

A Case of Fraud: Phoenix House

Charles J. Russo, PhD, CPA, CMA, CVA, Assistant Professor,
Department of Accounting, Towson University, Towson, MD 21252

Lasse Mertins, PhD, CMA, Assistant Professor, Department of Accounting,
Towson University, Towson, MD 21252

Charles L. Martin Jr. DBA, CPA, Professor, Department of Accounting,
Towson University, Towson, MD 21252

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Abstract

This is an actual case that has been, as noted when reading the postscript, only partially resolved. Therefore the name and location of the facility as well as the names of the employees have been changed. The case has also been classroom tested in a graduate auditing class where the students found this case to be more relevant to their own situations rather than many of the cases involving large corporations. The case involves a HUD funded independent living facility for senior citizens. The facility is run by a handful of employees who report to a director who in turn reports to a Board of Directors. The voluntary Board doesn't get involved with the daily operations of the facility and for the most part does not exercise its oversight function. As a result, the director has a great deal of latitude with no supervision resulting in an atmosphere ripe for irregularities.

Keywords: forensic accounting, fraud examination, fraud theory, internal control, ethics, IMA Statement of Ethical Professional Practice

The Case

Location

The Shenandoah (Clear-Eyed Daughter of the Stars) Valley was first viewed by English settlers in 1716 by then Virginia Governor Spottswood and a company of explorers, the Knights of the Golden Horseshoe, when they

viewed it from the peaks of the Blue Ridge Mountains. Scotch-Irish and German immigrants coming from Pennsylvania began to settle the valley in the 1730's and established themselves along a well- worn Indian path, known as the Great Wagon Road (Lee Highway today), that traversed the center of the valley.

The City of Lexington, originally known as Gilbert Campbell's Ford, was established as the town of Lexington in the spring of 1778. The name chosen by the Virginia Legislature for the new county seat was in honor of the first great battle of the Revolutionary War, the battle of Lexington, Massachusetts, which had occurred three years earlier.

The City of Lexington was incorporated in 1841 and almost from the beginning its main industry was education. Lexington has a lively college atmosphere in addition to a host of sights. Its home to the Virginia Military Institute (VMI), where Gen. Thomas J. "Stonewall" Jackson taught; its students went off to the Civil War at New Market. Afterward, Robert E. Lee came here as president of Washington College, now Washington and Lee University.

Today, Lexington serves as the retail, cultural and historic center of Rockbridge County as well as the home of local government and the courts. The addition of major shopping centers both within its boundaries and to its north on U.S. Rt. 11 has changed the character of the retail trade within its CBD.

The entire town of 7 158 is well known for its outstanding architecture, record for historic preservation, friendly people, cleanliness and extremely low crime rate. In short, Lexington is a very unique and special place. It is the perfect place for housing senior citizens.

Operations

Phoenix House is a HUD funded, church sponsored, senior citizen independent living facility for those 62 and older in Lexington Virginia. Phoenix House operates at a capacity of 50 independent living residents in a six story brick building. The apartments are primarily one bedroom but there are 5 two bedroom apartments available. The one bedroom apartments rent for \$822 and the two bedroom units rent for \$1050 per month. With HUD subsidies, residents may pay as little as \$123 for a one bedroom and \$355 for a two bedroom per month. Residents do not pay for gas and electric.

Phoenix House has been in operation for over two decades and is presently at full capacity.

The Phoenix House staff is comprised of six employees: Director, part time bookkeeper, administrative assistant, service coordinator, maintenance man, and a janitor. All but one employee has resided in Lexington his/her entire life. Only the service coordinator, who does not reside in Lexington, has a college degree. Although Phoenix House is church sponsored, the church has very little if anything to do with the facility. The seven voluntary member board of directors is comprised of locals with varying backgrounds. Two of the board members are retired professionals, two others are actively employed while the other three members are home makers but none are CPAs or Attorneys. Five of the employees and all of the Board members have known each other since childhood.

According to the employee manual, the director, Nora Sadstone, is responsible for efficiently and effectively operating the Phoenix House. She is on call 24/7. Her normal hours are Monday – Thursday 8 am – 5 pm. However, with board meetings and fire drills she may have to be on the premises in the evening two nights per month. If there is a problem with the facility or the residents, she is the first to be notified. In most cases she calls the maintenance man to physically respond. If there is an emergency with one of the residents, she normally makes sure 911 has been called. She may then call the service coordinator requesting her to call a specific resident's familial contact.

The director is also responsible for approving applicants for residency and for dismissing residents from the premises, budgeting, staffing, training of administrative assistants, authorizing expenditures, signing checks to cover expenditures, and is one of the co-signers on the payroll checks. Although weekly hours are submitted by employees, she must approve the allocation of the hours among work, personal time, sickness, and/or vacation. She also keeps track of her own hours and allocation of those hours without review by someone else. Nora has been the only director employed by Phoenix House since its inception.

The part-time bookkeeper, Ella Bond, who works approximately 24 hours over a three day work week, has been employed at the facility for over 10 years. Her primary duties are to record all transaction, prepare the checks (general and payroll), make rent deposits and assist the director in creating the budget. Because of her institutional knowledge, she is the person

employees turn to when the director is not present for guidance. Ella is very knowledgeable, competent, and reliable.

The administrative assistant, Sally Prune, is a full time employee working 5 days per week with normal hours 8:30 – 4:30. She answers the phone, greets residents at the office door and makes note of their concerns, type's correspondence, collects and initially records the monthly rent checks which the residents placed in a lock box inside the administrative office, and gathers the initial data from those who are applying to become Phoenix House residents. She was hired at Phoenix House in January 2009. She is also related to the maintenance man.

The service coordinator, Jackie Huggs, is extremely competent, is sensitive to the needs of the elderly and is timely in all her endeavors. She assists residents in becoming aware of and completing the necessary paperwork to obtain supplemental state or federal funding. She organizes bi monthly information sessions between appropriate professionals, such as nutritionists, and the residents. Based on her RN training, she is often first on the scene for any medical situations encountered by the residents. Jackie holds a BA degree in psychology and a Masters in Gerontology. Her typical work week is 7 am – 5 pm, Monday through Thursday. Her position is funded by an annual HUD grant.

The maintenance man, Anstel Beerman, has been employed at the Phoenix House for over a decade. He is responsible for all maintenance issues. He is on call 24/7 and is notified either directly by the residents or by the director when there is a mechanical problem. During the work week, work orders are prepared and logged in by the administrative assistant that requires the attention of Anstel. He is required to complete the work orders within 5 business days or less. Once the work is complete, he signs off on the work order and it is filed away by the administrative assistant. At times Anstel is asked by the director to perform personal tasks while being paid by Phoenix House. An example of such a task is where Anstel waited at the director's personal residence for a furniture delivery.

The janitor, Marcus Slowbee, has one of the longest tenures at Phoenix House. His responsibilities include vacuuming and cleaning the hallways and public bathrooms. He gathers the trash from various bins throughout the building and takes it to the outside dumpster. He is also responsible for maintenance of the building exterior and adjacent land.

Latitude

Early in her appointment as director of Phoenix House, Nora became aware that she had a great deal of latitude in making managerial decisions. The Board, nor anyone else, reviewed her work with any scrutiny. She was free to commit funds for any housing related project and she could come and go as she pleased without providing documentation for her hours. It wasn't long before she hired her husband to do the necessary painting of resident apartments. He was hired and paid as an independent contractor. He was paid by the job along with all expenses, such as paint, ladder, brushes, etc. Resident apartments were painted when a resident moved out and when the apartment was in need of repair. Often the 'need of repair' was based upon Nora's need for extra cash. His pay per job was far greater than one would normally be paid.

As her tenure passed, Nora became more brazen in her use of House funds. She would charge personal items, such as bathing suits and other clothing on her House card. When attending a training conference located a bit out of town in a resort area, she would rent a condo from friends at a higher than market price for the conference period plus a couple of days longer. When attending meetings out of state, her husband would often accompany her. She would rarely attend any of the conference presentations. She and her husband would treat the event as a vacation. They would enjoy all the area had to offer. Sometimes Nora would purchase a massage. All the while, Phoenix House was paying for all of the expenses.

As time passed, Nora would often take a long weekend by not coming in on Mondays. For the remaining days of her work week, Tuesday, Wednesday and Thursday, she would normally arrive around 11 am, spend one hour chatting with her employees, go to lunch from noon to 2 pm and finally do some House business from 2 pm – 3 pm. She typically left at 3 pm. On days when there was a scheduled evening fire drill or a scheduled Board meeting, she would not be present during the day. She would only arrive in the evening.

Nora was a shop-a-holic. She was always buying new shoes, handbags, and clothes. Due to her free spending ways, she and her husband found themselves in severe financial difficulty in the spring and summer of 2009. By the fall of 2009, unbeknown to any of the members of the Board of Directors, the Sadstones filed for bankruptcy.

The financial burdens took a toll on Nora. She found herself quite depressed. She hardly ever showed up for work from late spring through early fall of 2009. However she did show up to require the bookkeeper to cut her paychecks in advance. She signed those paychecks and convinced the other signatory, a board member, to also sign the checks. Eventually, she 'claimed' personal time for the months she was out. After all, the records indicated she had earned the time.

While the director was out on personal time, Phoenix House was being run by the other employees. The residents barely knew Nora was missing. The part time bookkeeper and the service coordinator relied very little on the director when she was present so they continued to work independently. The maintenance man and the janitor were following direction from the administrative assistant, so nothing changed for them. The newly hired administrative assistant knew enough to keep Phoenix House running including paying the bills since she was trained by Nora to sign the checks using Nora's name. Sally was instructed by Nora to repeatedly practice copying Nora's signature until Sally's forgery looked very similar to Nora's own signature.

When the Cat's Away

With her supervisor taking an extended leave and Sally becoming quite adept at forging Nora's signature, Sally started to write House checks for personal items. According to court records, Sally used business checks to purchase a laptop, clothing, professional football season tickets, and paid for her broadband bill among other items.

When Nora finally returned to work 'full time', she became aware of some of Sally's improper activities. Nora informed the Board of Sally's indiscretions. The Board instructed Nora to hire a public accounting firm to perform a fraud audit. The agreement with the CPA firm required the public accounting firm to determine the dollar extent of the fraud, but not to investigate further as to who committed the fraud since Sally's hand was already caught in the cookie jar.

Prior to the CPA firm initiating the audit, Nora spent a full weekend in the office shredding as much as she could to obscure her improper activities. She shredded so much at a frantic pace that she jammed the shredder, necessitating the maintenance man to fix it on Monday.

While the audit was ongoing, Sally was temporarily relieved of her duties. Once the audit was complete and the full scope of Sally's theft was determined, Sally was fired. It was determined that Sally stole almost \$27,000 from Phoenix House. Once confronted by her lawyer with a list of what she stole and how much, Sally contended that she never stole that much nor did she steal many of the items on the list. She said she doesn't even use broadband. Unfortunately Sally's comments never got beyond her lawyer and her denials were never investigated by anyone. The audit evidence supported someone's fraudulent behavior and Sally had already been identified as the culprit; however, the audit firm did not gather evidence to support who stole each and every item. It was assumed all of the theft was attributable to Sally. Nora presented the auditor's findings to the County prosecutor.

Prior to the trial and upon advice of her attorney, Sally repaid the entire \$27,000 hoping for leniency from the courts as to jail time. Through the grapevine, Sally learned that since she repaid the money, the Board was not going to press for jail time. At trial, she pled guilty. The judge requested a victim impact statement from a representative of Phoenix House. Nora prepared and presented the statement to the judge. When asked by the judge regarding jail time, Nora stated that the Board believed jail time would be appropriate. Board members were never made aware of Nora's comment regarding jail time. The judge, who also knew Sally's family, admonished her and gave her six months in county detention.

Postscript: Sally served her jail term and was employed shortly thereafter. Nora found out where she was employed and informed her new employer of her embezzlement. Sally was immediately fired from that job and has been unable to find employment elsewhere. She is presently separated from her husband. Nora still serves as director of Phoenix House. At the insistence of a new board member, her husband is no longer the Phoenix House painter. A painting contractor was hired at a much lower fee based upon a Board instituted competitive bidding process. The Board is still not aware of Nora's bankruptcy and she continues her same behavior.

MODULE 1 (Internal Control):

QUESTIONS: Provide and cite authoritative support for all your responses. PCAOB would not apply to this case, but AICPA standards (SAS) would be appropriate. Organizational behavior literature may also be helpful in evaluating this case.

1. Explain the concept ‘tone at the top’ and how the tone is being set in this case.
2. Identify and explain the internal control weaknesses of Phoenix House. Provide suggestions as to how to correct each of these weaknesses.
3. How should the director’s hours worked or not worked be supported? Devise a system to account for the director’s hours.
4. Comment on the thoroughness of the fraud audit. If you believe the auditors should have done more, what should they have done and how should they have done it? State and keep in mind the fraud triangle.
5. How may this voluntary Board enhance its oversight activities?
6. Should the Board be informed of Nora’s activities? If your answer is yes, who should inform the board and how would that person go about informing the Board?
7. Has Nora violated HUD regulations or Federal laws? If so, be specific and provide support for your answer.

MODULE 2 (Ethics):

QUESTIONS: This case shows several examples of unethical behavior. Provide and cite authoritative support for all your responses. Please refer to IMA’s Statement of Ethical Professional Practice where applicable.

1. Explain the concept ‘tone at the top’ and how the tone is being set in this case.
2. The standard of “competence” in the *IMA Statement of Ethical Professional Practice* states several responsibilities that an ethical manager should follow. Which of these responsibilities did Nora and Sally not follow?
3. The director, Nora Sadstone, makes several decisions that are not in the best interest of Phoenix House. Describe several of these unethical decisions and explain how these actions violated the

standard of “integrity” in the *IMA Statement of Ethical Professional Practice*.

4. Imagine you are an employee at Phoenix House and you noticed Nora’s unethical actions for several weeks now. What steps can you take to resolve this ethical conflict? Refer to the *IMA Statement of Ethical Professional Practice*’s procedure for the resolution of ethical conflicts.

Teaching Notes to accompany A Case of Fraud: Phoenix House

Case Learning Objectives and Implementation Guidance

This case has the main objective to teach the importance of adequate internal controls in organizations (Module 1). Having effective internal controls is essential for preventing fraudulent activities in companies. This is especially true in small companies where upper management often have multiple responsibilities, but there is limited oversight to control those activities. This case describes a scenario in which a director of a small assisted living facility, Phoenix House, uses the latitude of her position to improve her personal financial situation and lifestyle. Students are asked to identify internal control weaknesses and provide solutions to improve the internal control system. Therefore, they learn to understand the implications of weak internal controls and to improve their critical thinking skills by generating ideas about how a more effective internal control system could be implemented. In this context, the fraud triangle is used to explain how the circumstances surrounding the Phoenix House may have contributed to the increased risk of fraudulent behavior.

The first module can be assigned to students in undergraduate and graduate auditing and management accounting courses. It may complement the textbook materials covering internal controls and can give the students an applied way to further learn about the importance of strong internal controls. This case can be discussed in a 75-minute class or can be completed as a homework assignment.

Another important topic that this case covers is ethical decision-making (Module 2). The director, Nora Sadstone, makes several unethical decisions that lead to major financial losses for the Phoenix House. We tie this case to IMA’s Statement of Professional Ethical Practice because it deals with an internal ethical conflict (AICPA’s Code of Professional Conduct is more geared towards public accounting conflicts). Therefore, students get exposure to the concept of ethical guidelines and to the negative

consequences that unethical behavior can cause. By using this case, the students learn to apply the standards of the IMA Statement of Professional Ethical Practice to a realistic practical setting and learn to understand why it is sometimes “easier said than done” to report unethical behavior.

This module is adequate for undergraduate and graduate courses in management accounting and capstone accounting courses. It requires a basic understanding of the IMA Statement of Professional Ethical Practice and encourages creative thinking of detecting, managing, and solving unethical decision-making. Similar to the first module, this module can be assigned as an in-class discussion or as a homework assignment.

MODULE 1 (Internal Controls)

1) Explain the concept “tone at the top” and how the tone is being set in this case.

The concept “tone at the top” is a leadership philosophy where the actions of top executives, or in the Phoenix House case, the director Nora Sadstone, ultimately set the culture for the rest of the employees. Actions taken by management, whether ethical or unethical will create a trickle-down effect on the rest of the employees. If management at the top acts in an ethical, hardworking, friendly manner then chances are next level managers and supervisors, will act similarly and ultimately this behavior will trickle all the way down to the lowest level employees within the organization.

However, the concept of “tone at the top” can work in a negative manner, such as within Phoenix House. Here, one is not held accountable for one’s actions nor should one do what is best for the organization but only do what is best for the individual. The director, Nora Sadstone, stopped showing up to work regularly, misused funds, and even trained her assistant to forge her signature on company checks. The director’s lack of integrity and dishonesty set the tone for the organization. Consequently, it should be no surprise that Sally, the administrative assistant, began forging Nora’s signature to finance her own desires. This led to Sally’s ultimate guilty plea for embezzlement and six month jail time. However, Sally did not commit the major crime in this case. She merely followed the guidance of her “leader” Nora Sadstone, who conveniently hid her own embezzlement and admonished Sally long after she repaid more than her share of the embezzlement and completed her time in jail. This is a prime example of ‘tone at the top’ ultimately causing the downfall of a subordinate.

Alternatively, it may be more appropriate with non-profits and yellow book audits, for the tone to be set by the Board. The Board may set a more proper tone by communicating its expectations of ethical and moral character to leadership and seeking to understand their personal situations by engaging in frequent 'social' conversations. Internal control policies and procedures may be enhanced by permitting employees to have a stake in their development. The Board may also establish upward communication from staff by encouraging the reporting of irregularities as well as their suggestions for increased efficiency and effectiveness within the organization.

2) Identify and explain the internal control weaknesses of Phoenix House. Provide suggestions as to how to correct each of these weaknesses.

Phoenix House had several internal control weaknesses which ultimately lead to Sally Prune pleading guilty to theft and serving six months in jail. Identifiable internal control weaknesses include lack of separation of duties, lack of oversight by the Board of Directors, and a lack of a formal bidding process for the hiring of contractors.

Lack of Separation of Duties

The director, Nora Sadstone, was not only in charge of authorizing expenditures but she also signed the checks to cover the expenditures. As a result, it would be very easy for her to approve a "phantom" expenditure and after the bookkeeper wrote the check, Nora could sign it and then use the funds as her own personal expense account. Because Phoenix House is a small institution the best way to correct this weakness would be to require a Board member to review the supporting documentation and then sign the checks once every two weeks. The board member who is the second signer should maintain a log of checks presented for signature. Often when the control is a second signature, the first signer will create a fraudulent check as the first or last check in sequence and just not present it for a second signature

Banks routinely cash checks without signature or with the wrong signature. Controls over such an occurrence may be strengthened by having a Board member prepare the monthly bank reconciliation with an eye towards fraudulently signed checks and reconciling items that don't clear.

Lack of Oversight by the Board of Directors:

Nora was allowed to keep track of and submit her hours worked to payroll without anybody overseeing these hours. This meant, there was no one but Nora, herself, to ensure that Nora worked the time for which she was being paid. Ultimately, this led to Nora working fewer and fewer hours than she claimed she did, as well as, receiving an advance on her pay which she never repaid. She simply took the extra compensation as payment for unused, but falsely accumulated, vacation time. Nora's activities may be controlled by having a subordinate keep track of Nora's beginning and ending hours on a daily basis and have Nora complete a time sheet indicating when and where her hours were spent (refer to question 3 response for greater detail). Some Boards are more progressive and do not require a detailed time sheet as mentioned previously. Those Boards develop specific goals and tasks for the director to accomplish and then monitor progress toward them.

Additionally, Nora approved and was one signee on her own payroll check. To correct this weakness, Nora should not be permitted to sign payroll checks. Only a board member should be authorized to sign payroll checks after reviewing the supporting documentation for the check. Advance payments of payroll should never be permitted.

Another weakness in this area involves Nora's unlimited and unchecked use of the company credit card without having to substantiate her purchases. The Board should require Nora to be accountable for her credit card charges by requiring her to provide support for each purchase with a detailed explanation for very large or unusual purchases. This support is required with each monthly credit card statement and then verified by a Board member prior to that Board member signing the check.

Ideally, upcoming seminars should require Board pre-approval and then reimbursement for seminars should be made after documentation is provided that indicated the employee actually attended the seminar. The Board may require employees to prepare a written summary of the seminar as well as provide a statement from a seminar official that the employee was in attendance.

The Board needs to scrutinize the performance and work of the director. By holding Nora accountable for her actions and inactions, many of the internal control issues would disappear.

Institution of a Formal Bidding Process:

Nora had the authority to hire her husband as a painter at a pay-rate much higher than normal because there was a lack of oversight and formal bidding process at the Phoenix House. To correct this weakness, the Board of Directors should institute a process where vendors and contractors are selected based upon a formal bidding process. Those bids may be collected by an employee but then forwarded on to the Board for determination of which company will be awarded the contract. Relatives or companies with relatives in management positions are ineligible.

3) How should the Director's hours worked or not worked be supported? Devise a system to account for the Director's hours.

There should be a formal Project Management system for all employees. Properly implemented project management software requires all employees to input the type of work they complete each day along with the time spent on the specific project or at a minimum they could summarize their main activities at the end of each week to increase accountability. These reports should be provided to the director for review with the director's spreadsheet being provided directly to the Board of Directors for their review.

Furthermore, this system should be designed to require that all employees input the time they enter the office and the time they leave, similar to a time card. This may be done through a card key system where the employee must insert his/her specific card key to enter and exit the premises. Time stamping would be accomplished electronically with Nora's activity being reviewed by a Board member. While this may make the employees including the director feel like their every step is being monitored, it is worth reminding them that Phoenix house was recently the subject of embezzlement and that such a system would help ensure that proper internal controls were instituted to protect the facility.

4) Comment on the thoroughness of the fraud audit. If you believe the auditors should have done more, what should they have done and how should they have done it? State and keep in mind the fraud triangle.

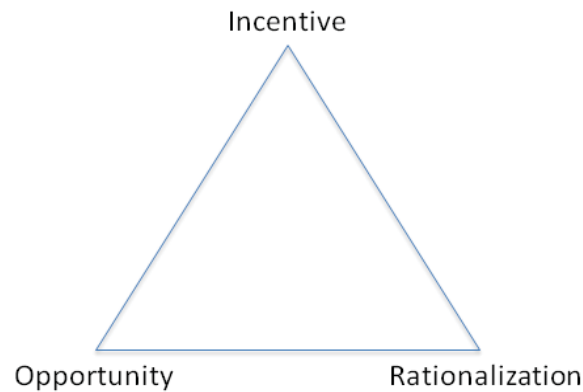
As part of a fraud audit, an auditor is required to gather evidence regarding the fraud in conjunction with legal proceedings related to the fraud (Mancino). Since a fraud audit is considered a consulting service based on suspicion or discovery of fraud, auditors are not required to support an opinion and the work performed is determined by the engagement letter (SSCS1).

The fraud audit was appropriately performed given the contract restriction of only determining the amount of the theft. It is impossible to comment on the thoroughness of the fraud audit because the procedures used by the external auditors were never mentioned in the case. All that was mentioned was that the auditors located \$27,000 of theft and though they didn't gather evidence to support who committed the act, they believed that Sally Prune was the culprit. Unknown to them were the improprieties committed by Nora Sadstone.

If the auditors were permitted to seek evidence as to who committed the acts, Nora's recent bankruptcy would propel her to the top of the suspect list. Unfortunately, the shredding of documents by Nora Sadstone conceivably may have left the auditors hamstrung in their efforts to conduct a thorough fraud audit.

Increased Emphasis on Professional Skepticism

Putting aside any prior beliefs as to management's honesty, members of the audit team must exchange ideas or brainstorm how frauds could occur. These discussions are intended to identify fraud risks and should be conducted while keeping in mind the pertinent characteristics of the fraud triangle: incentive, opportunity, and rationalization.



Nora was desperate for cash since she was going through a personal bankruptcy. She was in a position to perpetrate irregularities and to cover her trail. Nora, as director, always felt she had the authority to do whatever she wanted to do. Throughout the audit, the engagement team should think about and explore the question, "If someone wanted to perpetrate a fraud, how would it be done?" From these discussions, the engagement team should be in a better position to design audit tests responsive to the risks of fraud.

Responding to Management Override of Controls

Because management is often in a position to override controls in order to commit irregularities and financial-statement fraud, the auditors would have to test for management override of controls. This would involve interviewing the other employees within the firm which would have shed a great deal of light on the improper actions of the director.

5) How may this voluntary Board enhance its oversight activities?

The Board needs to enhance its oversight activities to ensure appropriate corporate governance is in place. Phoenix House fell victim to employee embezzlement because the Board lacked financial literacy and because the Board and employees lacked independence since they had known one another their entire lives. The Board of Directors should add financially literate professionals from outside the community to its rank, such as a CPA and an attorney. By adding the additional members mentioned above, the Board would be adding independent professionals who have sworn an oath which requires them to act in an honest and ethical manner.

The Board of Directors must take a more active role in Phoenix house. A member of the Board should review the director's time sheet and determine if her activities properly support her payroll charges. A member of the Board should review and sign payroll checks instead of Nora. All conference and meeting expenses must be adequately supported prior to reimbursement. The Phoenix House credit card may not be used for personal items at any time. The monthly credit card bill must be reviewed by a Board member prior to payment.

Ideally, those who handle cash, such as the administrative assistant and the director, should be bonded so that Phoenix House is insured in case of embezzlement. With bonding comes periodic background checks (initially upon hiring and then once every three years would be appropriate) which should reveal any recent financial difficulties, such as a personal bankruptcy. Additionally, the director's annual performance should be evaluated by the Board including interviewing each of the other employees.

6) Should the Board be informed of Nora's activities? If your answer is yes, who should inform the Board and how would that person go about informing the Board?

Nora's activities have gone undetected for numerous years. None the less, the Board should be informed of Nora's activities. The problem with this situation is only the bookkeeper and the administrative assistant knew what Nora was doing and of course they were all 'life long friends.' Since the Board fired Sally, she may naturally be compelled to say someone else was doing something wrong within the organization, but one may be reluctant to listen to her after what happened. Sally would need evidence (which was mostly shredded by Nora) and the help of the other employees, the auditors, and her lawyer to seem credible to the Board.

The only other person that could possibly approach the Board would be the bookkeeper. When Nora began asking the bookkeeper to cut her paychecks in advance, this should have raised a red flag to her. This, along with her multiple days of absence, should have been enough to inform the Board that she believed Nora was not acting within the scope of her duties and that they should look into it further.

7) Has Nora violated HUD regulations or Federal law? If so, be specific and provide support for your answer?

Based solely on the information provided in the case, it would appear as if Nora committed fraud when she used the Phoenix House's funds to pay for her lavish lifestyle, paid above market price to stay in a friend's condo and various hotels during professional seminars for which she did not attend, used these seminars as a guise for a personal vacation for she and her husband, authorized above market pay to her husband for painting jobs, and she did not reimburse her employer for the advanced pay during her extended absence. Unfortunately, no evidence was ever found to link her to the alleged crimes and thus it would appear as if no crime has been committed.

However, Nora has violated HUD regulations. Congress passed the Housing and Community Development Act in 1974. HUD's mission is to create strong, sustainable, inclusive communities and quality affordable homes for all. Title 42 – The Public Health and Welfare Chapter 69 – Community Development, Section 5307 – Special Purpose Grants defines how HUD grant money is to be used. For Phoenix House, the funds provided through HUD are to be used for technical assistance in running Phoenix House. Funds are only to be used for paying expenses incurred by the organization, maintenance and repairs to the building, and payroll of organization employees. Using HUD funds to purchase personal items and pay for vacation trips is a violation of the grant. This represents 'equity skimming' which is the willful misuse of any part of the rent, assets, proceeds, income or other funds derived from a HUD project. (HUD Consolidated Audit Guide)

Furthermore, Nora shredded documents much like the executives of Enron had done back in the early 2000's. Enron's act prompted Congress to pass the Sarbanes Oxley Act which among other things made it a felony to delete or shred any documents which auditors and investigators may find important for a period of no less than seven years. If it were determined that the Phoenix House met the conditions for a HUD required audit, then according to Chapter 1 of the Housing and Urban Development Office of Inspector General (HUD OIG) Consolidated Audit Guide, the Phoenix House audits "must be performed in accordance with the standards for financial audits as promulgated by the American Institute of Certified Public Accountants (AICPA) professional standards (generally accepted auditing standards or GAAS) including Statement on Auditing Standards (SAS) No.

117, Compliance Audits, issued by the AICPA Auditing Standards Board, and government auditing standards (generally accepted government auditing standards or GAGAS). issued by the Comptroller General of the United States.” As a result, Nora would be in violation of the provisions for document retention originally required in the Sarbanes Oxley Act.

MODULE 2 (Ethics)

1) Explain the concept ‘tone at the top’ and how the tone is being set in this case.

Please refer to the Module 1 Teaching Notes (same as question 1, Module 1).

2) The standard of “competence” in the *IMA Statement of Ethical Professional Practice* states several responsibilities that an ethical manager should follow. Which of these responsibilities did Nora and Sally not follow?

The standard of competence in IMA’s Statement of Ethical Professional Practice emphasizes that individuals should “perform professional duties in accordance with relevant laws, regulations, and technical standards”.

Although Nora has the professional competence and qualifications to be a successful director of Phoenix House, her choices do not follow ethical guidelines. She carries out several activities that clearly violate Phoenix House’s rules and regulations. First, she overpays contractors (especially her own husband) for their services. Secondly, Nora instructs Sally to copy her signature to make purchases for Phoenix House. This illegal activity opens the door for Sally to commit fraud by purchasing personal items on the organization’s expense. She then purchased a laptop, clothing, football tickets, and broadband internet. Thirdly, Nora shredded many documents to cover up her own illegal behavior, which is in itself unlawful, as she removed evidence that the CPA firm could have used to investigate the improper activities. In summary, although Nora and Sally may have the professional competence to fulfill their professional duties, they do not have the ethical competence to abide by the laws.

Another competence related issue is Nora’s lack of participation in continuing professional education. Although she officially signs up for professional conferences, she does not attend the presentations at those

conferences. The IMA's Statement of Ethical Professional Practice states that individuals need to "maintain an appropriate level of professional expertise by continually developing knowledge and skills." If they do not stay up-to-date with the newest developments in their area, then they may not follow the correct rules, laws, and regulations. Nora does not try to stay current with changes that take place in her profession, but prefers to turn her conference visit into a vacation with her husband.

3) The director, Nora Sadstone, makes several decisions that are not in the best interest of Phoenix House. Describe several of these unethical decisions and explain how these actions violated the standard of "integrity" in the IMA Statement of Ethical Professional Practice.

Nora's primary personal weakness is her lack of integrity. First, the IMA's Statement of Ethical Professional Practice points out that one should avoid conflicts of interest. She hires her husband for painting jobs and pays him more than market price which is a clear conflict of interest. In addition, the case states that several employees and Board members have been friends since childhood. Therefore, although they are aware of Nora's wrongdoings, they do not do anything about it because they consider each other friends. These relationships prevent a working environment in which inappropriate behavior is not accepted and sanctioned.

There are many other activities that reveal Nora's lack of integrity and show that she doesn't perform her duties ethically: charging personal expenses to Phoenix House's credit card, coming to work late and leaving early, not communicating personal bankruptcy to the Board, requiring a bookkeeper to pay her salary early, instructing Sally to copy her signature, and shredding important documents. Although not all of these activities are illegal, they are all unethical in the sense that they are not in the best interest of the organization, but rather in the best interest of Nora.

The AICPA Code of Professional Conduct provides a good guideline on how one can test whether a decision was made with integrity. One can ask the following two questions when making an ethically difficult decision: "Am I doing what a person of integrity would do? Have I retained my integrity?" (AICPA COPC, Section 54.03). If Nora would have asked herself these two questions after making the decisions mentioned in the previous paragraph, then Nora would have answered both with "No."

4) Imagine you are an employee at Phoenix House and you noticed Nora's unethical actions for several weeks now. What steps can you take to resolve this ethical conflict? Refer to the *IMA Statement of Ethical Professional Practice's* procedure for the resolution of ethical conflicts.

It should be the first priority to solve ethical conflicts internally. Based on the IMA Statement of Ethical Professional Practice, one should report ethical conflicts to the direct supervisor. However, in Phoenix House's organizational structure, the immediate supervisor would be Nora Sadstone. Nora is directly involved in the ethical conflict, and therefore, she would not be the right person to contact when an ethical conflict exists. Since Nora is the director, there is no higher manager that can be notified. Thus, one should inform the Board about the ethical issue. If the Board does not adequately respond to Nora's unethical behavior, because many of the Board members also have a long-term friendship with her, then one has the option to ask the IMA Ethics counselor for advice. The IMA Ethics counselor may provide guidance on how to resolve the issue, and the "whistleblower" would not have to worry about violating the organization's confidentiality regulations.

In the Phoenix House case, it is difficult for the employees to report Nora's unethical behaviors because 1) they risk Nora finding out and potentially laying off the "whistleblower", and 2) they are all friends and could lose long-lasting friendships because they reported Nora's wrongdoings. Phoenix House is a small organization and it is likely that the other employees would find out who reported Nora's unethical behavior. Hence, it is plausible that employees would rather tolerate the supervisor's unethical decisions because they are not personally affected by them. However, from an ethical perspective, the employees should report unethical behavior because it has an enormous negative financial impact on Phoenix House and it is their responsibility to behave in the best interest of the organization.

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