LICENSE TO STEAL

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CASE DESCRIPTION

The primary subject matter of this case concerns employee fraud. Secondary issues examined include risk assessments and internal controls over cash. The case has a difficulty level of four or five, appropriate for senior level or first year graduate level. The case is designed to be taught in one or two class hours and is expected to require four hours of outside preparation by students.

CASE SYNOPSIS

License to Steal provides an engaging scenario based on a familiar activity: obtaining car license plates. The case is based on a real-world fraud in which a cashier in a state revenue office embezzled approximately $360,000, mostly $24 at a time. The case emphasizes the importance of fraud risk assessment and internal controls over cash. Case questions begin by asking students to identify fraud risk factors and then consider various alternatives employees have for reporting suspected ethical violations. Since ineffective controls contributed to the fraud, students are asked to consider management culpability for institutional fraud by their staff. These questions are followed by a summative assignment to prepare a control assessment worksheet (template provided) in which students identify control objectives, as well as associated risks and control activities for each objective.

The case is ideal for Auditing, Accounting Information Systems, or Forensic Accounting students at the graduate or undergraduate level, since it focuses primarily on the development of good internal controls and the consequences of poor controls. In addition, the state government setting highlights the need for controls in all types of entities. The case offers a wealth of information on the internal processes of the state offices involved, the background of the fraudster, and results of the forensic investigation. License to Steal should be assigned after students have been introduced to the concepts of fraud and internal control over cash.

CASE BODY

INTRODUCTION

Juanita was excited about her new job in security operations at the state revenue office. The excitement wore a little thin when, after almost a year, she had not discovered anything significant despite faithfully watching her camera feed and performing her other duties. All

Juanita saw were customers visiting the office to get their drivers' licenses and car tags renewed, apply for titles for new cars, and occasional chitchat among the staff when the office was not busy. All good news, but not very exciting for a new security officer. Then something happened: Juanita noticed a cashier working busily, going between her desk and the cash drawer, but the cashier had no customer at her window (Sanders, 2008a). Juanita immediately took her concerns to the highest level of management in the office.

"What do you mean, the cashier doesn't have a customer, but she's taking money from her cash drawer?" Marla had been Head Administrator of the Office of State Revenue for the state for years and had never encountered an open theft of cash. "Surely there is a logical explanation," she hoped. Marla asked the cashier's immediate supervisor to come to her office.

The supervisor quickly explained, "That's Karen's stuff. Karen needs cash to refund customers, but she has to get another clerk to cash the customers' checks because Karen herself takes in so little cash. This is Karen's standard procedure when a personalized license plate is defective or denied. There have been a lot of defective plates lately, I guess, because sometimes Karen needs 20 or more checks cashed each day." The supervisor seemed sincere and believable, but Marla had a terrible feeling that they had just discovered the tip of an iceberg.

STATE GOVERNMENT BACKGROUND

The Department of Finance and Administration (DFA) is one of many state agencies that operates under the executive branch, i.e. the governor. Within the DFA there are many divisions, including the Division of Revenue Services, which is responsible for collecting approximately $8 billion in annual revenue from sources including income taxes, excise taxes, and motor vehicle fees. To protect the state's funds, the DFA instituted an array of internal controls that applied to all of its divisions. DFA established an Anti-Fraud Policy and Code of Ethics for state agencies, including an annual Code of Ethics Acknowledgement Statement to be signed by state employees. The DFA Internal Audit Department (Internal Audit) developed a statewide risk assessment program and trained officials in all state agencies regarding the purpose and implementation of the program. Annually, state agencies complete the risk assessments and submit them to Internal Audit where they are reviewed and used to help develop the next internal audit plan for the state.

Since some DFA divisions process large amounts of cash, the department developed a Cash Management and Banking Procedures Manual. Among other things, the manual addresses proper segregation of duties and the role of supervisory oversight. The manual also explains proper cash handling procedures, including a requirement that refunds be made by state checks. To strengthen controls further, the state requires pre-employment criminal background checks for all positions that include cash-handling duties.

As additional precautionary measures, the DFA provides an anonymous fraud hotline for state agencies. Also, state legislation requires agencies to report all suspected fraud or misuse of state funds, and it offers strong protection for whistle-blowers as well as heavy sanctions for those who retaliate against such employees. Finally, the DFA obtains fidelity bonds to protect the state in the event a fraud is committed that would otherwise result in a significant, uncovered loss.

Revenue Office Structure and Procedures

Marla was head Administrator for the Office of State Revenue, which operated under the purview of the DFA and its Division of Revenue Services. In the Office of State Revenue, there are five district offices as well as 140 local offices, commonly referred to as “revenue offices”. Marla had ultimate administrative, though not direct, responsibility for the activities and personnel in all the various revenue offices throughout the state. In addition, there was a local revenue office physically located in the same building as the administrative offices where Marla worked.

Revenue office personnel register motor vehicles, issue drivers’ licenses and state identification cards, collect sales tax on vehicle purchases, and issue titles for vehicles. Many customers use online or mail-in services, but revenue offices are always busy with walk-in customers as well. Walk-in customers pay using debit/credit cards, checks, or cash.

Personalized License Plates

Most license plate customers want the generic state license plate for their vehicles, but the state also offers personalized license plates. Personalized plates are customer-designed and have to be unique, such as “IAMLATE” and “MBA2022”. Customers have their choice of ordering personalized plates online, in person at a designated revenue office, or through the mail.

Personalized license plates require numerous procedures beyond standard license plates. At the time personalized license plates became available in the state, Karen was already a clerk at the revenue office. When the state began to offer personalized plates, Marla and the revenue office supervisor looked to Karen to develop forms, procedures, filing systems, and other infrastructure necessary to provide personalized plates. Karen became known as the personalized plate guru, and she alone handled all requests for personalized plates for the entire state. No other revenue office employee was ever involved with personalized plate procedures, and no one knew exactly what Karen did on a daily basis.

Personalized plates required fees ranging from $25-60 at the time of the initial order and annually when renewed. Once Karen approved the design and received payment from the customer, she sent the customer a notification letter confirming details of the order and recorded the transaction in the revenue office accounting system. Manufacture of the plate took six to eight weeks. Upon the plate’s completion, the state could mail the plate to the customer or send it to Karen for in-person pick up by the customer, as indicated at the time of order.

Since Karen was the only revenue office employee in the state who processed personalized plates, she had a private office to perform her duties. The other cashiers all shared space behind a customer counter. Physically separating Karen from the other clerks ensured that personalized license plate customers did not wait in the wrong line, as well as provided space for storing the additional paperwork required for personalized plates.

Marla felt that assigning all these tasks to Karen ensured accountability for the personalized license plate function, made it easier to train just one person in these special procedures, and provided enough work to keep one full-time employee busy. During the 20 years Karen had been an employee of the revenue office, she had consistently received excellent annual performance reviews. Karen was a trusted, valuable employee of the department who had designed and implemented an effective system to issue personalized license plates.

Karen and the other cashiers balanced their cash drawers daily: the cash receipts from customers were required to correspond to the transactions entered by each clerk in the revenue office accounting system. Each clerk had a unique user identification in the system and sole custody of an assigned cash drawer. Marla knew that none of the cash drawers had significant shortages or overages. So, what could be going on here? Why was Karen cashing so many checks with the driver's license cashiers?

THE INVESTIGATION

Initial Steps

The security director came to Marla with the video observation on September 20. Marla watched the video herself and felt angry when she saw the cashier removing cash from her drawer with no customer present. She at once called the cashier's supervisor to her office and received the explanation that the money was for "Karen's stuff", and that the cashiers never directly refunded cash to a customer. Knowing that Karen worked independently and that the other cashiers were unfamiliar with specialized plate procedures, Marla was suspicious of Karen's activities. Marla and her superiors strategized about how to handle the situation, and how to determine whether and how Karen might be stealing.

Marla decided the first step was to question Karen. Although Karen's reasons were somewhat vague, she indicated that she was mailing refunds in cash to customers whose orders she could not fill. Marla asked Karen where that day's refund money was and instructed her to go get it. Karen returned with the money. Marla had Karen identify the customers whose checks had been cashed in order to provide refunds. Marla then made sure the cash was deposited, and state checks were issued and mailed to refund the customers.

Within days of mailing the refund checks, the revenue office started receiving phone calls and letters from customers about the refunds. The customers all indicated that they had received their personalized license plate, had paid the correct amount, and wanted information on how to return the check to the state. In Marla's mind, these responses confirmed that Karen was stealing, but Marla needed more information.

Marla ordered an accounting system report detailing the most recent two weeks of Karen's transactions. The report she received was alarming for one reason: the majority of personalized plates were being issued for free. Although all cashiers had the capability to issue plates for free, the only legitimate reasons for doing so were because the plate was defective or because the plate was being replaced due to age. The number of free plates issued greatly exceeded those typically recalled and replaced because of age. Marla knew that it was highly unlikely that such a great number of plates were defective. For one thing, there would have been numerous customer complaints about the hassles of returning an incorrect plate and waiting for its replacement. There were no such complaints, yet the report clearly showed that most personalized plates were issued free of charge, at least in the last two weeks.

State Police Interviews

Based on the security video, the initial interviews, and now the accounting system report, coupled with the responses from customers to whom Marla had mailed the refund checks, Marla was convinced that theft had indeed occurred. Marla contacted the State Police on October 2 to report the apparent theft of state funds. She also contacted DFA Internal Audit, the Office of Legislative Audit, and her own division's legal counsel. Her initial groundwork took about two weeks.

The State Police began an investigation the same day Marla contacted them. In a room with no windows, one-at-a-time, an officer first interviewed each of the cashiers who worked on the front counter. In addition to questioning them regarding Karen's check-cashing activities, each cashier was asked if she had ever stolen from the state. Three of the cashiers admitted to stealing cash overages ranging from $0.25 to $200 at the end of any given business day. Because daily overages were not recorded in the accounting system, the total amount misappropriated by these cashiers could not be determined. All three cashiers' employment was terminated on October 2. Other than cashing checks for Karen when requested to do so, none of the front counter cashiers had any further knowledge or involvement in Karen's activities.

The officer interviewed Karen last, and she appeared to be in a daze. Karen answered the officer's questions, but she did not seem to grasp the severity of the situation. After the interview, Marla spoke with Karen privately and explained that Karen could no longer work at the revenue office. Karen took the news in stride and then asked, "Is this going to keep me from getting another state job?" Marla was stunned.

Karen was taken to her office, allowed time to collect her personal items, and then she was to be escorted out of the building. As Karen began gathering her things, a wave of panic washed over her, and she left suddenly without any of her belongings. Eventually, other employees packed her personal items, and they were collected by Karen's sister.

MISSED OPPORTUNITIES AND RED FLAGS

Since Marla's office was in the same building as the revenue office, she would often visit the cashier line to talk with employees. As she reflected on Karen's termination, Marla remembered some of the conversations she had with Karen over the years. She and Karen shared an interest in horses, and Karen's daughter competed in equestrian events. Karen and her sister were inseparable, and Karen's family took expensive vacations with her sister's family. In addition, Marla knew Karen had a young son with serious health issues.

Karen's annual salary was just $31,500, yet she had an expensive hobby, travelled, and incurred high medical bills. In hindsight, Marla could not help but wonder if she had missed some early clues. Although unknown to Marla, four years earlier, a cashier in the revenue office questioned a supervisor about the propriety of Karen's check-cashing activities. Unfortunately, the supervisor did not fully address the complaint, and in fact the employee was told, “It is procedural to comply (Sanders, 2008b).”

Marla was shocked that the fraud by Karen had gone unnoticed, and the thefts by the other three cashiers were troubling due to their implications for the internal control culture. Karen and the other cashiers had passed a criminal background check required by the state prior to being hired. However, despite handling cash, the state did not perform a credit check on cashiers at the time of initial employment or anytime thereafter. In addition, publicly available bankruptcy reports were not matched to employment records. If bankruptcy reports had been reviewed, the state would have known that Karen and her husband filed for bankruptcy protection eight years before the fraud was discovered. Six years after filing for bankruptcy protection and two years before the fraud was discovered, the couple had paid approximately $75,000 of the $100,000 they owed, and the bankruptcy was closed. However, based on Marla’s brief conversations with Karen, there was never any indication of personal financial problems.

THE FRAUD

DFA Internal Audit and the Division of Legislative Audit worked together to unravel the fraud and estimate the amount of the theft. Here is what they discovered:

Karen would take a genuine check from a customer for a personalized plate, usually $25, and pretend that one dollar of the check was paying for a duplicate registration, thus giving her a reason to need the check cashed. Karen would explain to the front line cashier that she needed to refund all but the single dollar to the customer and needed the check cashed to do so. The cashier would keep a dollar to pay for the duplicate registration Karen said was ordered. Karen had to make use of the front line cashiers because they had access to a much higher volume of cash than she did. Once back in her own office, Karen would order the plate anyway. When entering the transaction in the revenue office accounting system, Karen selected the option “issued for free,” so no funds were required to balance from her drawer to the system. Then, Karen would keep the $24 cash she had obtained. Because customers got the plate they ordered and for which they had paid, there were no customer complaints. In addition to Karen’s cash drawer balancing, so did the drawers of the other cashiers who kept and entered the one dollar they received from the transactions. Karen’s check cashing was so frequent that the front line cashiers accepted it as a routine procedure.

Forensic Investigation

Employees of the revenue office indicated that Karen had been requesting that they cash checks for as long as they could remember. However, a change in computer systems and routine destruction of agency documents made investigating transactions more than ten years earlier infeasible. Thus, the scope of the investigation encompassed activity for only the preceding ten years which included 14,323 transactions completed by Karen. At the request of state police and due to statute of limitation issues, investigators separately identified amounts misappropriated in the last three years of Karen’s employment. Analysis of personalized license plate reports for the last three years identified 10,907 orders, of which 8,142 (75%) were processed without a fee and 2,765 (25%) were processed with a fee.

Because Karen's scheme relied on claiming a duplicate registration request accompanied the application for a specialty license plate, auditors performed another analysis. Auditors identified a four-day leave of absence Karen took three months before her termination and used a subset of reports to compare the number of duplicate registration requests processed while Karen was on duty versus when she was on leave. During the four days that Karen was on vacation, other employees in the revenue office processed eight duplicate registration requests. During the four days surrounding her leave (two days before and two days after), Karen processed seventy-four duplicate registration requests—a nine-fold increase.

Using information from the analyses described above, other reports, interviews, and mathematical extrapolation procedures, auditors estimated the amount Karen stole over a decade to be $362,381, mostly $24 at a time. Investigators admitted the estimate would likely have been more, if transactions prior to the change in accounting systems could have been analyzed.

Audit Report & Agency Response

The Division of Legislative Audit submitted its report to the Legislative Joint Audit Committee of the legislature five months after the fraud was discovered, and the Committee forwarded the report to the Prosecuting Attorney and State Police. The report included a list of ten internal control weaknesses that contributed to the fraud as shown in Table 1. The initial management response from the Office of State Revenue (below) was also included in the Legislative Audit report:

> *Management has reviewed the recommendations provided in this report, and we agree with the findings. Several mitigating controls were put in place immediately upon the Department of Finance discovering these thefts. Additional work is ongoing to identify weaknesses in our business processes and design and implement the changes to correct any issues. Supervisors and managers within the Revenue Division will receive training on the Cash Management Policy of the division as soon as possible.*

Table 1: Internal Control Weaknesses

1	Management did not exercise proper fiscal oversight responsibility.
2	No segregation of duties in Special License section.
3	Cash refund policies per Agency Manual were not followed.
4	Available audit trails/logs were not reviewed.
5	Not all audit trail deletions/changes were kept on file for each cashier.
6	Agency did not use ROA and reports available as oversight tools.
7	No controls over transaction adjustments posted in the ROA system.
8	No controls/reconciliations regarding number of personalized license plates ordered without a fee.
9	No supporting documentation maintained for personalized license plates ordered without a fee.
10	Management did not follow up regarding cashiers' concerns that Karen was refunding taxpayers with cash, nor is a mechanism in place to track such issues or management's resolution.

Source: Investigative Report, Legislative Joint Auditing Committee, February 23, 2009, p. 7.

REFERENCES

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ADDITIONAL SOURCES

Interviews with and information provided by Ricky Quattlebaum, Director of Internal Audit, Arkansas Department of Finance and Administration.

Interview with Marla McHughes, Assistant Administrator for Office of State Revenue, Arkansas Department of Finance and Administration, Sept. 26, 2018.