from Mr. Smith.

A second meeting was called with Mr. Smith at which time he admitted to the newly discovered transactions and advised there were life insurance proceeds from the insured investment that he expected to receive due to the death of the other investment participant. Mr. Smith intended to use these funds to pay restitution. Once again, he denied that there were any more unauthorized transactions.

A few days after the second meeting in 2003, the financial staff discovered an unexplained $30,000 cash transaction to Mr. Smith drawn on an Old Authority bank account. The transaction appeared to be start-up cash for an event at the Old Facility, even though the Old Facility had been demolished in 1999. Mr. Smith authorized that the cash be delivered to him by armored courier.

Moreover, in the course of the investigation, the financial staff found reference to a “royalty contract” between the Old Authority and a memento manufacturer on a computer at the remote site. The manufacturer had been producing and selling replicas of the “Old Facility” to sports enthusiasts as mementos and paying a royalty to the Old Authority. The Board of Directors was unaware of this agreement.

On further investigation, it was discovered that the royalty checks from the memento manufacturer had been forged by Mr. Smith and deposited into his
personal checking account. When Mr. Smith was confronted with this new evidence, he admitted to the transactions and again said there were no other unauthorized transactions.

The financial investigators were stymied for they did not know how many computers either Authority owned. Neither Authority had any policies with regard to the use of computers. The financial investigators found at least four computers that were available to Mr. Smith, yet other information from the check register indicated that may have been at least three more computers.

To add to the financial woes, the CFO of the New Authority, who supervised Mr. Smith’s activities at the New Authority as well as Mr. Smith’s diminished accounting activities for the Old Authority, admitted that he approved Mr. Smith’s taking the Old Authority’s financial documents home. The CFO stated that on one occasion when he needed the Old Authority’s checkbook, Mr. Smith had to bring it from his home. Furthermore, a review of the Old Authority’s checking account showed that on several occasions, the bank had paid checks in excess of $2500 on Mr. Smith’s signature alone, without the required second endorsement of the Board Chairman.

From a review of the Old Authority’s tax records, it was clear to the financial investigators that Mr. Smith had never issued a Form W-2 or Form 1099 to recognize his compensation for any of the unauthorized payments he had taken. Lastly, as noted in the parallel investigation above, there had been another cash shortage a few months before the unauthorized consulting fee check was discovered. In February 2003, the Operations Manager of the New Authority had ordered a surprise vault check at the New Facility. The initial cash count revealed a shortage of $9050.00. Mr. Smith was contacted by the Operations Manager, since only Mr. Smith and his subordinate had the combination to the safe. Mr. Smith indicated that he had taken a “short term loan” and would promptly replace the funds, which he did the next day by sliding an envelope under the Operations Manager’s office door containing a $7000.00 check and $2050.00 in cash. A further detailed vault cash count determined an additional shortage of $6000.00. Mr. Smith took responsibility for this further shortage and told the Operations Manager that no there was no additional shortage. He promptly repaid this amount too.

In mid-September 2003, Mr. Smith paid restitution in excess of $155,000, with money from the insured investment account proceeds. This account had been fortuitously augmented with a life insurance payment due to the death of the other participant in the investment.

5. Smith’s explanation and rationale

Mr. Smith stated that his salary at the Old Authority was approximately $70,000.00. He described his duties with the Old Authority as those of a controller, where he had oversight of all financial transactions and financial controls.
Mr. Smith stated that in March of 2001 he began paying himself consulting fees for what he viewed was extra work handling part-time accounting matters for the Old Authority. He usually billed approximately twenty (20) hours a month at $70.00 per hour. The $1400 check that was first uncovered in 2003 was one of these unauthorized payments. These checks were not destroyed and were marked in the check register as “consulting fees” to Mr. Smith at $70.00 per hour, although Mr. Smith did not submit invoices to the Old Authority for these fees. To justify the reasonableness of his fees, Mr. Smith pointed to another consultant who billed the Old Authority $70.00 per hour but did submit invoices to the Old Authority. Mr. Smith was quoted as stating that the auditors from the local accounting firm were aware of the consulting fee checks to Mr. Smith. One auditor was said to have remarked to Mr. Smith that the $70.00 per hour he was charging was a “cheap rate” and that “he should come work for the auditors.” Mr. Smith admitted he did not have Board of Director approval for the consulting fees he paid to himself, but he did not think it was a problem. He stated that he worked overtime on weeknights and weekends on Old Authority accounting matters and that he went to his remote office after work hours to pick up the mail and work overtime. Mr. Smith believed that he had earned the consulting fees.

When first confronted regarding the investment account, Mr. Smith stated that he did not recall issuing checks to a financial services company. Thereafter, the New Authority officials showed him $25,000 in Old Authority canceled checks payable to a financial services company for the investment account partially owned by Mr. Smith. Only then did Mr. Smith agree that these payments were personal and not related to Old Authority business.

When the Old Facility closed, employees were given one-half of their annual salary as a retention payment to keep them available for employment by the New Authority when the New Facility was completed. Mr. Smith acknowledged that he received his authorized $35,000 retention payment from the Old Authority. However, he then admitted that he paid himself an additional retention payment of $20,000, which was improper and unauthorized.

Mr. Smith admitted to calling the Old Authority’s bank in July 2002 to request an event start-up cash delivery from an Old Authority checking account and he admitted that the armored courier had delivered $30,000 in cash to him at the New Facility’s money room in a sealed bank bag. Mr. Smith stated there was no event and the money did not make it to the safe. Mr. Smith used the $30,000 to pay bills and day-to-day living expenses. He also bought a vacation home, took gourmet cooking classes, and bought some expensive clothes for himself and his family.

Mr. Smith disclosed that he had diverted royalty fees belonging to the Old Authority, which were from a company that manufactured replicas of the Old Facility. The royalty checks totaled about $9000.00 and were made payable to the Old Authority, directed “to the attention of Mr. Smith.” It seems that the “To the attention of Mr. Smith” language was used to dupe the bank into believing
that the checks were payable to Mr. Smith. Smith removed these checks from the Old Authority’s mail and deposited them into his personal bank account.

6. How did Smith steal the cash?
Mr. Smith explained that he and another employee who reported to him had the authorization code to order cash to be delivered to his office at the New Facility for event start-up cash. These cash withdrawals would appear as a charge against the Authority’s checking account. Mr. Smith selected the biggest public event scheduled for the New Facility (which is owned by the New Authority), however he ordered the event start-up cash from the Old Authority’s bank account. When the cash was delivered by armored courier to the New Facility’s money room, he signed the cash into the New Facility’s safe.

Mr. Smith knew internal controls were in place with ticket seller/cashiers at each public show. The cashiers were assigned a roll of pre-numbered tickets and each cashier had to cash out and make an accounting with the event promoter for each ticket roll. The event promoter had the ability to do its own independent audit of ticket receipts, where the promoter would compare the turns on turnstile counters to the tickets sold. Internal controls here were tight.

At the end of each event, after withdrawing the event start-up cash provided by the New Facility, the net ticket sales revenue from the event was placed in a locked bag and transferred to the promoter’s bank by armored courier. Mr. Smith denied stealing any ticket sales revenue. However, the procedure broke down when bagging the event start-up cash that had been withdrawn from the ticket sales funds. The event start-up cash was bagged separately and was to be sent via another armored courier back to the Old Authority’s bank for deposit into the operating account from which it had been first withdrawn to start the event.

Mr. Smith admitted he could override this control procedure and did so by placing the start-up cash into the New Facility’s safe at the conclusion of the event. Mr. Smith gave the excuse that he was busy and it would save time reordering start-up cash for the next big public event if that start-up cash was left in the safe. During the next few weeks, Smith physically removed the cash by stuffing it in his suit pockets.

When the next scheduled event was about to occur, he told his employees he had returned the event start-up cash to the Old Authority’s bank. He then told them he now believed it would be less cumbersome to access the New Authority’s bank account for the event start-up cash, rather than withdrawing and redelivering start-up cash to the Old Authority’s bank. When he began to confess to what he had done, Mr. Smith admitted he had used the armored courier scam before in early 2001 for about $5000, and he therefore knew that this theft scheme would work. That theft had not been detected.

On balance, Mr. Smith thought he had been a good controller since he was sure that no one who was under his supervision had stolen from either Authority.
Moreover, Smith viewed all of the funds he had taken as “loans” that he fully intended to repay from his future compensation and proceeds from the insured investment account.

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<td>1. Identify internal control weaknesses that provided the opportunity for Mr. Smith to commit the fraud. Include in your answer both preventive and detection internal controls.</td>
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<td>2. What recommendations would you make for strengthening controls at the New Authority?</td>
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<td>3. Both the Old and New Authorities were audited by a local accounting firm, although the fraud was not uncovered by the external auditors. Explain how the auditors should have searched for fraud (theft of assets) at the Old and New Authorities. What tests could the auditors have performed that might have detected the fraud? Be specific.</td>
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