

BROKEN TRUST: AN EXPENSIVE AFFAIR

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ABSTRACT

Public officials are entrusted with hard-earned tax dollars meant to benefit the community in ways set out by elected representatives. Controls and policies are put into place to ensure that individuals do not misappropriate those funds for other purposes, including their own personal gain. Sometimes safeguards are insufficient or break down in the face of human failings and human relationships. This case, which is based on actual events, illustrates ways in which the principles of proper internal controls, good human resources practices, and effective ethical reasoning were all lacking. Background is provided about a city comptroller who rose from humble beginnings to earn the trust of his co-workers and community. He used his position to embezzle funds to finance an affair with a vendor to the city. The existing internal controls did not catch him, and his thievery was not discovered until he left the city's employment.

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INTRODUCTION

As Human Resources Manager for the City, Melinda had not slept much during her tenure. Within her first six months on the job, Jonathan Reese, former Director of Administrative Services, was arrested and charged with embezzlement. Now that the case is closed, she is faced with orders from the mayor to ensure that this “never happens again!” She has a city council meeting next week where she and the City Comptroller must present a comprehensive solution to the conditions that led to the crisis within the Comptroller’s Office.

Melinda knew that fraud cases were not uncommon in smaller organizations. However, the city in question was a moderately sized metropolitan municipality in the southern United States. It has approximately 370,000 residents and enjoys about one percent positive population growth annually. This is slightly above average for the state (0.8 percent population growth). The median household income is approximately \$40,000 with median home value at \$130,000. Melinda and the Human Resources Department keep busy, as the city has over 1,200 employees working in either full or part time positions at any given time. The city has an annual budget of approximately \$94 million, \$11 million in long term debt commitments, and \$96 million in capital assets.

LEAVING THE COURTHOUSE

A group of city employees were at the courthouse when the Jonathan Reese’s sentence was imposed. Melinda had become friends with Rebecca during the crisis. As the current Comptroller and a former assistant to Reese, Rebecca was central to the prosecution’s case. Melinda listened to her coworkers’ assessment of the outcome.

“I know he committed these crimes, but it is still unbelievable to me,” said Jill, a staff accountant in the comptroller’s office. “He was so friendly to everyone, so driven to succeed, and so meticulous about his work.”

“Not to mention how savvy he was with technology,” added Rebecca. “It is amazing to me that someone who started working on the road crew for our city could be such a natural with computers without any formal training. When he began working for the city, his undergraduate degree was in history, not business.”

“Is that right? Wow, how in the world did he learn all of the business skills to become the city comptroller and then the director of administrative services?” asked Jill.

“On the job, at first,” said Rebecca. “He developed our computer payroll system before he became comptroller. His supervisors and coworkers were so impressed with the system that he kept getting promoted. Then he began taking accounting classes and received an accounting degree so he could hold the comptroller title. It was really just a formality, though. He was already doing most of the comptroller work already.” Both women were silent for a moment. They were devastated by the ramifications of Jonathan’s actions on the city, their jobs, and his family.

“His wife wasn’t at the hearing,” said Jill. “I don’t blame her. Can you imagine learning of his indiscretions on the news? I’m shocked that the affair with the software vendor representative was documented in those work emails.”

Rebecca pondered, “Jonathan and the software vendor did seem close, but I only thought they had a good working relationship. It would have made sense, right? It was a multi-million dollar contract.”

Rebecca continued, “I’m still pretty mad that it was my name he forged to get the money to fund the relationship. Dual signatures on documents mean nothing at all if forgery is involved.

I hate the fact that my name is associated with this debacle. I should have known something was wrong with that account. He has some nerve to pull this twice. The system should have locked him up when he was caught forging checks during his college years at the campus bookstore.”

“It’s not your fault, Rebecca. It is all on Jonathan,” responded Jill. “We do, however, need to reevaluate the controls in our department as well as policies throughout all city administration offices. We are not only business professionals, but government representatives. That carries a lot of responsibility. Just think if you hadn’t found the unfamiliar account activity when you closed the account? This could have continued for years.

Jill noticed that within the group of employees talking, Tony, a clerk in the Administrative Services Department, looked distressed. “Tony, are you okay? You are awfully quiet.”

“I’m fine,” said Tony, “just trying to absorb everything that just happened. Jonathan has always been a friend and supporter of mine. He hired me and mentored me. But I think we need to move forward and focus on current issues. We have a lot of work to get done today since it is the end of the fiscal year. There is nothing we can do to help Jonathan now. We need to keep the city’s finances running as smoothly as possible.”

Tony did not know what else to say. He had suspected that Jonathan was having an affair but didn’t say anything. Jonathan made numerous trips using city funds for vendor conferences and meetings with Mary Anne, the vendor software representative, which seemed unnecessary. In addition, Jonathan had accidentally copied him on a personal email sent to her, which was risqué, to say the least. But Tony was not in a place to say anything. He held a clerical position in the administrative services department; Jonathan was his boss. At the time, Tony didn’t want to rock the boat when he didn’t know anything for certain. And besides, who could he call?

Melinda and Rebecca were the remaining two employees with management experience. Even though Melinda was in human resources and Rebecca was fairly new in the comptroller role, the city council was looking to them to provide explanations and suggestions. It was important they understood each step of the embezzlement. They also knew that their recommendations could not come with requests for costly additional resources, such as additional employees.

RISE TO THE TOP

After obtaining a bachelor’s degree in history, Jonathan Reese had a hard time finding employment that utilized his skills. He needed to pay back his substantial student loans, so he accepted work with the city road crew. After six months, he was thrilled to be offered a job with the city as an assistant at the historical museum. He accepted the job and despite being underpaid, Reese enjoyed using his knowledge of city, county and state history to create new exhibits. His colleagues soon discovered that he was a computer whiz, and he began developing programs to assist with museum administrative duties. In a year’s time, he was overseeing accounting and budgets for an exhibit grant. His knowledge of technology made him indispensable, and he continued to improve himself by taking extra classes.

Reese’s efforts were noticed. He was hired by the city government to be the city acting comptroller with the understanding that to obtain the position permanently, he would complete his last semester of accounting courses at the local university. He assumed the position of comptroller permanently with the completion of his degree, hard work, and extra effort. After two short years, he became the director of administrative services. His responsibilities included overseeing the city budget and managing the comptroller office. After fifteen years with the city,

Jonathan Reese left city employment to become CFO over a state program which included distribution of federal funds.

THE TRUTH COMES TO LIGHT

Shortly after leaving the city director position, Reese was arrested on allegations that he stole \$75,000 in city funds. He was initially charged with fifteen counts of felony theft, but prosecutors later combined the theft counts into two charges. In addition, Reese was charged with two felony counts of forgery, and a misdemeanor count of abuse of office. The prosecuting attorney said that although Reese used money he stole from the city to fund his romance with the software vendor representative, investigators could not find sufficient evidence that he used his position to influence a financial software contract that had earned the vendor's company more than \$2.2 million.

According to investigators, Reese's embezzlement started when he was the comptroller. His arrest report states that he "knowingly took unauthorized control by forging the assistant comptroller's signature on checks intended for the city government, deposited them into a city account, and then used the funds for personal activities." The bank account was initially established for a permanent endowment fund in support of city park beautification. Due to the economic downturn in the community, the fund had yet to earn a positive return.

Mary Anne, the vendor representative who had been working with Reese on the city's software contract, was promoted to vice president of sales for the software company about six months after their affair and his embezzlement activities began. At the time of her promotion, Mary Anne had been with the company for seven years. Her company specialized in software for municipalities, and Reese sought out a technology solution to help manage the city's finances. Mary Anne and Reese continued their affair with rendezvouses all over the country. Reese's public servant salary was not enough to maintain his new lifestyle which triggered the beginning of the embezzlement. In his pursuit of the affair, Reese went so far as to use a city cell phone to participate in graphic conversations and picture exchanges with Mary Anne and then sent the transcripts of the texts to his city email account. None of these communications were initially intercepted by the city's information technology department.

Rebecca discovered irregularities in the endowment bank account that led authorities to learn that city money was missing. Reese had changed the endowment portfolio to another bank, but left \$10,000 in the first account to keep it open. Rebecca had repeatedly asked Reese to close the original account and move the last amount of the endowment fund to the new bank. When Reese left city employment, she attempted to close the account herself. She discovered an overdraft charge that needed to be paid before the account could be closed. Looking further, she found "unfamiliar activity" in the account history. She and the new Assistant Comptroller, Mike, traced deposits to checks that were intended for city revenues. The funds represented taxes paid for 911 services, rebates, and vendor payments for snack and soda machines. Reese had routed the funds through the now defunct account and then into his personal bank account via checks with Rebecca's forged signature. He depleted the additional deposits as well as the trailing endowment principal.

He pled innocent at his arraignment the day after his arrest. During the trial, it was revealed that Reese previously had been convicted of forgery while he was studying history in college working for the campus bookstore. This was a surprise to the city and state officials, as they had never bothered to run a background check on him.

Reese's attorney described his client as bright and charismatic with a compulsive drive to succeed. But those attributes that carried Reese to the top also contributed to his downfall. His attorney was quoted to say, "It seems like every time things get going really well for him he starts to make bad decisions. Many times when someone rises really fast, ego gets the best of them."

THE VERDICT AND SENTENCE

Reese suffered major consequences for his actions. In exchange for dropping one felony charge, Reese pled guilty to one count of felony theft and one count of felony forgery. Reese was sentenced to 25 years in prison with eight years suspended and over \$75,000 in fines. The prosecutor intended to both punish Reese and get the taxpayers' money back. In addition, Reese was fired from his new job as CFO over a state program.

Melinda knew the city council meeting she was preparing for would not go smoothly. Although the perpetrator was caught and punished, the negative consequences of Reese's actions were far reaching. The trust of the citizens in their city officials was betrayed. Public sentiment reflected increasing cynicism toward government and financial professionals. Public confidence in the role of government to use public funds to benefit the community as a whole was at an all-time low. Her recommended changes had to be far reaching and comprehensive in order to begin to repair the damage. She opened the file and began her last edits.

POST-TRIAL EVENTS

The software system that Reese advised the city to purchase while he was having his affair with the vendor's representative led to additional financial implications after the verdict and sentence. More than four years after the trial, the city comptroller and treasurer were forced to transfer over \$4 million from reserve funds into the general budget. This was a direct result of the poor installation and implementation of the financial software system by Reese. During the initial set up, a base budget figure one digit too large was used (\$1,500,000 instead of \$150,000) and this error went unnoticed by state auditors and city officials for several years.

Jonathan Reese spent very little of his original sentence in jail. He spent ninety days in lockup and was then transferred to a local work release center. He was allowed to work in the community for about a year before officially being paroled after serving only sixteen months of his original sentence.

STUDY QUESTIONS

1. Identify the conditions necessary for fraudulent behavior and how they are present in this case (see AU Section 316, *Consideration of Fraud in a Financial Statement Audit*). Do you believe the fraud is more or less severe since it was committed on a governmental entity (as opposed to a for-profit business entity)?
2. Which internal controls should have been in place to prevent this crime? Discuss at least three deficiencies in relation to the case.
3. What are the overall costs to the city for this crime? Be sure to consider all relevant costs, not just the embezzled funds.
4. What is a "governmental permanent fund?" In addition,
 - a. What type of transactions should be recorded in a permanent fund and an associated special revenue fund in terms of earnings and other transactions?
 - b. What type of irregularities, if any, happened in this case's permanent fund?

5. Some observers argue that the prosecuting attorney's use of Reese's personal messages sent through the city email system was a step too far and a violation of his privacy. Employees are allowed to make some personal, private phone calls from work. Shouldn't this same principle apply to email and text messages? Why or why not?
6. Virtue ethics is one approach to ethical decision making that emphasizes development of one's character and embodiment of virtuous traits. In his book *Moral Courage: Taking Action When Your Values are Put to the Test*,² Rushworth Kidder describes five widely shared values or virtues:
 - 1) honesty – truthfulness, sincerity, free from deceit;
 - 2) respect – esteem for a sense of the worth of a person;
 - 3) responsibility – moral, legal, or mental accountability;
 - 4) fairness – free from self-interest, prejudice, or favoritism;
 - 5) compassion – sympathetic consciousness of others' distress with a desire to alleviate it.

Which of the values did Jonathan violate? How? Which other individuals in the case acted (or failed to act) with virtue? How should they have handled the situation? Explain your reasoning.

7. Describe fiduciary duty for a government employee. Professionals responsible for the financial transactions and records of an organization must maintain high ethical standards and awareness. Are the ethical standards higher for financial professionals in the governmental sector than those in the business sector? Would Jonathan Reese's fraud be handled differently by administrators if he worked for a company instead of a city? Can you suggest ways to prepare students entering these professions for these responsibilities? Does the accounting profession offer any guidance?

² Kidder, Rushworth M., 2005. *Moral Courage: Taking Action When Your Values are Put to the Test*, New York: William Morrow, pp. 39-76.