



THE FRAUD BEAT

When the Boss Trumps Internal Controls

What a difference a hotline, a routine audit and the right reporting chain could have made.

by Joseph T. Wells

When a college was so broke it couldn't even afford copy paper, toner and other inexpensive supplies, it took some sleuthing to find the reason. This article summarizes the heroic efforts of one CPA, without pay or outside staff (or experience in fraud detection), who helped bring down a powerful and arrogant college president.

Mary-Jo Kranacher, CPA, was an adjunct professor in a large, urban public university. One day after work she was headed out of the building when a colleague, clutching a sealed manila envelope, said in a low voice, "Mary-Jo, I need for you to see this material. But not here, not on campus."

Kranacher took the envelope home and carefully examined its contents. She was shocked to see page after page of purchase orders and vouchers she believed to be clearly inappropriate expenses that had been paid with the college's funds: liquor stores, personal credit card charges and international travel, to name a few. Each and every document had been authorized by the college president, Regina (not her real name).

Regina had been hired three years earlier with great fanfare and support. But the honeymoon was short-lived; she quickly developed a reputation as a ruthless dictator who was fiscally irresponsible. Those who dared to question her authority or decisions found themselves on the street. The personnel director, for instance, was fired while he was at lunch. Upon his return he found the locks on his office had been changed and his personal effects unceremoniously dumped into boxes for him to tote home. And that was just the beginning.

The Freedom of Information Act

and the Privacy Act

Two powerful federal laws govern access to government records.

■ **The Freedom of Information Act**, passed in 1966, gives the public access to information held by the federal government, with certain exceptions. Each state has its own laws concerning disclosure of state and local government bodies. There is no specific form for requesting information; it is generally by letter directed to the head of the particular agency.

■ **The Privacy Act** (5 USC, section 552a) concerns your ability to request records maintained about you individually. As with the Freedom of Information Act, there is no specific format for requesting the records. The government may withhold information under certain exceptions, such as national security concerns.

REIGN BY TERROR

I'd personally seen Regina's management style before. At the age of twenty-something, I was appointed a special agent of the Federal Bureau of Investigation. While I was attending the FBI Academy in 1972, J. Edgar Hoover died in his sleep. I learned about it when I went to breakfast the next morning. You couldn't wipe the smiles off the faces of many veteran and rookie agents.

Although Hoover did much good by helping create a legendary law enforcement agency, few would dispute that he reigned by terror. Those employees who displeased him were demoted, transferred or fired. Even U.S. presidents were fearful of Hoover's wrath. He surrounded himself with those who would obey him without question. According to lore, the FBI director was once reading a memorandum when he noticed that the document's margins were too wide. On the memo, he wrote, "Watch the borders." Without asking why, Hoover's underlings immediately dispatched agents to the crossings at Mexico and Canada, too fearful to inquire of him as to what they should be watching.

Much the same atmosphere existed in Regina's reign. Although the college had various boards and committees to provide fiscal oversight, the president ruled with an iron fist; her decisions were not to be questioned by anyone, any time, under any circumstances. Regardless, Kranacher knew by looking at the documentation that something appeared very, very wrong.

Rumors also had been swirling around the institution that Regina's lavish spending habits added to the deepening financial crisis at the school. Whatever the situation, the CPA was determined to get to the bottom of it, even if it cost her job. By gaining the trust of several employees who worked in the administrative offices of the college, Kranacher was secretly provided with documents that showed the president had used the school's expense account reimbursements to line her own pockets. Kranacher compiled a summary report with copies of the illicit expense account charges that she presented confidentially to the faculty governance and union leadership at the institution. But nothing happened.

DEEP DEBIT

The financial problems of the college had not escaped the notice of one enterprising newspaper reporter. Like many journalists, he hardly considered himself an accounting expert. Through inquiries of others at the college, he finally was led to Mary-Jo Kranacher. He came right to the point: “What is going on here?” Kranacher explained that she didn’t have sufficient records to know, for certain, the extent of the problem. The reporter asked, “If I get them, can you help me?” Kranacher agreed to tell him what records she needed to see, and he would request them from the college through the state’s open records law, which is modeled after the federal Freedom of Information Act (see sidebar below). Kranacher would review the documents and give him her findings. In return, the reporter agreed to keep her identity confidential. Not Deep Throat, exactly—more like Deep Debit.

Obtaining the college’s records proved more difficult than either of them had imagined. They received duplicate boxes of documents in no particular order, and missing records that had to be requested again and again. Finally, after months of painstaking and frustrating work, Kranacher was able to piece together what had occurred.

DISCRETIONARY, SMESHONARY

The president of the college initially was allotted a “discretionary fund” of several thousand dollars to “support the educational, social and cultural events and programs of the college.” This fund had little oversight, so Regina used it as a conduit for spending that was highly questionable—if not downright fraudulent. For example, Kranacher found \$84,000 had been transferred out of the Adult and Continuing Education program and into the discretionary fund. The president also had raided the Auxiliary Enterprises Corporation, a college-related program that raised money from food services, bookstore sales and campus parking. Other targets included the College Foundation, a tax-exempt corporation formed to solicit and administer funds through various fundraising activities, and the College Student Association, which raised money from student clubs and other sources.

Steps to Take

- ***Do a thorough background check.*** Such a vetting before Regina was hired probably would have revealed her true stripes. Some assume a person vying for a CEO position requires nothing more than a perfunctory screening. That’s not only incorrect, the truth is quite the opposite; the more important the position, the more thorough the screening should be. Regina didn’t get to be a tyrant overnight—no doubt she had much previous practice.
- ***Scrutinize the expense accounts of executives.*** Some CPAs incorrectly believe there is a difference between the honesty level of executives and the rank-and-file; there isn’t. Indeed, according to the Association of Certified Fraud Examiners’ (ACFE) *2004 Report to the Nation on Occupational Fraud and Abuse*, executives were the worst offenders in expense account fraud and abuse.

■ **Conduct a routine audit.** Regular audits by independent CPAs go a long way toward preventing (but not necessarily detecting) fraud at all levels. The thought of other eyes examining the finances has been shown to be a powerful deterrent; the ACFE 2004 report documents that fraud losses are cut in half when an organization is audited.

■ **Ensure the board of directors does its job.** Providing oversight is the board's responsibility and it must do it right. CEOs cannot be permitted to operate without checks and balances on their authority. As Lord Acton so succinctly put it, "Power corrupts and absolute power corrupts absolutely."

WHILE ROME BURNED

Even though the college was already in deep financial trouble, Regina went on a spending frenzy. There was the nearly \$300,000 spent to renovate the residence that the college provided to her without charge, plus about \$70,000 to refurbish her office. And almost \$25,000 went for her coronation ball as president, paid through the discretionary fund which was subsequently relabeled the inauguration fund. Kranacher discovered that Regina had taken an "official trip" to South Africa that included her husband and son, all on the college's nickel. And she blew nearly \$6,000 on upgrades to her taxpayer-provided automobile. She even bought 400 copies of a book that she had edited.

FRAUD OR FOLLY?

Although Kranacher had informed university officials of the problems at the college, it wasn't until Regina's wild spending hit the newspapers that a formal outside audit was conducted. The auditors ultimately concluded there was insufficient evidence—because of the wide latitude given the college president—to prove fraud. Instead, Regina was instructed by university officials to repay about \$12,000 of the college's money, and was asked to step down from her position as college president.

This was Kranacher's first case of misappropriation, but it certainly wasn't her last. She went on to earn her certified fraud examiner designation and is now the head of the Association of Certified Fraud Examiners' Higher Education Committee, which is responsible for providing free support for antifraud education to colleges and universities. She said that she has learned a lot from this case and the ones that followed.

"The situation with Regina is a classic illustration of how management override can defeat the internal control systems that are run by human beings who are often beholden to management for their jobs," Kranacher observed. "Because this college president's style was so intimidating, those below her were afraid to speak out when she involved them in improperly transferring college money to her discretionary fund. In previous administrations, the president's discretionary fund was rarely over \$5,000. In my estimation, Regina misspent at least a half-million dollars." Taking the steps to prevent a situation like this would have been much more effective than dealing with the aftermath.

OTHER MISSING LINKS

Kranacher says others share responsibility for allowing this boondoggle to occur.

“University officials didn’t insist on having an anonymous reporting mechanism, such as a hotline. I’ve now learned just how vital this is to the early detection of fraud. And the internal auditors for the university share a portion of the blame, too. Even though they were well-meaning, they’d had no antifraud training and therefore weren’t aware of the kinds of people who are most likely to commit these offenses. In addition, the internal audit staff reported to the managers of the university rather than the board of trustees. When you have someone who is tyrannical, he or she must receive close independent scrutiny.”

A historical look at massive fraud cases supports Kranacher’s latter point: Barry Minkow of ZZZZ Best infamy, Ivan Boesky, WorldCom’s Bernard Ebbers and the Rigas family in Adelphia—the list goes on. Good CEOs are strong team players. Bad ones believe it’s their way or the highway. Kranacher is glad for the experience, but not eager to relive it.

“I lost a lot of sleep over this. I worried that by trying to find the truth I’d lose my job or get sued,” she told me. “Working on this case in a cloak-and-dagger fashion may sound exciting, but in reality it is quite unnerving. And finally, I am not sure how thrilled I am about being called Deep Debit.” ♦

Joseph T. Wells, CPA, CFE, founder and chairman of the Association of Certified Fraud Examiners, is a contributing editor to the JofA. He twice won the Lawler Award for the year’s top article in the JofA, for which he was named to the Journal of Accountancy Hall of Fame. Wells is also a member of the Business and Industry Hall of Fame. His e-mail address is joe@cfnenet.com.



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