

INTERGOVERNMENTAL AUDIT FORUMS

New York/New Jersey and New England Joint
Intergovernmental Audit Forum November 28-29, 2006

The Good, the Bad, & the Ugly:
Case Studies in
Public Corruption and Fraud

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Dave Cotton is chairman of Cotton & Company LLP, Certified Public Accountants. Cotton & Company is headquartered in Alexandria, Virginia. The firm has a practice concentration in assisting Federal and State agencies, inspectors general, and government grantees and contractors with a variety of government program-related assurance and advisory services. Cotton & Company has performed grant and contract, indirect cost rate, financial statement, financial related, and performance audits for more than two dozen Federal inspectors general as well as numerous other Federal and State agencies and programs.

Cotton & Company's Federal agency audit clients have included the U.S. Government Accountability Office, the U.S. House of Representatives, the U.S. Small Business Administration, the U.S. Bureau of Prisons, and the U.S. Marshals Service. Cotton & Company also assists numerous Federal agencies in preparing financial statements and improving financial management and accounting systems.

Mr. Cotton received his BS in mechanical engineering (1971) and an MBA in management science and labor relations (1972) from Lehigh University in Bethlehem, PA. He also pursued graduate studies in accounting and auditing at the University of Chicago, Graduate School of Business (1977 to 1978).

Mr. Cotton is presently serving on the Advisory Council on Government Auditing Standards. He is a member of the advisory board of the Institute for Truth in Accounting. He is serving on the American Institute of CPAs (AICPA) Anti-Fraud Programs and Controls Task Force, and is a former member of the AICPA "Group of 100." He is the past-chairman of the AICPA Federal Accounting and Auditing Subcommittee and has served on the AICPA Governmental Accounting and Auditing Committee and the Government Technical Standards Subcommittee of the AICPA Professional Ethics Executive Committee.

Mr. Cotton served on the board of the Virginia Society of Certified Public Accountants (VSCPA), and on the VSCPA Litigation Services Committee, Professional Ethics Committee, Quality Review Committee, and Governmental Accounting and Auditing Committee. He is member of the Greater Washington Society of CPAs (GWSCPA) and is serving on the GWSCPA Professional Ethics Committee. He is a member of the Association of Government Accountants (AGA) and is past-advisory board chairman and past-president of the AGA Northern Virginia Chapter. He is also a member of the Institute of Internal Auditors and the Association of Certified Fraud Examiners.

Mr. Cotton has testified as an expert in governmental accounting and auditing issues before the United States Court of Federal Claims and other administrative and judicial bodies.

Mr. Cotton served as a technical reviewer for the 1999 through 2003 editions of the AICPA Audit and Accounting Guide *Audits of Federal Government Contractors*.

Mr. Cotton is the author of the AICPA continuing education courses *Fraud in Governmental and Not-for-Profit Audits—the Auditor's Responsibilities Under SAS 82* and *Joint and Indirect Cost Allocations: How to Prepare and Audit Them*. He also has been an adjunct instructor at the Inspectors General Auditor Training Institute (*Auditing the Federal Contracting Process* and *Contract and Procurement Fraud*) and currently teaches at the George Mason University Small Business Development Center (*Fundamentals of Accounting for Government Contracts*).

Notes

**The Good, the Bad, & the Ugly: Case Studies in
Not-for-Profit Corruption and Fraud**

- > The FBI's Grave Concern
- > Foundation for New Era Philanthropy
- > The Autocratic Church Treasurer
- > Mr. Travel Voucher
- > Statewide Care and Maintenance
- > IRS = J.R. Stevens
- > The Errant EFT
- > Mistakes Were Made, Heads Rolled

Case Analysis

WHAT WERE THE FRAUD RISK FACTORS?

Fraud Risk Factor: A characteristic that provides a *motivation/pressure* or *opportunity* for fraud to occur; a *rationalization/attitude* supportive of fraud; or an *indicator* that fraud might have occurred or might be occurring



*Remember: Four words have
preceded EVERY fraud that has
ever been committed ...*

Notes

Remember: Eight words have followed EVERY fraud that has ever been discovered ...

Case Study

The FBI's Grave Concern

Case Study

The FBI's Grave Concern

- J. Edgar Hoover is buried in Congressional Cemetery; along with John Phillips Souza, Matthew Brady, and 80 members of Congress
- Congressional Cemetery is operated by a not-for-profit corporation
- The corporation was managed by a volunteer board of directors

Notes

Case Study

The FBI's Grave Concern

- John Hanley, a retiree, was superintendent, daily administrator, executive director, and a member of the board of the cemetery from 1988 to 1997
- He was paid \$24,000 per year and allowed to keep rental income (about \$600 per month) from an old gatekeeper's house
- The board trusted Hanley and exercised little to no supervisory oversight

Case Study

The FBI's Grave Concern

- Hanley managed the cemetery, sold burial plots and headstones, collected contributions and fees, deposited funds, and maintained the accounting ledger
- The board became concerned in 1996 when they received a complaint about a purchased headstone that was missing, and then learned of an IRS lien for non-payment of taxes

Case Study

The FBI's Grave Concern

- The subsequent investigation revealed that Hanley had embezzled (at least) \$175,342 by depositing cemetery revenue into a bank account in the name of "Stones on All c/o John S. Hanley"
- Among the deposits stolen by Hanley was a \$4,545.80 check from *The Society of Former Special Agents of the FBI* intended to pay for a memorial to J. Edgar Hoover

Notes

Case Study

The FBI's Grave Concern

- Hanley used the embezzled funds to buy racehorses, gamble, and "support his lifestyle"
- Hanley had told the cemetery board that he was a retired banker, independently wealthy, and owned racehorses

Case Study

The FBI's Grave Concern



Case Study

The FBI's Grave Concern

FRAUD RISK FACTORS/INDICATORS

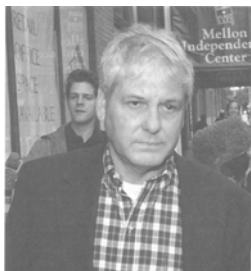
Notes

Case Study

Foundation for New Era Philanthropy

Case Study

Jack Bennett



“ He’s a father who is loyal and faithful, loving, prayerful, a gentleman, respectful, high morals, who wouldn’t even think of words like *scheme* or *fraud*.”

--Joyce Bennett

Case Study

Jack Bennett--the early years

- Education degree from Temple University
- A few terms teaching at Agnes Irwin Gils’ School
- Married Joyce in 1967
- Enrolled in medical school at age 30
- Flunked out of medical school at age 33
- Became a drug counselor

Notes

Case Study

Jack Bennett--the formative years

- Started ***Community Organization for Drug Abuse Control (CODAC)***
- Pennsylvania’s governor asked Jack to join the statewide Council on Drug Abuse
- Discovered his true callings--rubbing elbows with the rich and famous; and fundraising

Case Study

Jack Bennett--the formative years

- Founded ***Nova Institute International***-- assisting small non-profits raise money in return for a small cut of the proceeds
- Nova failed, largely because Jack insisted on donations being paid directly to Nova, with his promise to pass on the donation, less his fee; respectable donors balked
- The IRS closed in in 1984 and “asked” why Nova had never paid taxes

Case Study

Jack Bennett--the formative years

- Jack became a church-going man in 1982, following his father’s death
- Church of Our Savior helped Jack and Joyce pay off their \$30,000 IRS debt
- Jack also made important contacts at the Church
- Jack founded ***Human Services Systems***

Notes

Case Study

Human Services Systems

- Influential partners included Richard Ohman, CEO of Colonial Penn Insurance; William Thatcher Longstreth, 5-time Philadelphia councilmember; and John Salveson, prominent Philadelphia businessman
- HSS contracted with corporations to provide mental health care to employees on a subscription fee basis
- Clients: Bell Telephone, Playtex Products, Federal Reserve Bank of Philadelphia

Case Study

Other new ventures

- Jack also founded the *Center for New Era Philanthropy*--to raise and distribute grant monies
- Using a \$350,000 grant from Bell, Jack started the *Bell Institutes for Non-Profit Excellence* which gave short courses on non-profit business planning, organizational development, board development, and fundraising
- "You're only as good as your board of directors"

Case Study

A pattern emerges

- In 1987, HSS checks started bouncing
- Jack began moving money from New Era to HSS to Bell to New Era to HSS to Bell ...
- When HSS's executive vice president, John Salveson, told Jack this was illegal, Jack asked "what's check kiting?"
- Salveson resigned soon after discovering that Jack had transferred \$300,000 of Bell money into Jack's personal account to pay for Jack's "consulting time"

Notes

Case Study

Jack kept moving onward and upward

- In 1988, Jack met John Templeton, Jr., chief of pediatrics at Philadelphia Children’s Hospital, and John Templeton, Sr., founder of Templeton Investment Funds
- **Templeton Institutes** was formed to extend Jack’s fundraising skills into the religious realm (including a course called “Ethics in Business and Philanthropy”)
- By 1989, Jack’s check kiting was becoming burdensome--he needed to cover nearly \$900,000 and did not know where that money would come from

Case Study

“New Concepts in Philanthropy”

- Jack told Dr. Templeton (Jr.) that he had found a wealthy donor (who wanted to remain anonymous) who agreed that if Jack could find 20 people willing to put up \$5,000 each, the wealthy donor would match all of the donations
- It worked; donors were thrilled at the doubling effect of their donations
- Jack’s fame grew by leaps and bounds

Case Study

Big-time fundraising, “Rolodex gold”

- Jack’s contacts became extensive and impressive: NJ Gov. Tom Keane; Vivian Weyerhauser Piasecki; Matilda Cuomo; Peter Jennings; Laurence Rockefeller; William Kanaga; John C. Whitehead; Raymond Chambers; Julian Robertson
- Jack needed to pay off the “New Concepts” donors
- He went back to the well

Notes

Case Study

Jack's friend "of significant wealth"

- Jack announced that his friend of significant wealth was starting a new matching fund, this time with a minimum donation of \$50,000
- Everyone thought the friend was John Templeton, Sr.; Jack did not deter that thinking
- Money flowed in; the word spread

Case Study

If it quacks like a pyramid

- 1990 receipts: \$366,000
- 1991 receipts: \$1,300,000
- 1992 receipts: \$9,000,000
- 1993 receipts: \$41,000,000
- 1994 receipts: \$160,000,000
- Organizations worldwide could not resist the prospect of doubling their money in 6 months
- Jack's anonymous benefactors grew as well--from one to six
- Many donors just "let their money ride"

Case Study

Trappings of success

- Jack used some of the flowing funds to maintain the right image and lifestyle: \$675,000 home; Sterling automobile (later a Lexus); new offices and furnishings; first-class travel for the family
- "Pump-priming philanthropy:" \$21,000 to the Billy Graham Crusade; \$250,000 to Philadelphia's Academy for Natural Sciences; \$250,000 to the Salvation Army

Notes

Case Study

The “Center” became the “Foundation”

- A foundation uses earnings from an endowment to fund good works
- New Era had no endowment; the money came in, the money went out
- Donors were told to list their donated funds as being in a *quasi-escrow* account with New Era
- Some donors asked who the New Era board members were
- Jack produced an impressive list; but there was no board

Case Study

Jack took no salary from New Era

- New Era transferred \$9 million to HSS to stave off bankruptcy
- New Era donated \$2.75 million to Multi-Media Publishing, a failing venture run by Jack’s friend, Richard Ohman
- New Era paid Ohman \$200,000 per year for “consulting services”
- New Era transferred \$2.5 million between 1993 and 1995 to Bennett Group International to pay the salary and expenses of BGI’s sole employee--Jack Bennett

Case Study

Where were the auditors?

- New Era did not need an audit
- But, Jack did need financial statements
- McCarthy & Company had been doing New Era’s books since 1991 when Jack had donated \$15,000 to the *John McCarthy for Assemblyman* campaign
- McCarthy & Company assigned Andy Cunningham, a 30-year-old accountant, to prepare New Era’s financial statements

Notes

Case Study

Young Andy asked some good questions

- “Why are their ‘personal loans’ of \$100,000 on the books?”
 - *Jack told Andy he’d write a check to pay those off if Andy would wipe the debt off the books and not include any mention of related-party transactions in the statements*
- “Where are the board meeting minutes?”
 - *Jack told Andy to just skip those for this year*

Case Study

Young Andy asked some good questions

- “Why is the \$41 million in donor funds listed as ‘charitable contributions’ if that money was going to be returned to donors in 6 months?”
- “Why is there no liability listed for the promised matching amount?”
 - ✓ *Jack told Andy that those matches had already been made, and the \$41 million was New Era’s, free and clear*
- Andy decided to simply do as his boss, John McCarthy, had told him: “keep this guy happy”
- No one had counted on Albert Meyer

Case Study

Enter Albert Meyer

- 44-year-old immigrant from South Africa
- Taught accounting at Spring Arbor College in Michigan by day; kept the school’s books at night
- Albert noted a \$294,000 payment from the college to the Heritage Values Foundation
- The director of HVF explained that it facilitated donations to the Foundation for New Era Philanthropy, and the college’s money was going to double

Notes

Case Study

Enter Albert Meyer

- Albert immediately contacted all of the college's board members and told them this did not sound right; the board told Albert to mind his own business
- Albert obtained New Era's financial statements and began asking questions

Case Study

Albert's excellent questions

- *Why is Jack Bennett circulating an audit report when the notes say the accountants only conducted a review?*
- *Why is there a \$1.1 million transfer to "non-marketable equity securities" [start-up money for Multi-Media] with no other explanation?*
- *Why is there another transfer in excess of \$1 million to something called Bennett Group International [Jack's salary]?*

Case Study

Albert's excellent questions

- *Why aren't beneficiary donations listed as current liabilities, since they have to be doubled and returned every six months?*
- *Why does an organization that supposedly handled \$100 million in 1993 only have \$33,000 in interest earnings?*

- Albert sent his questions directly to Andy and Jack
- Andy and Jack would not answer Albert's questions
- Albert decided to ask the *Philadelphia Inquirer*, *The Wall Street Journal*, the FBI, the SEC, the Justice Department, and the AICPA

Notes

Case Study

In the meantime ...

- Young Andy told Jack that he was concerned about the “tough questions” he was being asked about New Era
- He also told Jack that he--Andy--was having some personal financial problems
- In the “spirit of Christian giving,” Jack gave Andy \$50,000 to cover some of Andy’s personal loans; and then another \$26,000 to help out during the holidays
- No more tough questions from Andy

Case Study

THE WALL STREET JOURNAL.

- WSJ’s Steve Stecklow was one of the few people who stopped to listen to Albert Meyer
- Stecklow quickly discovered that the board member list was bogus
- Jack refused to answer any of Stecklow’s questions; but told him that the anonymous benefactors had never asked for receipts for tax purposes, because they were all so wealthy that they did not need tax deductions
- Stecklow’s story about New Era appeared in the WSJ the following Monday

Case Study

The pyramid collapses

- Prudential Kenosha got an advanced tip about the WSJ article and called in a \$65-million New Era loan
- Jack scraped together everything he could find, and came up \$44-million short
- Prudential filed suit on May 12, 1995

Notes

Case Study

The end was not pretty

- Shortly after the suit was filed, Jack confessed to his staff:
“I’ve betrayed you all. I’m so ashamed of myself. All I ever wanted to do was help people. There are no anonymous donors.”

Case Study

The end was not pretty

- But, in a videotaped address to 500 New Era participants, Jack said:
“Like Martin Luther King I also had a dream ... I was a vision person--about the larger picture--a visionary not involved in the nuts and bolts of the organization. My dream became a nightmare for thousands this past May. Jobs were lost, relationships destroyed, charities suddenly in financial chaos, anonymous philanthropists exposed, family and friends badgered and harassed.”

Case Study

The end was not pretty

- Judge Edmund V. Ludwig refused to allow Jack to plead not-guilty based on arguments that religious zeal and brain damage from a 1984 car accident had caused him to commit the crimes
- He pleaded ‘no contest’ to 82 counts of fraud, money-laundering, and tax violations
- Prosecutors asked for a 24.5-year sentence
- Judge Ludwig gave Jack 12 years
- Jack is scheduled for release in 2009

Notes

Case Study

The Bennetts



Joyce

Jack

Kristen

Case Study

Foundation for New Era Philanthropy



Case Study

Foundation for New Era Philanthropy

FRAUD RISK FACTORS/INDICATORS

Notes

Case Study

**The Autocratic Church
Treasurer**

Case Study

The Autocratic Church Treasurer



Ellen F. Cooke

Case Study

Ellen F. Cooke

- One of the most powerful officials--treasurer--in the national office of the Episcopal Church
- Salary--\$125,000--second only to the presiding bishop's
- Criticized during her tenure for her "autocratic and controlling management style"
- Dismissed in December 1995, because "her working style did not well serve our common mission"

Notes

Case Study

Ellen F. Cooke

- Following her dismissal, suspicions were aroused when she ordered a former co-worker to issue her an \$86,000 check for unused vacation and back pay
- The church hired Coopers & Lybrand to investigate

Case Study

Ellen F. Cooke

- C&L found that Ellen:
 - “systematically” diverted \$1.5 million from church accounts to her personal account
 - wrote \$225,000 of church account checks to 3rd parties such as her son’s private school and to the vestry and Rector’s Discretionary Fund at St. Luke’s Church (where her husband was rector)
 - wrote \$28,000 of checks payable to herself
 - charged \$325,000 on her corporate credit card for personal expenses
- Total embezzlement: \$2,203,884.29

Case Study

Ellen F. Cooke

- The investigation revealed that:
 - Ellen maintained her personal account in the same bank in which the church’s accounts were kept
 - in violation of church procedures, Ellen filled out check request forms, signed them, and also signed the checks
 - Ellen “maintained absolute control of the auditing and reconciliation functions of the treasurer’s office”

Notes

Case Study

Ellen F. Cooke

- In her defense Ellen claimed that:
 - there were “significant differences with the [C&L] report which need to be addressed”
 - her actions “were a cry for help which [she] fully expected to be discovered and questioned, and which escalated as [she] tried to escape a situation which had become intolerable”
 - "I must have done it," but testified that she could not remember the crimes

Case Study

Ellen F. Cooke

- In her defense Ellen claimed that:
 - she suffers from a “bipolar mental disorder that causes her to black out certain events”
 - she suffered from "pain, abuse and powerlessness" from working in a "male-dominated" church hierarchy

Case Study

Ellen F. Cooke

- Despite not being able to remember her crimes, Ellen had little trouble remembering how to spend money
- Embezzled church funds were spent on:
 - a farm in Virginia
 - a house in New Jersey
 - private school tuition for her sons
 - jewelry, clothing, meals, and trips for herself, family members, and friends

Notes

Case Study

Ellen F. Cooke

- Ellen was sentenced to five years in prison and was released in January 2001
- The church recovered all but about \$100,000 through insurance, sale of Ellen's ill-gotten assets, and settlements with financial institutions

Case Study

The Autocratic Church Treasurer



Case Study

The Autocratic Church Treasurer

FRAUD RISK FACTORS/INDICATORS

Notes

Case Study



Mr. Travel Voucher

Case Study

William John Burns

- Supervisor of USAID's Fiscal Services Office
- FSO was part of USAID's Office of Financial Management, Washington Accounting Operations Division
- FSO disbursed about \$74 million per year of USAID's \$6.5 billion budget
- FSO disbursed about \$4 million per year for travel expense reimbursements

Case Study

William John Burns

- USAID bureau chiefs authorized obligations for travel expenses
- They tended to estimate high when deciding how much to obligate
 - This allowed them to avoid having to add to an obligation; and also tended to 'support' future year budget requests
- Bureau chiefs were usually careful to de-obligate and reprogram unspent funds in the current year

Notes

Case Study

William John Burns

- But, obligated amounts were often spent in subsequent years rather than in the current year
- De-obligated prior-year money reverts to the US Treasury and cannot be reprogrammed for agency use; hence, bureau chiefs did not track it or care about it
- FSO's top priority was de-obligating current-year funds

Case Study

William John Burns

- FSO had high turnover--about 40% per year
- Burns trained and supervised all FSO employees
- There had been concerns about USAID's accounting and internal control systems for some time
- During the past few years, the Office of Financial Management had grown in personnel and responsibility--some thought it was too large for a single manager to handle

Case Study

William John Burns

- The USAID director appointed a task force to conduct a major review of the Office of Financial Management "in order to strengthen areas identified as potentially vulnerable"
- The task force's review did not look at FSO, but expressed concern that OFM "was too extensive" and had "lax accounting practices"
- USAID's IG also expressed concerns about OFM's "untimely payment of bills" and "inadequate and untimely reviews" of voucher records

Notes

Case Study

William John Burns

- The IG did not do any audits within FSO, because “relatively speaking there was less money and less chance of corruption there”
- “We cannot audit everything if it is not of monetary significance” [Deputy IG]
- A new computer system was being installed, but the installation was plagued by “high error rates”
- Due to these installation problems, some offices (including FSO) did not use the new system

Case Study

William John Burns

- *Burns began his crime spree in 1982; it ended in 1988; he stole more than \$1.2 million*
- Burns took upon himself the accounting chore no one else wanted--reconciling prior year unliquidated obligations
- Burns established a false identity--Vincent Kauffman--and diverted unexpended travel money to 'Kauffman's' bank account

Case Study

William John Burns

- Burns' salary at the time of his arrest was \$35,108 per year
- He lived in a 3-garage, \$335,000 home and had 5 expensive cars
- He had attended 3 Super Bowls
- He told a neighbor that his hobby was “shopping for major appliances”
- He told co-workers that he inherited money when his mother died in 1982

Notes

Case Study

William John Burns

- Burns plead guilty to embezzlement, fraud, and evading taxes on August 11, 1988
- He forfeited nearly all of his assets and agreed to repay the balance of his estimated \$1.2 million theft
- On October 11, 1988, Burns was sentenced to 6 years in prison

Case Study

William John Burns

- Despite the longstanding concerns by USAID management and its IG about weak accounting controls, Burns' crimes were not discovered by the special task force or any IG audits or reviews
- During a routine security check for renewing Burns' clearance, the low-level investigator decided to drive by Burns' home
- He found the home and expensive cars to be inconsistent with Burns' salary

Case Study

Mr. Travel Voucher

OPPORTUNITY



**MOTIVE
PRESSURE**

**ATTITUDE
RATIONALIZATION**

Notes

Case Study

Mr. Travel Voucher

FRAUD RISK FACTORS/INDICATORS

Case Study

***Statewide Care and
Maintenance***

Case Study

NOTE

- *This case study was derived from the findings of an actual quality control review.*
- *All names, numbers, and other identifying information have been changed to prevent the identification of the actual organizations and individuals involved.*

Notes

Case Study

Statewide Care and Maintenance

- > The audited organization, the firm, the audit, and the QCR
- > The audit approach
- > The initial risk assessment
- > Significant deficiencies

Case Study

The Audited Organization

- > SCAM is a nonprofit corporation
- > 90-95% of annual revenues from state/federal programs
- > Manages educational and child care programs throughout the State of New Spendalot (NS)
- > SCAM submits its A-133 audit reports to the NS Department of Enlightenment (NSDE)

Case Study

**The Audit Firm--
Watt, Woodue, Lykit, Toobee & Co.**

- > 25 professionals; mostly tax and write-up work
- > Azu R. Lykit, managing partner, is also president of the NSACPA
- > SCAM is WWLT's first A-133 audit client
- > Partner-in-charge of SCAM audit is Wanda S. Toobee (previously with 2 other firms that audited SCAM)
- > Senior-in-charge of SCAM audit is Ian C. Zilch

Case Study

Why Was a QCR Needed?

- NSDE performs desk reviews
- NSDE noted an unusual item in SCAM's financial statements
- NSDE preliminary workpaper review disclosed anomalies
- Due to Mr. Lykit's stature in the state, NSDE wanted someone far away and independent to do the QCR

Case Study

SCAM's Financial Statements: Assets

Cash	\$ 750,478
Due from State	375,500
Accounts Receivable	774,027
Related Party Notes Receivable	13,698
Other Contract Receivable	69,203
Prepaid Expenses	131,098
Deposits	499,316
Supplies Inventories	469,805
Buildings less Accum. Deprec.	<u>1,222,976</u>
Total Assets	<u>\$4,306,101</u>

Case Study

**SCAM's Financial Statements--
Liabilities and Fund Balance**

Amounts to be Provided By Future Deposits	\$ 996,883
Accounts Payable and Accrued Liabilities	1,293,309
Due to the State	213,665
Notes Payable	866,160
Accrued Payroll	<u>390,720</u>
Total Liabilities	\$3,760,737
Contingencies	0
Fund Balance	<u>545,364</u>
Total Liabilities and Fund Balance	<u>\$4,306,101</u>

Case Study

**SCAM's Financial Statements--
Revenues and Expenditures**

Total Revenue	<u>\$ 14,171,029</u>
Salaries and Fringe Benefits	\$ 6,882,858
Educational and Operating Supplies	3,512,454
Personal Services Contracts	827,754
Travel & Other Expenses	329,281
Contracts and Leases	1,468,697
Accounting, Legal and Operating Expenses	861,993
Buildings, Equipment and Improvements	<u>227,006</u>
Total Expenditures	<u>\$ 14,110,043</u>
Excess of Revenue Over Expenditures	<u>\$ 60,986</u>

- Case Study*
- WWLT's Audit Approach--
PPC's Guide to Audits of Nonprofit Organizations**
- > Materiality: \$121,500
 - > Tolerable Misstatement: \$90,000
 - > Individually Significant Item: \$36,000
 - > Misstatements to Accumulate:
 - Known
 - Uncorrected Known
 - Likely

- Case Study*
- WWLT's Initial Risk Assessment**
- > All areas deemed "significant"
 - > Control risk in all areas assessed at "maximum"
 - > "Prepaid estimation" identified as "an unusual accounting technique needing special attention"
 - > SCAM told WWLT to "conduct a more rigorous audit than usual" due to certain alleged employee irregularities

Notes

Case Study

Cash

➤ Per the financial statements:	\$ 750,478
➤ Per the workpapers:	
• Per trial balance and bank rec.	(\$811,949)
• After reversing held checks to A/P	(\$246,405)
➤ WWLT's adjusting entry:	
Dr. Cash	\$996,883
Cr. Amounts to be Provided	
by Future Deposits	\$996,883

Case Study

The Significance of Cash

➤ Three years prior to this audit, another NSDE contractor lost its NSDE contracts	
• Audited financial statements showed negative cash and poor liquidity	
➤ That "defunding" situation was well-known in the NSDE contractor community	

Case Study

Mr. Lykit's Explanations

➤ "Adjusting entries were necessary, because the accounting system generates automatic interfund receivable/payable entries."	
➤ "The accounting theory is, as there is only a single bank account, the settling up process is viewed as an allocation of cash."	

Case Study

Mr. Lykit's Explanations

- "The adjusting entry creating the liability account [Amount to be provided ...] is an accepted methodology, commonly used, and universally understood here in New Spendalot."
- The presentation is not misleading, because there was no change in the fund balance."

Case Study

What Does GAAS Require?

- GAAS incorporates the AICPA *Code of Professional Conduct* [AU 220.04]
- Rule 102 of the *Code*:
 - "A member who knowingly makes ... false and misleading entries in an entity's financial statements or records shall be considered to have knowingly misrepresented facts in violation of Rule 102."

Case Study

Effect of the Cash Presentation

	<i>As Presented</i>	<i>As Restated</i>
Cash	\$750,478	(\$246,405)
Current Ratio	0.687	0.609
Acid Test	0.509	0.386
Debt to Equity	6.896	5.520
Soundness of State's Program	Good Shape	Questionable

Notes

Case Study

Supplies Inventories

- Miscellaneous educational supplies located at 12 sites throughout the state
- Stated value of \$469,805--or 11% of stated total assets (14% of total assets if cash is corrected)
- Financial statement note: "inventories are stated at cost determined by the FIFO method"

Case Study

What Does GAAS Require?

- "Observation of inventories is a generally accepted auditing procedure. The auditor who issues an opinion when he has not [observed inventory counts] ... has the burden of justifying the opinion expressed."
[AU 331.01]

Case Study

What Does GAAS Require?

- AU 331 describes three acceptable methods of auditing inventories:
 - Observation and testing of physical counts at or very near the balance sheet date
 - Testing of well-kept perpetual inventory records and comparison with physical counts
 - Evaluation and testing of statistical sampling or other scientific inventory determination methods

Notes

Case Study

SCAM's Inventory System

- No perpetual inventory system
- No periodic or annual physical counts
- Inventory determined as follows:
 - Opening balance
 - Plus purchases
 - Minus *estimated usage* during the year
 - Equals ending inventory
- Adjusting entry: \$234,000 increase "to correct inadvertent recording as expenses"

Case Study

WWLT's Inventory Testing

- Examined a 50% sample of invoices for inventory additions
- Decided that *estimated usage* was reasonable
- Tested the \$234,000 addition by examining invoices; found \$64,537 not supported; required no adjustment
- "During performance of other audit work, staff visited several sites and noted the existence of supplies"

Case Study

Mr. Lykit's Explanations

- "These were not actually inventoriable supplies, but more like prepaid expenses"
- "*Montgomery's Auditing, 10th Edition*, lists supplies inventory as a component of prepaid expenses"
- "The workpapers support testing of the FIFO supposition"

Case Study

**Related Party Transactions in the WPs ...
But Not Disclosed in the Financial Statements**

- Purchase of a building from executive director for \$468,000
- Payables to related parties totaling \$99,554; including \$66,951 in past due rent owed to the executive director
- \$72,000 in short-term loans from the executive director's sister

Case Study

What Does GAAP Require?

- Disclosure of material related party transactions [per FAS 57]:
 - Nature of relationship
 - Description of transactions
 - Amounts for each period
 - Amounts due to or from related parties as of the balance sheet date; and terms of settlement

Case Study

Mr. Lykit's Explanations

- "The disclosure regarding the \$468,000 building purchase appears weak"
- "Not all of the \$99,554 that the workpapers called related party transactions were actually transactions with related parties. We are not sure why the auditor identified them as such"
- "The \$72,000 loan from the executive director's sister was immaterial"
- "The \$66,951 in delinquent rent could certainly be added"

Notes

Case Study

**The \$468,000 Building--
What the WPs contained**

- > Board meeting minutes (1 day before the balance sheet date) deferring a decision on the purchase
- > Board meeting minutes (25 days after the balance sheet date) approving the purchase
- > DMV title (dated 6 months after the balance sheet date) showing the asset still owned by the executive director

Case Study

Mr. Lykit's Explanation

- > "We felt that confirmation from the executive director that the [building] was pledged, an independent valuation, and evidence of transferability were more than sufficient procedures"

Case Study

**\$549,979 Leasehold Improvements--
What the WPs Contained**

- > All payments were to Ivana M. Werthet
- > I.M. Werthet is SCAM's "highest paid employee" (salary twice that of the executive director)
- > I.M. Werthet, age 29, is SCAM's full-time "maintenance manager;" But also runs her own general contracting business
- > I.C. Zilch memo: "vendor file contains only personalized invoices on I.M. Werthet stationary with no other support for labor or materials charges"

Notes

Case Study

Mr. Lykit's Explanation

- "We viewed Ms. Werthet's status as that of an independent contractor and tested leasehold improvement transactions to her invoices without exception. It is her responsibility, not SCAM's, to maintain the detailed support"

Case Study

Mr. Lykit's Explanation for Not Confirming Receivables

- Some of the receivables were "traced to work done in prior years"
- A \$24,955 insurance receivable was not confirmed, because "the amount had not been settled with the insurance company"
- A \$69,203 contract receivable was "not confirmed, because at the time of the audit [6 months after the balance sheet date] it had not yet been billed"

Case Study

Transaction Testing of Non-Payroll Expenses

- Total non-payroll expenses: \$8,220,063
- Tested a statistical sample of 38 transactions totaling \$16,628
- Tested 4 attributes
- Test results were above the defined "maximum acceptable error rate" of 10% for two attributes tested:
 - "Properly supported" 21.07%
 - "Correctly recorded" 14.02%
- No further testing performed

Notes

Case Study

Mr. Lykit's Explanation

- "Based on cumulative knowledge and experience with the client and results of procedures performed in other areas, most ... expenditures are clearly insignificant."

Case Study

New Spendalot Times Herald

**Nonprofit Executive Director Indicted
on 19 Counts of Fraud, Tax Evasion,
and Embezzlement**

Case Study

New Spendalot Times Herald

**State Decides Nonprofit's Educational
Contracts Will Not Be Renewed--
SCAM Vows To Fight State's Action**

Notes

Case Study

New Spendalot Times Herald

**State Board Of Accountancy
Sanctions CPA Firm--
“Gross Negligence” Found In Audit Of
Nonprofit Organization**

Case Study

New Spendalot Times Herald

**Nonprofit Sues Auditors
For \$12 Million--
Three Firms Accused Of Substandard Audits
That Resulted In Loss Of State Funding**

Case Study

New Spendalot Times Herald

**Nonprofit Sues
State Officials
Department of Enlightenment
Auditor, Investigator, and General Counsel
Accused of Defamation**

Notes

Case Study

Statewide Care and Maintenance



Case Study

Statewide Care and Maintenance
FRAUD RISK FACTORS/INDICATORS

One more important fact

- > WWLT's audit fee from SCAM was about \$36,000 per year
- > WWLT also maintained SCAM's accounting system and did other consulting work for SCAM
- > Non-audit fees WWLT received from SCAM totaled about \$330,000 per year

Notes

Handout Page NN

Case Study

IRS = J.R. Stevens

Case Study

IRS = J.R. Stevens

- J. R. Stevens was an IRS official in the collections division of the IRS Maryland and Delaware district office
- He embezzled \$77,218 by altering 13 checks made payable to “IRS” to read “JRStevens”
- After depositing each check into his personal account, he recorded the taxpayer’s debt satisfied

Case Study

IRS = J.R. Stevens

- Stevens was caught because he diverted a check for \$6,578.66 but then failed to record the debt as satisfied
- The IRS then garnished the wages of the taxpayer’s wife

Notes

Case Study

IRS = J.R. Stevens

- Stevens was clever enough to only divert treasurer's and cashier's checks, which are not routinely returned to check writers
- Similar cases
 - An IRS officer changed "IRS" to his initials "ARS"
 - An IRS employee changed "IRS" to "MRS" followed by her last name

Case Study

IRS = J.R. Stevens

OPPORTUNITY

FRAUD

MOTIVE PRESSURE **ATTITUDE RATIONALIZATION**

Case Study

IRS = J.R. Stevens

FRAUD RISK FACTORS/INDICATORS

Notes

Case Study

The Errant EFT

Case Study

The Errant EFT

- *Black on Black Crime, Inc.*, was founded in 1972 to deal with crime and civil rights issues in Cleveland
- In 1997, BBCI found itself on the wrong side of the crime issue

Case Study

The Errant EFT



Art McKoy, BBCI founder and president

Notes

Case Study

The Errant EFT

- On March 31, 1997, a City of Cleveland clerk wired \$617,596.99 to EFT account number 968-112-417-9436, the account (she thought) for Cinergy Services, Inc., one of the City’s utility providers
- Cinergy’s account number, however, is 968-112-147-9436
- Account number 968-112-417-9436 belongs to BBCI; the money appeared in the account on April Fool’s Day, 1997

Case Study

The Errant EFT

- Cleveland was a bit behind in doing account reconciliations, so the erroneous transfer was not discovered until almost 5 months later, in August 1997; and it took finance department personnel 5 more weeks to figure out where the money had ended up
- The errant money had only been missing for 6 months; surely, it shouldn’t be too difficult to get it back

Case Study

The Errant EFT

- So, if you were the president or chairman of a small not-for-profit organization, and found \$617,596.99 in your checking account, what would you do?

Notes

Case Study

The Errant EFT

- BBCI had received \$7,000 from the City in 1996, so the \$617,596.99 deposit was somewhat of a surprise
- BBCI chairman Abdul Rahim Ali Hasan said he was not alarmed since BBCI had submitted more than 100 state and federal grant applications
- He said the bank told him that it was a federal wire transfer intended for BBCI
- City officials asserted BBCI was told that the wired money came from the City of Cleveland

Case Study

The Errant EFT

- In any event, by September 1997, the money was gone
- President McKoy, Chairman Hasan, members Eric Norvell and Derek Washington and BBCI were indicted on October 30, 1997 on one grand theft felony count each
- Norvell plead guilty to a misdemeanor charge of accepting stolen money
- McKoy, Hasan, and Washington went to trial

Case Study

The Trial

- McKoy said he thought the money had come from “a guardian angel”
- He said that Albert Belle and Mike Tyson had shown interest in BBCI and he suspected that the money might have come from them
- McKoy said that Hasan told him it would be okay to keep and spend the money

Notes

Case Study

The Errant EFT

- The 12-member jury found McKoy, Hasan, Washington, and BBCI guilty on April 23, 1998
- The jury concluded that *“McKoy and [his] fellow Black on Black officials knew that a fortune they discovered in their bank account last year belonged to the City of Cleveland and used deception to keep control of it.”*

Case Study

The Errant EFT

- Although evidence at trial showed that Art McKoy did not receive or benefit from any of the money personally, on May 21, 1998, he was sentenced to 2 years in prison
- Chairman Hasan was sentenced to 3 years in prison
- Washington’s sentencing was postponed pending a psychiatric evaluation; he was later sentenced to 3 years in prison
- BBCI was fined \$10,000

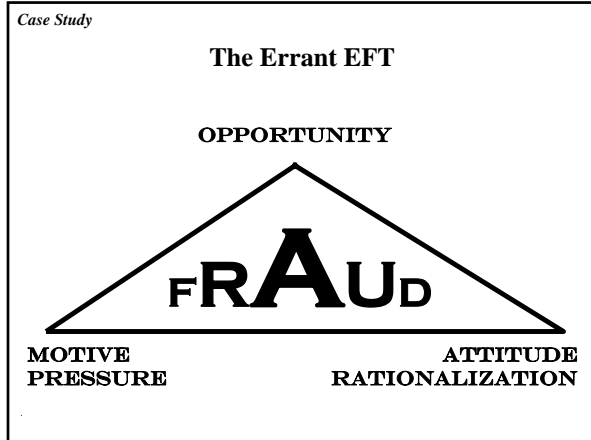
Case Study

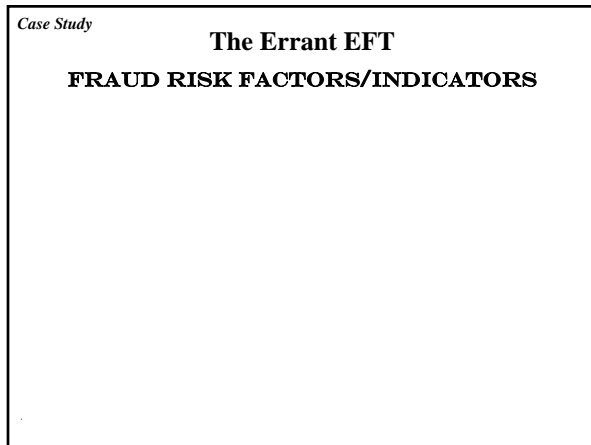
The Errant EFT

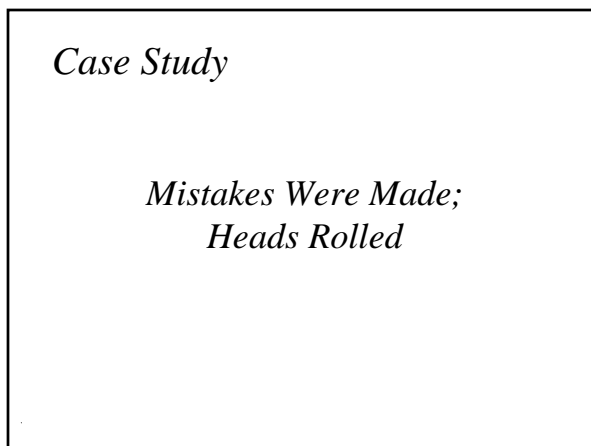
- Art McKoy was released from prison on May 18, 2000, and has resumed his leadership role with BBCI
- He now claims that he does not believe that the wire transfer was a mistake
- The City has recovered less than \$400,000 of the \$617,596.99

New York/New Jersey and New England Joint
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Notes







Notes

Case Study

Cuyahoga Metropolitan Housing Authority

- In 1990, CMHA was an agency in trouble.
- The State Auditor had declared the 1989 books to be “unauditable.”
- Federal officials had forced the resignation of CMHA’s chief executive, George James
- New leadership was needed, the board decided

Case Study

Cuyahoga Metropolitan Housing Authority

- Claire Freeman seemed like just what CMHA needed to turn itself around



Case Study

Cuyahoga Metropolitan Housing Authority

- Claire Freeman seemed like just what CMHA needed to turn itself around
- Claire’s credentials were impressive:
 - Deputy Assistant Secretary at DoD
 - Deputy Assistant Secretary at HUD
 - Undersecretary of Administration at HUD

Case Study **Cuyahoga Metropolitan Housing Authority**

- > Someone with this background doesn't come cheap, however.
- > Terms of her contract (total value, about \$210,000 per year):
 - \$120,000 base salary ("highest paid housing boss in the country")
 - \$10,000 signing bonus
 - \$10,000+ "performance bonus" each year
 - \$10,000+ annual contributions to her tax deferred savings plan
 - 7% contribution to a basic benefit plan
 - 8% contribution to her retirement saving plan
 - Four weeks paid vacation (\$10,000 value)
 - "Relocation" and "transitional living" expenses
 - \$24,000 Chrysler LeBaron, plus full-time driver
 - Tuition reimbursement
 - \$360,000 life insurance policy
 - 75% disability insurance policy
 - \$250,000 to remodel her executive offices

Case Study **Salary Comparison**

	<u>CMHA</u>	<u>NYC Housing Authority</u>
Operating Budget	\$42 Million	\$1 Billion
Properties	38	330
Residents	14,000	600,000
Employees	650	15,000
Director's Salary	\$120,000	\$95,000
(1998 Salary)	\$218,000	

Case Study **Cuyahoga Metropolitan Housing Authority**

- > Claire took aggressive action to turn CMHA around
- > Immediately fired 5 assistant deputy directors
- > Hired Ronnie Davis as CMHA CEO (1995 wage and benefits package: \$378,965)
- > Hired Dr. Kent Stephens as a consultant (Consulting contract payments of \$327,000 from 1992 to 1998)
- > Hired Ira A. McCown, Jr., to plan and develop a low income home ownership program (which if successful would result in up to a \$375,000 bonus for McCown)

Notes

Case Study

Cuyahoga Metropolitan Housing Authority

- Claire failed to inform the board, however, of two facts about Ira McCown:
 1. He had a felony conviction in connection with another housing deal
 2. Ira and Claire were romantically involved

**Claire Freeman became Claire
Freeman-McCown in June 1997**



Case Study

Cuyahoga Metropolitan Housing Authority

- McCown's "New Town/In Town" project did not succeed
- CMHA spent 2 years, thousands of hours, and \$600,000 on consulting fees on the project
- The reason the project failed was not complex
 - The homes to be bought by low income families ranged in price from \$100,000 to \$158,000 (compared to an average \$94,000 sales price in the area where the first set of houses was to be built)
 - To qualify to purchase a home under the program, an applicant would need to have income below \$34,300 to \$42,900
 - Income at those levels would not qualify for a mortgage of the size needed to buy one of the program's houses

Case Study

Cuyahoga Metropolitan Housing Authority

Upon learning of McCown's prior felony conviction, the CMHA board ordered Claire to fire him and terminated the New Town/In Town project

The New Town/In Town project failure attracted the attention of the State Auditor, HUD, and

The Cleveland Plain Dealer

Case Study

The Cleveland Plain Dealer

- > While investigating the New Town/In Town project and the relationship between Claire and McCown, Plain Dealer reporters discovered an anomaly in Claire's compensation package
- > They discovered that CMHA had been paying the mortgage payments on Claire's townhouse in Alexandria, Virginia
- > Claire explained this as simply part of her "relocation" and "transitional living" expenses and fully covered under her employment contract

Case Study

Claire's Townhouse



- > Purchased in 1989 for \$225,000
- > Claire moved to Cleveland in 1990
- > CMHA began making the mortgage payments in 1994
- > Payments since 1994 totaled almost \$100,000

Notes

Case Study

Cuyahoga Metropolitan Housing Authority

- > Claire produced a letter--authorizing the payments--signed by three board members
- > The board's lawyer said, "The board has profound reservations about the authenticity of this document."
- > The board members say they never signed the letter

The Cleveland Plain Dealer [May 19, 1998]

CMHA head has to go
Freeman-McCown's sweet deal on moving expenses sours her reputation
beyond redemption



The Cleveland Plain Dealer [May 21, 1998]

CMHA's director suspended
without pay

Now the board owes us
answers

Notes

The Cleveland Plain Dealer [May 22, 1998]

Stokes asks for federal probe
of CMHA finances

Cleveland Life OHIO'S LARGEST AFRICAN AMERICAN WEEKLY
NEWS MAGAZINE [May 27, 1998]

Targets

Is America Taking Aim At African
American Leaders?



The Cleveland Plain Dealer [May 30, 1998]

Suspended chief sues CMHA
Freeman-McCown says board violated
contract

Notes

The Cleveland Plain Dealer [September 30, 1998]

CMHA board fires suspended
chief exec

HUD suspension of Freeman-McCown left board
with no choice

The Cleveland Plain Dealer [December 31, 1998]

State audit questions \$6 million
CMHA spent

"They have tarnished the financial health of this agency.
It puzzles me, and it distresses me."
-- Claire Freeman-McCown

The Cleveland Plain Dealer [February 10, 1999]

CMHA ex-chief liable for
spending

State auditors frame possible legal action

Notes

Key Witness for Freeman-McCown



- F. Aurelius McKanze
- Handwriting expert
- Testified that board member signatures on letter authorizing mortgage payments were authentic

The Cleveland Plain Dealer [October 2, 1999]

CMHA's ex-chief loses lawsuit

Freeman-McCown must pay back \$462,200, jury finds

The Cleveland Plain Dealer [October 2, 1999]

- "F. Aurelius McKanze, later revealed to be Fulton McCants, testified that he was a certified document examiner with an extensive military and academic background."
- "But his credentials turned out to be unsubstantiated, and a Plain Dealer inquiry revealed a 30-year history of convictions, mostly for forgery and theft offenses."
- "Willis [Claire's attorney] said that he thought McKanze did hurt Freeman-McCown's case."

Notes

The Cleveland Plain Dealer [October 27, 1999]

**Bogus expert witness pleads
guilty to perjury**

He testified CMHA letters were genuine;
faces up to five years in prison

Lawyers for Freeman-McCown insisted that they
did not know of McKanze's background, and said
they got his name from the phone book, under
"handwriting analysts and experts."

The Cleveland Plain Dealer [November 30, 1999]

Perjurer accused of lying again

Notes from doctors fake, prosecutors say

McKantz arrived at his sentencing hearing completely
bald, and with letters from two physicians stating that he
was dying of prostate cancer.

The Cleveland Plain Dealer [December 4, 1999]

Perjurer awaiting penalty is dead

"possible suicide" according to police

Notes

The Cleveland Plain Dealer [March 22, 2001]

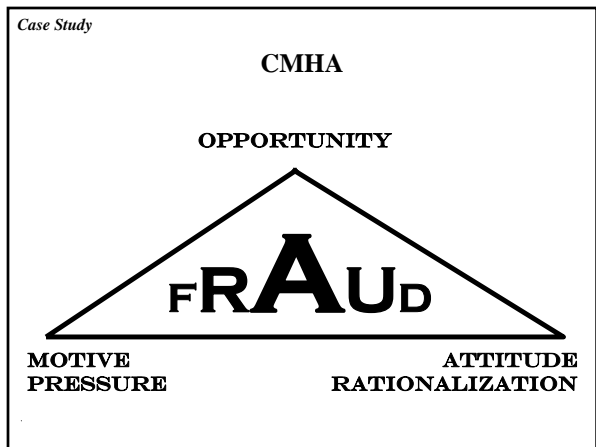
Former housing director, deputy
indicted

Accused of stealing funds slated for poor

Cleveland Life OHIO'S LARGEST AFRICAN AMERICAN WEEKLY
NEWS MAGAZINE [May 27, 1998]

FREEMAN. SCAPEGOAT?

Fed grand jury ignores role of Deloitte &
Touche, HUD officials and Auditor of State
Jim Petro in 8 year CMHA \$10.7 million
Title V spending controversy



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Notes

Case Study

CMHA

FRAUD RISK FACTORS/INDICATORS

Corruption and Fraud—Recommended Additional Reading

- ✓ *Frankensteins of Fraud: The 20th Century's Top 10 White-Collar Criminals*, By Joseph T. Wells, CFE, CPA [www.marketplace.cfenet.com]
- ✓ *Occupational Fraud and Abuse*, By Joseph T. Wells, CFE, CPA [www.marketplace.cfenet.com]
- ✓ *The Informant: A True Story*, By Kurt Eichenwald
- ✓ *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*, By Bethany McLean and Peter Elkind
- ✓ *Conspiracy of Fools: A True Story*, By Kurt Eichenwald
- ✓ *Final Accounting: Ambition, Greed and the Fall of Arthur Andersen*, By Barbara Ley Toffler
- ✓ *Inside Arthur Andersen: Shifting Values, Unexpected Consequences*, By Susan E. Squires
- ✓ *Unaccountable: How the Accounting Profession Forfeited a Public Trust*, By Mike Brewster
- ✓ *Enron : The Rise and Fall*, By Loren Fox
- ✓ *Power Failure: The Inside Story of the Collapse of Enron*, By Mimi Swartz and Sherron Watkins
- ✓ *24 Days: How Two Wall Street Journal Reporters Uncovered the Lies that Destroyed Faith in Corporate America*, By Rebecca Smith and John R. Emshwiller
- ✓ *Disconnected: Deceit and Betrayal at WorldCom*, By Lynne W. Jeter

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The Good, the Bad, & the Ugly:
Case Studies in
Public Corruption and Fraud

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