

THE VIRGINIA BEACH, VIRGINIA SCHOOL DISTRICT
DEFICIT OF 1995: EVALUATING INTERNAL CONTROL
AND IDENTIFYING RISK

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ABSTRACT: In August 1995, Virginia Beach, Virginia taxpayers were informed that their school system had run a \$7 million deficit for the 1994-1995 budget year, despite several previous assurances that the school system would finish the year with a surplus. Shortly thereafter, the actual deficit was found to be \$12.1 million. A Special Grand Jury report was subsequently released describing the causes of the financial crisis.

The Government Accounting Standards Board considers budgeting, where government administrators forecast revenues and identify expenditures, to be an integral part of accountability. The Virginia Beach School District (VBSD) utilized budgeting to control its operational planning and to evaluate its performance, yet the deficit occurred. What went wrong? This instructional case, based on actual occurrences, provides students an opportunity to apply what they learn in an auditing or accounting information systems course to evaluate internal control, identify risks, and answer this question for themselves.

Key Words: Case, internal control, risk assessment, fraud.

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INTRODUCTION

The Government Accounting Standards Board states that the objective of financial reporting is to assist a government entity in fulfilling its obligation to be publicly accountable and to enable users to assess accountability (GASB 2007). Budgeting, a process whereby government administrators forecast expected revenues and identify planned expenditures, is considered an integral part of accountability.

In August 1995, Virginia Beach, Virginia taxpayers were informed that their school system had run a \$7 million deficit after several previous assurances that the system was fiscally sound and would finish the year with a surplus. By November 1995, an external audit determined that the actual deficit was \$12.1 million. Three months later a Special Grand Jury report was released describing the causes of the financial crisis and addressing the means to correct the situation. It was August 1996 before all legal actions against those involved with the deficit were completed. What went wrong?

PART I - THE BUDGET PROCESS

The Virginia Beach School District (hereafter, the "VBSD" or the "School") is the second largest school system in the Commonwealth of Virginia (Weintraub et al. 1995). The VBSD, with its elected eleven person School Board, is a separate legal entity, but is fiscally dependent on the primary government of the City of Virginia Beach (hereafter, the "City"). The constitution and code of the Commonwealth of Virginia place control of educational policy with and responsibility for developing the School budget on the local School Board and the authority and responsibility to appropriate school funds with the local government body. Thus, the School Board and the VBSD Superintendent have no incentive to ensure operational efficiency, to prioritize expenditures, or to control costs because they are not responsible for imposing taxes on City residents.

Funding sources for the VBSD system include:

- An appropriation from the City, which is fixed and known prior to the commencement of the VBSD's fiscal year (i.e., July 1);
- Revenues from the Commonwealth of Virginia received in April of each fiscal year. The largest part is "Basic Aid," which is based on average daily student membership (ADM) from September to March.

- Federal impact funds based on the number of military dependents in the school system during the prior fiscal year. These funds are appropriated by Congress prior to the beginning of the federal fiscal year in October. The funds are received in two installments: 85 to 90 percent in December or January and the remaining balance in April or May. (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996)

School administrators prepare the budget for the next fiscal year in the format specified by the guidelines of the Virginia Board of Education and present it to the School Board on or before March 1. The School Board conducts public hearings on the budget and may choose to modify the budget proposal. The major classifications and line items of the budget must receive School Board approval on or before April 1. The approved School Board budget is then forwarded to the City Manager who may only recommend changes to the total estimated expenditures (City of Virginia Beach 1995).

The City Manager submits the School budget, incorporated within the City budget, to the City Council by April 2. After that date, the City holds public hearings on the entire City budget. The City Council approves the VBSD appropriation in total or by major classifications by May 15, as prescribed by the Virginia Board of Education (City of Virginia Beach 1995).

The City Council appropriates a lump sum of funds for School operations, debt service and construction-in-progress, but it is the School Board who controls transfers of funds among the major budget classifications and line items. Enterprise and Special Revenue Funds were separately appropriated by the City Council until fiscal year 1994-1995.

After the City Council approves the VBSD appropriation, the Council has no authority over or oversight responsibility for School funds. Changes to major budget classifications can only be made with School Board approval. Line item transfers within major budget classifications of less than \$10,000 can be made with the approval of the Superintendent or the Superintendent's designee, and are to be reported monthly to the School Board. Other than for certain emergency purposes, transfers of \$10,000 or more require School Board approval prior to the transfer (Virginia Beach City Public Schools 1997).

Virginia law assigns responsibility for a balanced budget to the School Board and Superintendent. The School District needs the consent of the City Council to overspend its

budget or, by law, there is “malfeasance in office” (Thiel and Weintraub 1995; Holden 1996).

The VBSD employs an internal audit staff to confirm compliance with operating procedures. At the time of the deficit, the VBSD Internal Auditor reported jointly to the Superintendent and School Board. Further, the School administration was not required to share internal audit information with the City Council or City staff (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996). Figure 1 presents the organizational structure of the VBSD at the time of the financial crisis and as it exists currently.

< Insert Figure 1 here >

All VBSD funds are audited annually by a Certified Public Accountant with the cost of the audit shared by the City and the VBSD. The City Finance Department issues the Comprehensive Annual Financial Report (CAFR) for the City, which includes all VBSD-related funds (City of Virginia Beach 1995).

Part I Requirement

During the planning process, an auditor is required to obtain an understanding of the entity to be audited and its environment, including internal control, in order to assess the business risk faced by the entity being audited (AU 314). Based on what you’ve learned about the VBSD budget process, identify and explain three case-specific practices that should be considered by the auditor when assessing risk and designing audit procedures.

PART II - THE PRECURSORS OF THE BUDGET CRISIS¹

School Administrative Personnel Issues

Beginning in 1987 with the retirement of the Superintendent of nineteen years, the VBSD underwent numerous changes in administrative personnel that helped precipitate the financial crisis of 1995. Mordecai Smith was named Director of Budget Development in 1989, reporting to the Chief Financial Officer (CFO). Prior to this appointment, he had

¹ Information in this section was collected from over 200 articles in *The Virginian-Pilot* (February 26, 1995 through July 3, 1998); the *Richmond Times Dispatch* (March 3, 1996; August 13, 1996; August 15, 1996); the report of the *Special Grand Jury of the Circuit Court of the City of Virginia Beach*, 1996; and the KPMG Peat Marwick *City of Virginia Beach School Board Presentation* of November 7, 1995.

served as a senior budget and management analyst for five years with the City. Smith was described as “confident and ambitious” and “appeared to be in control” (Weintraub 1995).

Dr. Sidney Faucette became Superintendent of the VBSD in July 1991, the fourth person to hold this position in four years. In hindsight, the appointment appears to have been unwise. After his stint as Superintendent had ended, Faucette was described as having a “dictatorial management style,” a “reckless approach to spending decisions,” and an “abhorrence for any surplus that might revert to the City” (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996). Further, employees noted that Faucette did not like dissent from his subordinates, was uninterested in fiscal or budgetary matters, and spent tax money impulsively without regard for the budget or established procurement policies (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996).

In 1993 there were considerable personnel changes. Dr. James Pughsley became Deputy Superintendent, Kevin Jones became the Internal Auditor, and Hal Canary was named CFO. The Director of Accounting resigned (and was not replaced until January 1996) and the Associate Superintendent, who had supervised the CFO position, departed. For a summary listing of VBSD and City personnel identified in this case, see Exhibit I.

< Insert Exhibit I here >

Fiscal Year 1993-1994 – The Problems Begin

In June 1993, City and School officials met to discuss a potential crisis in educational funding for the current fiscal year. In planning for the fiscal year 1993-1994 budget, Director of Budget Development Smith had disregarded revenue estimates made by the City’s staff; obviously this was an area of concern to the City.

Further, Superintendent Faucette had committed the VBSD to several unbudgeted projects. First was the lease of Celebration Station, an empty mall. The lease was executed in August 1992 with an option to buy the property, but no rent was budgeted in fiscal years 1993-1994 or 1994-1995. Second, Faucette personally negotiated a janitorial service contract with Servicemaster without involving the City Office of Facilities Management or the Purchasing Department. The original contract was for eight schools, but service was implemented system-wide. The short-term effect of the decision was to increase expenditures for custodial services. Third, the contract for the purchase of Thalia II, a defunct college building, for adult education classes was executed by Faucette before

the City Office of Facilities Management and the Purchasing Department had completed their study of the proposal. These departments subsequently recommended against signing the contract.

CFO Canary communicated the possibility of a budget crisis in writing to Faucette in August 1993. During the same period, Internal Auditor Jones forwarded an audit report to the Superintendent and the School Board Audit Committee (which consisted of Faucette, the School Board Chair and a School Board member), with copies to Deputy Superintendent Pughsley, CFO Canary, and Budget Director Smith. The report cautioned that “adequate controls do not exist to monitor unexpended appropriations in the School Operating Fund.” It also stated that “budgetary adjustments are not reported in monthly financial reports to the School Board members.” The report listed three pages of recommendations to address these problems (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996).

By October 1993, CFO Canary was forecasting \$7 million in budget overruns and suggested a system of additional controls needed prior to the coming year-end “to prevent the manipulations that were common at the last fiscal year end (1992-1993)”.¹ He noted that the \$2.5 million surplus for fiscal year 1992-1993 had been spent on \$9 million worth of projects (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996).

CFO Canary continued to be the harbinger of bad news over the next several months. In January 1994, he informed Faucette that the ADM figures used for state and federal aid calculations were in error. By February, Canary had issued a report to Faucette detailing how the unplanned projects were reeking havoc on the budget. At that time he predicted an additional \$4.6 million shortfall for 1993-1994. None of this information was conveyed to the School Board. In April, the School Board adopted a \$340 million budget resolution for fiscal year 1994-1995, totally unaware of the financial difficulties in the current fiscal year. Interim financial statements for June 30, 1994 for the School Operating Fund showed unrealized revenues of \$8.7 million, but with the transfer of fiscal year 1993-1994 purchase orders worth \$2.8 million to fiscal year 1994-1995 a deficit was averted. Figure

¹ With the concurrence of the School Board, Faucette had encumbered portions of budget surpluses for future purchases (referred to as “year end funds”) of unbudgeted or under-budgeted items.

2 presents the approved VBSD budgeted and actual revenues and expenditures for fiscal year 1990-1991 through fiscal year 1996-1997.

< Insert Figure 2 here >

Part II Requirements

- 1. Describe the VBSD's control environment, noting any areas of concern you might have that would impact the planning and conduct of the audit.**
- 2. With the importance of budgeting and the budget process to governmental entities such as the VBSD in mind, identify specific events that occurred during the 1993-1994 fiscal year that would likely impact your assessment of internal control (i.e., control risk) for the audit of the 1994-1995 fiscal year.**

PART III - THE FINANCIAL CRISIS ARRIVES¹

Fiscal Year 1994-1995

The fiscal year began with Internal Auditor Jones noting mathematical errors of \$573,000 in the current year budget and the need to have the corrected amounts approved by the School Board. Soon after this report, Superintendent Faucette dismissed CFO Canary, citing the large deficit in 1993-1994, and named Director of the Budget Smith as interim CFO.

In September 1994, it was determined that, as a result of using the wrong data, Smith had overestimated student enrollments for purposes of budgeting revenue and, therefore, there would be a shortfall in state funding. Smith, however, had underestimated student enrollments for hiring purposes, resulting in the need to hire 34 additional teachers that were not budgeted. During the same period, the VBSD was forced to buy out the Servicemaster contract at an additional unbudgeted cost of \$2.6 million. Internal Auditor Jones noted an additional \$2.4 million in errors in the budget that would result in a potential deficit.

In October 1994, the City's Director of Management and Budget, Dean Block, questioned acting CFO/Budget Director Smith about his "Five Year Forecast," and projected a deficit for subsequent years. Block specifically questioned enrollment figures and the VBSD's budget methodology. He expressed concern that historical data was not used for budget preparation and that Smith lacked documentation of certain budget items.

Superintendent Faucette sent a memo to the School Board acknowledging the school system “lacks certain financial safeguards and did not have a sound spending plan” since Faucette began his term in 1991. At the same time, a confidential memo from Internal Auditor Jones to Faucette and Deputy Superintendent Pughsley projected a potential deficit of \$6 million for fiscal year 1994-1995 and warned that funds might not be available for payment of utility bills. Specifically, electricity expenditures had consistently been \$8 million, but Smith transferred \$1.3 million from the \$8 million budgeted line item to other accounts.

In November 1994, the U.S. Department of Education advised Smith that Federal aid would be approximately \$8 million, \$4 million less than the \$12 million budgeted. Smith advised Faucette of this and that, additionally, an error in estimating state funding would result in \$4.5 million less revenue than predicted. Faucette responded by sending a memo to all budget unit directors ordering a delayed and limited spending plan. Despite all of this, when a School Board member predicted a possible deficit for the year at the monthly Board meeting, Smith advised the group to expect a \$2.8 million surplus in fiscal year 1994-1995.

Faucette finally advised the School Board in December 1994 of the state revenue reduction determined in September. He also explained that \$7.4 million in unplanned encumbrances from fiscal year 1993-1994 were causing problems in the current year. In response to the budget problems, he issued the following directives: 1) each unit would return unspent funding to the VBSD at calendar year-end; 2) all teacher workshops were canceled; 3) tuition would be charged for summer school; and 4) only essential supplies and equipment would be purchased and essential personnel replaced. At that time, Faucette noted that he expected a \$1 million rebate from the Virginia Retirement System and an additional \$3 million in federal funding for military dependents before year-end.

Late in December 1994, Internal Auditor Jones sent an audit report to Faucette noting the impact of a miscalculation of salaries and fringe benefits in the current year budget. The School Board had approved a 4 percent raise, while the budget contained only a 3 percent increase. The audit report also noted the carryover of \$2.8 million in purchase orders from fiscal year 1993-1994 to 1994-1995, and a shortfall in special education of \$2.6 million for salaries and tuition. Further, Jones stated that current budget practices called for the calculation of new budgets as a percentage increase over the

previous year's budget, with no consideration of previous actual expenditures. Jones stated that large transfers were not being approved by the Board and that Director of Budget Development Smith did not inform budget managers about budget transfers that directly affected them until after they occurred.

In February 1995, Faucette received another memo from Internal Auditor Jones detailing more budget shortfalls and control problems, but the memo was not given to the Audit Committee until March. Jones' report highlighted the following problems: no comparison of last year's actual to budgeted expenditures before planning for the next fiscal year, formal budget schedules did not total properly, purchase requisitions were processed without determining if funds were available, and Smith ignored the need for Board approval for transfers of \$10,000 or more.

Late in February, Faucette consolidated the positions of CFO, Director of Accounting, and Director of Budget Development under the CFO title. Smith was appointed CFO by a unanimous vote of the School Board. Smith's selection appears to have been pre-determined as he had contacted several School Board members who ultimately recommended his promotion to Faucette. Further, Faucette had appointed a CFO Screening Committee that included two School Administrators who had written letters of recommendation for Smith.

In March 1995, Faucette announced to his principals that all outstanding purchase orders should be canceled. A management letter was received from KPMG Peat Marwick, the City's audit firm during this time, noting many of the existing financial problems detailed by Jones and recommending methods for correcting the problems. Faucette, with Smith's concurrence, responded to the letter, disagreeing with many of the comments and stating that "transactions were made without variance from Generally Accepted Accounting Principles" (Weintraub 1995).

By April, local newspapers began carrying reports expressing concern for the VBSD spending, yet CFO Smith presented a financial summary and analysis to the School Board at that time stating there would be no deficit at the end of the fiscal year; in fact, he predicted a \$3 million surplus. Faucette maintained that the expected fiscal year 1994-1995 shortfall would be averted with a hiring freeze, and cuts in travel, training, and professional dues. In mid-April, Internal Auditor Jones resigned over concern that there

would not be enough funds to pay teachers, pay for supplies, or pay for summer school in the current year.

In late April 1995, the School Board submitted the School Operating Budget request for fiscal year 1995-1996 of \$429 million to the City Manager. Working with CFO Smith's fiscal year 1994-1995 actual figures, the City Director of Finance calculated a \$13.3 million deficit which she detailed in a memo to the City Manager. The Director of Finance noted that Smith had eliminated teacher workshops (\$4 million), transferred salary expenses from the School Operating Fund to a Title V1-B9 Grant (\$1 to \$2 million), transferred enrollment expenses from the Operating Fund to Construction In Process (\$300,000 to \$500,000), and transferred expenses from the Operating Fund to the Self Insurance and Cafeteria Funds (\$500,000 to \$2 million) to deal with the potential deficit. The memo commented that the VBSD expected \$3 million in additional federal funds for the year, a \$1 million rebate from the Virginia Retirement System, funds returned by the schools of \$300,000, and expected summer school tuition of \$500,000. During this period, Faucette was quietly interviewing as a candidate for a Superintendent's post in Gwinnett County, Georgia.

When the School Board subsequently queried Faucette regarding supply orders that had been canceled, he claimed Smith issued the freeze on ordering in error. Yet Faucette explained that instituting the \$12.5 million in cuts would generate a surplus at year-end. Faucette never presented the Board with figures for the Enterprise Funds so the School Board was unaware of transfers from these funds to the Operating Fund to balance the budget.

A week later, Faucette submitted his resignation, effective July 1995, to take the Superintendent's post in Georgia. Several weeks later, Deputy Superintendent Pughsley was named Interim Superintendent. Within the month of Faucette's departure, CFO Smith reported a fiscal year 1994-1995 surplus of \$0.5 million. A month later Smith requested several interdepartmental transfers for 1994-1995, but the clerical staff did not comply because Smith supplied no supporting documentation.

Much to the surprise of the public, on August 25, 1995, School administrators announced a \$7.4 million deficit for fiscal year 1994-1995. The report maintained that half of the deficit was the result of overspending, and half resulted from state and federal funding shortfalls. The City Mayor announced the City would make up the shortfall and

suggested merging the financial departments of the City and Schools for better monitoring and control. Immediately, members of the School Board claimed they were unaware of the fiscal problem.

Part III Requirement

Identify three examples of control activities that did not function properly and, therefore, contributed to the budget crisis of 1994-1995.

PART IV - THE FINANCIAL CRISIS UNRAVELED¹

Initial Reactions – The Blame Game

By early September 1995, parties to the financial crisis were assigning responsibility for the deficit to one another. Faucette contended he was not told by Smith how serious the problem was and that CFO Smith was responsible for budget oversight. Although he had previously been Director of Budget Development (since 1989), Smith stated that he “inherited the bad budget,” but had attempted to minimize the deficit.

Even though a Board member predicted a deficit as early as November 1994, the School Board maintained it was unaware of any problem until August 1995, as Smith had never expressed any concern for a potential deficit and he continually stated the budget would balance at year-end. The Board noted that both Smith and Faucette often answered questions with misleading information. Further, the School Board claimed the City should have noticed the problem sooner, particularly the budget line for federal funds that was \$4 million more than the Schools had ever received.

In a School Board meeting in early September, Smith admitted presenting misleading budget information to the Board under Faucette. He stated that there was not always full disclosure of the impact of planned projects.

In mid-September, the City Council passed a resolution expressing its concerns for the inadequacy of the VBSD budget controls and the need for financial oversight. The City demanded a complete explanation of the \$7.4 million deficit before it would fund the shortage. One week later, the City received the following explanation of the deficit from the Schools:

- Federal Impact Aid was overestimated in the budget at \$13.6 million, while actual revenues were \$8.7 million.

- Special Education ADM compliance required 64 additional teachers at a cost of \$2.5 million. (Note: The Director of Programs for Exceptional Children later maintained only 28 teachers were hired at a cost of \$850,000.)
- In fiscal year 1994-1995, underestimated student enrollments resulted in the unexpected hiring of 34 new teachers at an additional cost of \$6.2 million.
- Purchase orders from fiscal year 1993-1994 worth \$2.8 million were transferred to fiscal year 1994-1995.
- State Aid was based on September ADM rather than March ADM resulting in a \$1.5 million shortfall.
- Thalia II (Commonwealth College) was purchased in fiscal year 1993-1994 for \$1.75 million from the Operating Fund, not the Capital Budget, according to Smith. Faucette maintained it was bought with funds from the City reimbursement at year-end.
- A five year custodial service contract with Servicemaster that was signed in 1993 was bought-out in September 1994 and new custodial personnel were hired for a cost of \$1.4 million, which had not been budgeted.
- General sloppy bookkeeping, as noted in December 1994 by Internal Auditor Jones. These included multiple commitments of the same funds and \$2.5 million in mathematical and typographical errors in the fiscal year 1994-1995 budget. Then CFO Canary had noted the same problem in October 1993 and suggested that there was little or no understanding of the computer system used for financial records.
- In Spring 1995, the VBSD ceased the textbook rental program. Faucette wanted the funds remaining in the Textbook Fund transferred to other funds; however, the Fund had a \$1 million deficit due to transfers in fiscal year 1993-1994.

The External Audit

By late September 1995, the City Council requested KPMG Peat Marwick perform additional audit procedures and provide observations regarding the primary causes of over-expenditures in the School Operating Fund for fiscal year 1994-1995. Although the auditors were not engaged to perform a specific study of the School's internal control structure, the City did ask for specific recommendations to prevent a similar situation from occurring in the future.

The initial findings suggested the basic problem was an atmosphere of trust by the School Board and the City for reports supplied by the Superintendent and CFO. KPMG found that the Mayor, Vice Mayor, and City Manager had met monthly with the Superintendent and School Board Chair and accepted assurances that school finances were under control. Basic finance department rules were violated, the internal audit memos were overlooked or ignored, and when questions were raised by the City or School Board there was no insistence that they be answered.

KPMG found in interviews with CFO Smith that bills arrived in his office with "PAY" written in bold letters by Faucette, regardless of whether there were funds in the budget. Smith stated he was appalled by the "free spending of the Superintendent" with funds designated for other purposes. Further, he asserted that Faucette insisted on overestimating federal aid to prevent surpluses being returned to the City at year-end. Additionally, Smith charged that Faucette changed budget categories after the School Board approved the budget and that Faucette had the Board approve large transfers without explaining the impact on the budget. Smith also admitted that the system to monitor and control personnel costs was archaic. On September 26, 1995, Smith was placed on paid administrative leave by Interim Superintendent Pughsley pending further investigation of the deficit.

On November 3, 1995, KPMG released its audit findings on the fiscal year 1994-1995 budget deficit to the City Council and School Board (Holden and Vines 1995). The audit did not attempt to explain how or why the deficit occurred. The actual deficit was determined to be \$12.1 million, not the \$7.4 million that was initially reported.

Specific items noted in the report included unrealistic assumptions used in preparation of the operating budget; the large volume of budget transfers made budget-to-actual comparisons useless; the School Board budget was not used to evaluate or monitor actual results; payroll predictions were based on documents the administration did not understand; there was no sound method to track budget and payroll expenditures; the current reporting system made control and monitoring of personnel costs difficult; and department heads had no control over their own budgets.

It was determined that CFO Smith made \$43 million in budget transfers in fiscal year 1994-1995. Many of the transfers were used to shift portions of the deficit to programs that

legally had to be funded under federal or state mandates (such as Special Education) or those that had community support, making it politically difficult for the City Council not to fund a deficit. Further, Smith violated or circumvented School Board policy regarding approval of transfers of more than \$10,000. In fiscal year 1994-1995, he made 21 transfers not approved by the School Board. Additionally, in May 1995 he made a transfer of \$12 million to 19 line items when the School Board approved the transfer to 56 line items; he later transferred these items back to their original source without Board approval. Often, Smith would mask a large budget transfer by authorizing multiple smaller transfers of less than \$10,000 to circumvent required School Board approval.

Expenditures exceeding budget included \$5 million in personal service costs in instruction, pupil transportation, operations and maintenance; \$2 million in special education contractual services; \$1 million in school plant contractual services; and \$1 million in utilities. Other problems the auditors noted were that the September ADM was used for estimating Virginia Basic School Aid, the middle school payroll budget for fiscal year 1994-1995 was less than actual expenditures for fiscal year 1993-1994, and reprographic services were omitted from the fiscal year 1994-1995 budget all together.

Per the KPMG Peat Marwick (1995) specific discrepancies included:

- \$1,607,783 in state sales tax revenues received in August 1995 were incorrectly booked in fiscal year 1994-1995. These revenues belonged in fiscal year 1995-1996 per GASB 22 "Accounting for Taxpayer Assessed Tax Revenues in Governmental Funds;"
- \$517,914 in summer school tuition applied to fiscal year 1994-1995 belonged in fiscal year 1995-1996;
- \$2,025,000 in excess payments were made to the Virginia Retirement System for insurance and premiums;
- \$512,515 in utility bills for fiscal year 1994-1995 were incorrectly charged to fiscal year 1995-1996;
- \$270,359 in expenditures for renovations and asbestos removal belonging in the Operating Fund were incorrectly transferred to the Capital Projects Fund.
- an excess transfer of \$124,553 was made from the Self-insurance Fund to the Operating Fund;

- \$23,172 in additional athletic expenditures should have been transferred from the Operating Fund to the Athletic Fund; and
- a \$2,025,000 refund of excess insurance and pension contributions from the Virginia Retirement System should have been applied to fiscal year 1994-1995.

These findings resulted in a total revenue adjustment of \$2,125,697 and a total expenditures adjustment of \$2,706,493. Encumbrance adjustments for fiscal year 1994-1995 funds moved to fiscal year 1995-1996 for purchase orders carried into fiscal year 1995-1996 resulted in a reduction of \$108,665. Therefore, the total audited fund deficit was determined to be \$12,058,100 (approximately 3.6 percent of the total budget) (KPMG Peat Marwick 1995).

Part IV Requirement

Based on the information in the case and, in particular, the audit findings, provide five recommendations that the auditor might make to its client, the VBSD, in a management letter.

PART V - THE AFTERMATH¹

Within two days of the issuance of the report, the School Board approved a payback plan for the \$12.1 million deficit to the City. The plan called for repayment of the deficit by the Schools by June 30, 2000 and return of all future operating surpluses to the City with no guarantee that they would be returned to the Schools.

The State Attorney asked the Circuit Court to impanel a Special Grand Jury to investigate the deficit. Such a body has the power to subpoena school records and current and former school personnel, the right to recommend indictments to a regular Grand Jury, and authority to issue a detailed report with suggestions for legislative remedies. The Circuit Court granted the request for a Special Grand Jury, with deliberations to begin on December 4, 1995.

Meanwhile in Georgia, Faucette was explaining to his new School Board that he was “out of the loop” in the Virginia Beach budget process. He maintained the budget process rested with Director of Budget Development Smith who sent the budget directly to the School Board Budget Review Committee, and from there to the School Board. Faucette claimed he lost confidence in Smith in April 1995 and gave then Deputy Superintendent Pughsley oversight of the budget.

On hearing this report, Interim Superintendent Pughsley stated he was never given budget oversight and several School Board members confirmed his statement. In addition, the School Board Budget Committee claimed it did not set the budget policy, but simply reviewed budget documents. This Committee had been dissolved soon after Faucette left the system.

The Special Grand Jury Investigation

In December 1995, the Special Grand Jury (hereafter, the "Jury") began meeting twice a week with ten jurors. Over the next three months, the Jury reviewed all VBSD budget preparation memos for fiscal years 1993-1994, 1994-1995, and 1995-1996; the financial statements and CAFRs for the same fiscal years; all internal audits during the period; memos to the Superintendent, Deputy Superintendent, CFO, Director of Budget Development, Internal Auditor, and members of the Audit Committee; videotapes of fiscal year 1994-1995 School Board meetings; and the testimony of 58 people.

The Jury also requested an audit report from the City's internal auditor on VBSD budget transfers. The report concluded that there had been \$6.4 million in transfers greater than \$10,000 in 1994-1995. Further, some budget transfers approved by the Board were never made, other transfers were made without the appropriate authorization, and yet other transfers were made for amounts other than what was authorized.

In February 1996, former Superintendent Faucette appeared before the Jury for five and a half hours. He maintained his "job was only to recommend the budget, while the job of the School Board and the City Council was to approve it and appropriate the money."

When Faucette's former Administrative Assistant, Anne Meek, was interviewed, she stated "Dr. Faucette knew what he wanted and wasn't much interested in opposing views. He didn't trust the organizational structure to give him information. He relied on the grapevine." Meek further asserted the loss of administrative staff due to resignations and dismissals caused the loss of financial expertise, and loss of internal controls over the budget.

In mid February, while the hearings were still going on, the School Board voted seven to four to reinstate Smith as Director of Budget Development on a probationary basis. Several Board members contended that Smith was following Faucette's orders and did nothing inappropriate. Smith was to report to the Assistant Superintendent until a new

CFO was named. Interim Superintendent Pughsley had specifically requested the Board fire Smith. He immediately submitted his resignation over the reinstatement. In reaction to the re-instatement, the seven School Board members voting in favor were re-called before the Jury to explain their actions.

The Special Grand Jury Report

On February 26, 1996 the Jury report was issued. The Jury found that the School Board, then Superintendent Faucette, and CFO/Director of Budget Smith showed a “reckless unconcern” for fiscal responsibility and that the deficit in fiscal year 1994-1995 was the result of “fiscal incompetence, capital purchases made at the whim of the Superintendent, and a naive School Board which...apparently did not regard financial oversight as part of its responsibilities.” There was no finding of theft, fraud or felony, only malfeasance (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996). The report suggested that seven named School Board members resign or face prosecution for malfeasance.

The Jury noted that the organization of the financial staff made reporting difficult and monitoring of finances impossible. Faucette’s consolidation of the positions of CFO, Director of Accounting, and Director of the Budget eliminated oversight and made it imperative that a capable person perform the job. The report described CFO/ Director of Budget Smith as “incompetent” stating he “lacked the knowledge and expertise to perform either of these positions effectively.” Further, the report concluded that he “literally fabricated some numbers” making the budget useless for planning or management (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996).

As for the School Board, the Jury found that it ignored the warnings of former CFO Canary and former Internal Auditor Jones, was not aggressive in questioning the budget practices of Smith and Faucette, established an ineffectual Budget Review Committee that consulted with Faucette regarding all fiscal matters, reinstated Smith after his suspension by Interim Superintendent Pughsley, and refused to discuss consolidation of financial record keeping with the City (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996).

Further, the Jury noted the poor relationship between the School Board, School administration and the City prevented communication and discussion of the VBSD financial

problems. The jurors believed that the expertise of City staff may have helped remedy the fiscal year 1994-1995 problem.

The Jury recommended the following:

- The VBSD internal audit function be strengthened and the Internal Auditor report only to the School Board.
- The accounting and financial management of the VBSD be consolidated with the City.
- The Deputy Superintendent be included in the financial chain of command.
- The current law be changed to prohibit the School Board from interfering in School administrative hiring except for the positions of Superintendent, Internal Auditor, and Legal Counsel.
- The VBSD adopt all the recommendations of the KPMG audit. (Special Grand Jury of the Circuit Court of the City of Virginia Beach 1996)

In response to the report, several of the Board members named in the report resigned immediately. Director of Budget Development Smith stated he would not resign and still maintained he acted on orders from Faucette. In late March 1996, however, Smith did resign. His attorney claimed it was no longer possible for Smith to perform his job because of his treatment by School administration. The attorney for the School Board acknowledged that the Board had mustered enough votes to fire Smith if he did not resign.

Two School Board members named in the report also refused to resign their positions. In April, the regular Grand Jury indicted these two Board members on charges of malfeasance, which carries a fine of \$250, but does not include jail time. Curiously, neither Faucette nor Smith were indicted. In August, the trial of the two Board members started. The Board members maintained they were misled by School Administrators that there was no fiscal crisis. The question to be decided by the jury was one of the degree of skill and diligence expected of School Board members. The two Board members were acquitted of malfeasance after a ninety minute jury deliberation.

Part V Requirement

Auditors should periodically evaluate whether to retain a client. This decision is based on a variety of factors, some of which are not detailed in the case. However, based on the information that is provided (and assuming that the VBSD was audited

as a separate entity), identify factors an auditor might consider that would 1) support a decision by the auditor to continue with VBSD in 1995-1996 and 2) support a decision by the auditor to resign.

EPILOGUE

In the 13 month period following the initial report of the 1994-1995 deficit, the VBSD had had three Superintendents, one special audit, two reorganizations, twenty-three School Board members, and one Special Grand Jury investigation (Payne 1996). In 1996, the School Board re-established the Audit Committee with the VBSD Internal Auditor reporting directly to the Committee. Further, the VBSD revised its organizational structure and adopted the recommendations of the KPMG audit report. With the prompt attention to the deficit of fiscal year 1994-1995, the VBSD ended fiscal year 1995-1996 with a \$480,538 surplus, fiscal year 1996-1997 with an \$18.9 million surplus, and fiscal year 1997-1998 with a surplus of \$ 14 million.

In January 1997, the Virginia Beach City Council decided to give the VBSD a fixed percentage of City revenues from which it could develop its budget after the amount was determined. If the VBSD needed more funds, it could issue a special request to the City Council for a tax increase. The City believed this new formula would force the VBSD to be more fiscally responsible during its budget planning process.

General Case Requirements

- 1. According to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) report, *Internal Control—Integrated Framework*, an entity's internal control is designed and implemented to provide reasonable assurance of achievement of three broad objectives: 1) reliability of financial reporting, 2) efficiency and effectiveness of operations, and 3) compliance with laws and regulations. How did the management of the VBSD subvert each of these objectives?**
- 2. Two of the five interrelated components of internal control identified in COSO's *Internal Control—Integrated Framework* and in AU 314 are 1) the information and**

communication systems and 2) monitoring of controls. Identify internal control problems experienced by the VBSD that relate to these components.

3. Consider the three conditions usually present when a fraud occurs: Incentive/pressure to perpetrate fraud, opportunity to perpetrate fraud, and attitude/rationalization to justify the fraudulent activity. Identify any indicators that fraud might have occurred in the VBSD.
4. Statement of Auditing Standard No. 99, *Consideration of Fraud in a Financial Statement Audit*, had not been written when VBSD's financial crisis occurred. However, had it been, would the VBSD administration's unreliable financial reporting be considered as resulting from fraud, error, or both? If you believe fraud was evident, what broad scheme(s) was/were perpetrated? How? By whom?

CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

This instructional case provides students the opportunity to gain a better understanding of the importance of internal control through examination of the problems encountered by an actual governmental entity, the Virginia Beach School District. It also gives students some practical experience with realistic tasks such as gaining an understanding of an entity and identifying its business risks, evaluation of internal control, assessment of fraud indicators, and evaluation of whether fraud occurred. It is designed for use in an auditing or accounting information systems course that covers internal control and the consideration of fraud. The case also reinforces the importance of auditors or consultants not only recognizing client problems, but being able to make recommendations for improvement. While not central to the case, students are also asked to identify factors important to the client retention decision.

In order to successfully complete the requirements of this case, students must be able to do the following:

- Identify client practices that will impact risk assessment and the design of audit procedures;
- Demonstrate an understanding of the three objectives of internal control by identifying instances in which management subverted these objectives.
- Identify internal control issues using the five components of internal control (as identified in the COSO's *Internal Control – Integrated Framework* or AU 319).
- Identify events that would impact assessment of internal control.
- Identify conditions indicative of potential fraud and evaluate whether fraud actually occurred.
- Provide recommendations suitable for inclusion in a management letter to the client.
- Identify factors that would likely impact the auditor's decision to retain the client.

This case provides students with experience in applying the COSO framework and professional (auditing and quality control) standards. It also requires demonstration of critical thinking and effective written communication skills.

Implementation Guidance

This case is designed for use in either an auditing or accounting information systems class at the undergraduate or graduate level. All case requirements can be completed independently, so instructors may select the requirements that are most appropriate given course content and the timing of the assignment. Case requirements can be assigned separately throughout the course or simultaneously after all of the appropriate topics have been covered. If the requirements are assigned throughout the semester, the instructor could require students to respond individually or in small teams. If multiple requirements are assigned simultaneously, instructors are advised to permit students to work in teams, consistent with the approach used by public accounting and consulting firms.

The case includes 10 requirements, six of which relate to specific sections of the case and four of which are general in nature, relating to the entire case. The first requirement relates to an auditor's understanding of the client and related risks. Five requirements (both requirements from part II, the requirement from part III, and the first two general case requirements) relate to internal control. Two requirements (the last two general case requirements) consider the likelihood of fraud in the VBSD. The requirement for part IV asks for recommendations that an auditor might make to the client. The requirement for part V focuses on the client retention decision. All requirements are appropriate for use in an auditing course. If the requirements will be assigned simultaneously, the case should be assigned after coverage of the client retention decision, audit planning (including risk assessment), internal control, and the auditor's responsibility for fraud. All case requirements, with the exception of the requirement for parts I, II (question 2), IV, and V, are appropriate for use in an accounting information systems class. If the requirements will be assigned simultaneously, the case should be assigned after coverage of the COSO's *Internal Control - Integrated Framework*, and accounting information systems fraud and abuse.

The case should be introduced to the class by the instructor (approximately 15 minutes) upon assignment. The students should be assured that, while the case involves a governmental entity, no previous coursework in governmental accounting is required to complete the case. The instructor should follow with a brief explanation of a "fund" and stress the importance of the budget to a governmental entity. Students should be reminded

to focus on the specifics of the case in responding to each requirement. Further, students should be instructed to answer the assigned requirements at the end of each section of the case before moving to the next section. This will serve as a reminder to students that auditors and consultants typically do not perform their work with the benefit of hindsight.

Evidence of Efficacy and Student Feedback

This case was field-tested in an auditing class at a small, AACSB accounting-accredited, private university in the southeast. The case was assigned during the last month of the semester-long course after all facets of an audit had been covered. The course instructor previewed the case for approximately 15 minutes. Students, working in self-selected teams of two or three, were then given two weeks to complete the case. Each team submitted a written case solution, which was worth 5% of each student's final grade. When the graded cases were returned to the students, the instructor led a discussion of the case solution.

Following submission of the case, the students were administered a brief survey consisting of eleven statements regarding the case assignment. Students were asked to use a five-point, Likert-type scale (ranging from one – “strongly disagree” to five – “strongly agree”) to identify the extent of their agreement with each of the eleven statements. The survey was completed by 23 of the 25 students in the class. The statements and the mean response score for each are provided in Table 1. Overall, student responses were very favorable. The mean response score for 10 of the 11 statements exceeded four (“agree”). The highest mean response (4.52) came from the following statement: “The VBSD case helped me better understand the type of ‘real-world’ issues faced by an auditor.”

< Insert Table 1 here >

Figure 1
VBSD Organizational Charts

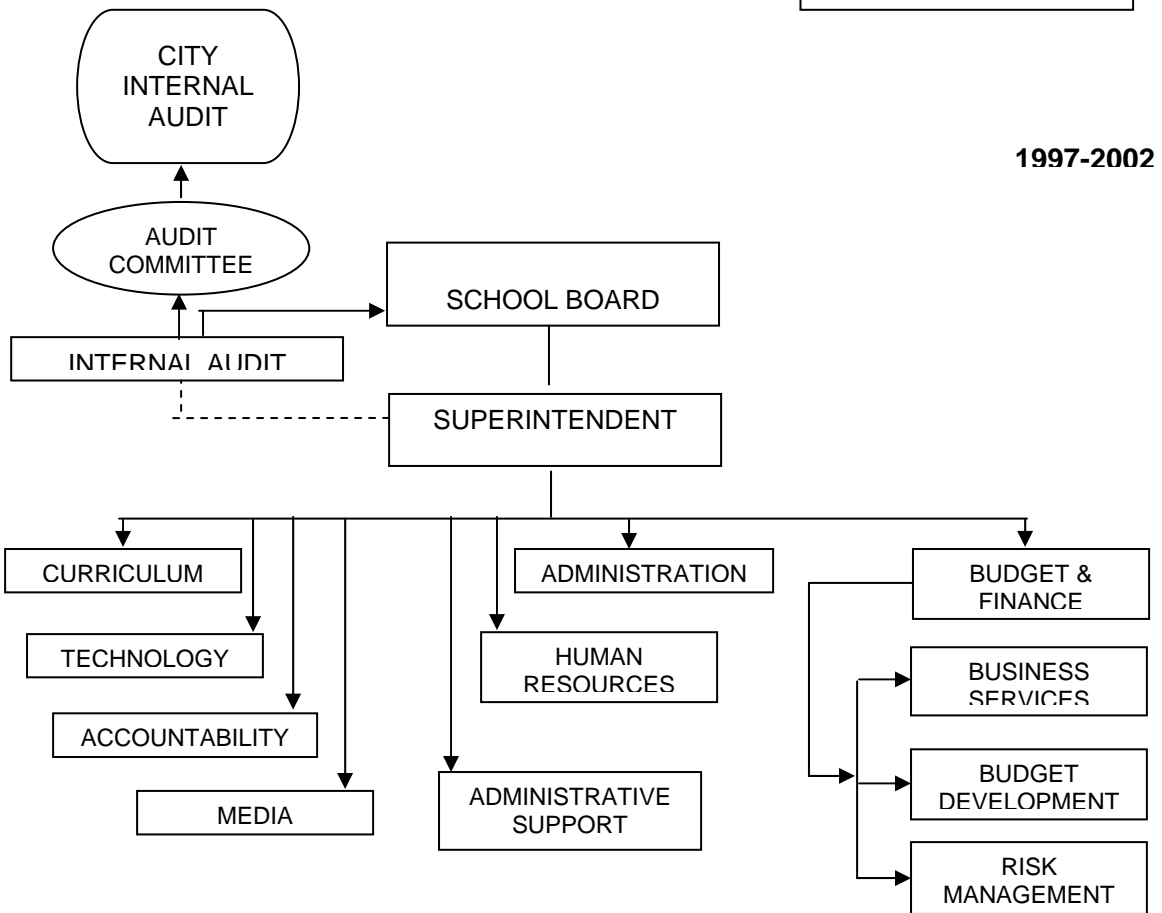
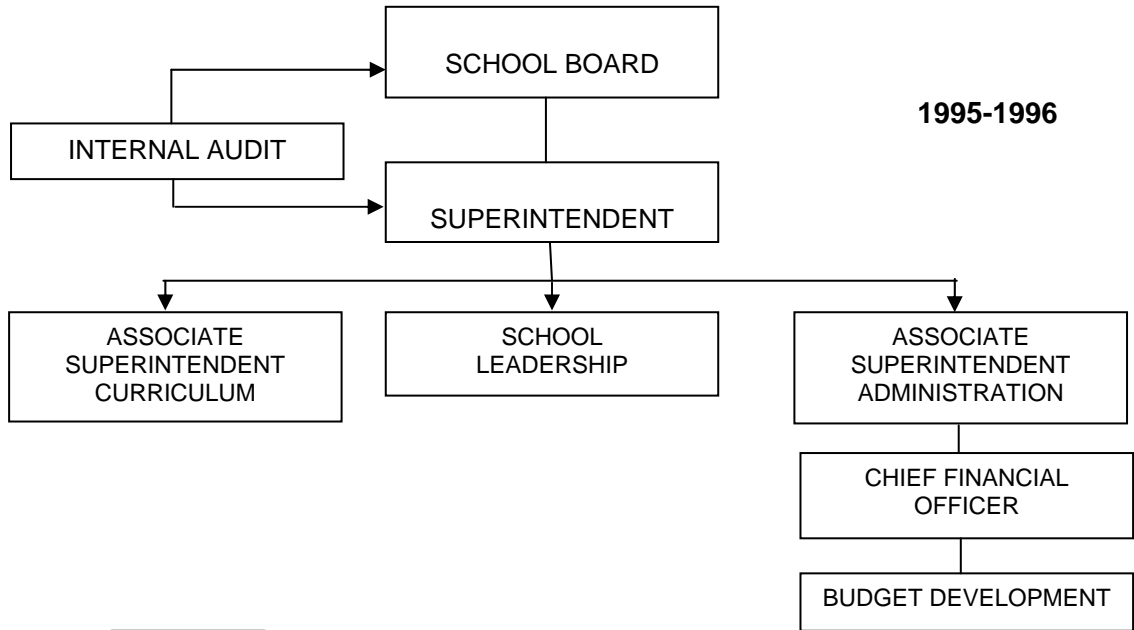


Exhibit 1
VBSD Case “Characters”

Virginia Beach School District

Sidney Facuette – Superintendent – Appointed in July 1991 and resigned in July 1995 to take a similar position in Georgia.

Mordecai Smith – Director of Budget Development/Chief Financial Officer – Appointed Director of Budget Development in 1989. Previously worked for the City of Virginia Beach as a budget analyst for 5 years. Appointed interim CFO in August 1994. The “interim” designation was dropped in February 1995 when Facuette consolidated the Director of Accounting and Director of Budget Development positions into the CFO position. In September 1995, Smith was placed on administrative leave by interim Superintendent Pughsley. Smith was reinstated as Director of Budget Development on a probationary basis in mid-February 1996 by the School Board. He resigned in late March 1996, shortly after the Special Grand Jury report was issued.

Hal Canary – Chief Financial Officer – Appointed in 1993 and dismissed by Facuette in August 1994 due to the large deficit in 1993-1994.

James Pughsley – Deputy Superintendent – Appointed in 1993 and named interim Superintendent upon the resignation of Facuette in 1995. Pughsley resigned over the reinstatement of Smith as Director of Budget Development by the School Board in February 1996.

Kevin Jones – Internal Auditor – Appointed in 1993 and resigned in April 1995 over concerns that funding would not be available to pay teachers and suppliers and to fund summer school.

City of Virginia Beach

Dean Block – Director of Management and Budget

Figure 2
VIRGINIA BEACH SCHOOL DISTRICT FINANCIAL INFORMATION

BUDGETED OPERATING REVENUES							
	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
Local	\$154,786,019	\$165,520,000	\$159,167,291	\$167,899,221	\$173,464,054	\$187,768,016	\$209,671,618
Virginia	\$123,037,082	\$119,692,800	\$143,029,869	\$145,006,060	\$154,659,465	\$157,092,801	\$169,894,421
Federal	\$6,500,000	\$6,797,000	\$10,603,000	\$10,605,000	\$12,666,952	\$13,504,673	\$7,736,640
TOTAL	\$284,323,101	\$292,009,800	\$312,800,160	\$323,510,281	\$340,790,471	\$358,365,490	\$387,302,679
ACTUAL OPERATING REVENUES							
	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
Local	\$142,650,381	\$165,881,917	\$163,285,930	\$176,340,530	\$174,926,143	\$187,450,670	\$205,847,251
Virginia	\$121,896,570	\$114,363,347	\$139,142,999	\$140,702,181	\$153,179,945	\$156,739,141	\$178,007,930
Federal	\$15,586,525	\$8,469,404	\$12,032,607	\$11,833,877	\$10,715,994	\$9,878,512	\$8,778,170
TOTAL	\$280,133,476	\$288,714,668	\$314,461,536	\$328,876,588	\$338,822,082	\$354,068,323	\$392,633,351
COMPARISON OF ACTUAL REVENUES TO BUDGETED REVENUES (Actual/Budget)							
	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
Local	-7.84%	0.22%	2.59%	5.03%	0.84%	-0.17%	-1.82%
Virginia	-0.93%	-4.45%	-2.72%	-2.97%	-0.96%	-0.23%	4.78%
Federal	139.79%	24.61%	13.48%	11.59%	-15.40%	-26.85%	13.46%
TOTAL	-1.47%	-1.13%	0.53%	1.66%	-0.58%	-1.20%	1.38%
BUDGETED EXPENDITURES							
	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
Operations	\$288,507,179	\$297,600,885	\$312,800,160	\$323,510,281	\$340,790,112	\$358,365,490	\$387,302,679
CIP	\$7,690,827	\$2,262,426	\$2,581,062	\$6,481,112	\$4,900,000	\$2,000,000	\$1,000,000
Debt							
Service	\$18,258,230	\$20,234,318	\$22,082,735	\$249,100,122	\$27,033,309	\$33,848,389	\$33,314,872
TOTAL	\$314,456,236	\$320,097,629	\$337,463,957	\$579,091,515	\$372,723,421	\$394,213,879	\$421,617,551
ACTUAL OPERATING EXPENDITURES							
	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
Operations	\$278,724,975	\$280,153,312	\$316,495,922	\$328,876,588	\$350,629,262	\$353,587,849	\$366,553,126
COMPARISON OF ACTUAL OPERATING EXPENDITURES TO BUDGETED EXPENDITURES							
Actual/ Budget	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
	-3.39%	-5.86%	1.18%	1.66%	2.89%	-1.33%	-5.36%
COMPARISON OF ACTUAL OPERATING REVENUES TO EXPENDITURES							
Revenue/ Expend	FY 90-91	FY 91-92	FY 92-93	FY 93-94	FY 94-95	FY 95-96	FY 96-97
	0.51%	3.06%	-0.64%	0.00%	-3.37%	0.14%	7.11%

Table 1
Summary of Student Feedback

<u>Statement</u>	<u>Response Mean</u>	<u>Standard Deviation</u>
1. I found the VBSD case interesting.	4.26	.54
2. I found this case to be more relevant (than other cases) because it involves real people making real decisions about a real entity, the VBSD.	4.26	.62
3. The VBSD case was understandable even though I have not had a class in governmental accounting.	4.09	.51
4. Completing the VBSD case in a team was beneficial to me in developing teamwork skills.	4.22	.67
5. The VBSD case provided real-world applicability of what I learned in class about the <u>three purposes</u> of an entity's internal control.	4.35	.57
6. The VBSD case provided real-world applicability of what I learned in class about the <u>components</u> of an entity's internal control (e.g., control activities).	4.39	.58
7. The VBSD case provided real-world applicability of what I learned in class about risk assessment.	4.13	.55
8. The VBSD case provided real-world applicability of what I learned in class about fraud and fraud risk factors.	4.39	.72
9. The VBSD case provided real-world applicability of what I learned in class about the client retention decision periodically made by an auditor.	3.96	.77
10. The VBSD case helped me better understand the type of "real-world" issues faced by auditor.	4.52	.51
11. Overall, the VBSD case provided a beneficial learning experience.	4.35	.49

Response Scale: 5 – strongly agree; 4- agree; 3 – neither agree nor disagree; 2- disagree; 1 – strongly disagree.

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