

## **Case 2-6**

### **Supreme Designs, Inc.**

Supreme Designs, Inc., is a small manufacturing company located in Detroit, Michigan. There are three stockholders of the company – Gary Hoffman, Ed Webber, and John Sullivan. Hoffman manages the business including the responsibility for the financial statements. Webber and Sullivan do most of the sales work, and they cultivate potential customers for Supreme Designs.

Hoffman recently hired his daughter, Janet, to manage the office. Janet has successfully managed a small clothing boutique in downtown Detroit for the past eight years. She sold the shop to a regional department store that wanted to expand its operations. Gary Hoffman hopes that his daughter will take over as an owner in a few years when he reaches retirement age. Webber and Sullivan are significantly younger than Gary Hoffman.

Janet is given complete control over the payroll, and she approves disbursements, signs checks, and reconciles the general ledger cash account to the bank statement balance. Previously, the bookkeeper was the only employee with such authority. However, the bookkeeper recently left the company, and Gary Hoffman needed someone he could trust to be in charge of these sensitive operations. Hoffman did ask his daughter to hire someone as soon as possible to help with these and other accounting functions. Janet hired Kevin Greenberg shortly thereafter, based on a friend's recommendation.

Greenberg is a relatively inexperienced accountant but he was willing to work for less than what the company had paid the former bookkeeper. Greenberg holds a Bachelor's degree in Accounting from Detroit Pistons College. He had been working for

Prince Brothers Enterprises for the past sixteen months. However, Prince Brothers decided to go public and the company hired Chauncey Bentley LLP to do the accounting and auditing work.

On April 29, 2011, about one year after hiring Kevin Greenberg, Janet Hoffman discovers that she needs surgery. Even though the procedure is fairly common and the risks are minimal, Janet plans on spending five weeks in recovery because of related medical problems that could flare up if she returns to work too soon. She asks Greenberg to approve vouchers for payment and present them to her father during this time, and her father will write the checks during Janet's absence. Janet had previously discussed this plan with her father and they both agreed that Greenberg was ready to assume the additional responsibilities. They did not, however, discuss the matter with either Webber or Sullivan.

The bank statement for April arrives on May 3, 2011. Janet did not tell Kevin to reconcile the bank statements. In fact, she specifically told him to just put those aside until she returns. However, Kevin decides to reconcile the April bank statement as a favor to Janet and to lighten her work load after she returns.

Although everything appears to be in order, Kevin is not sure what to make of his finding that Janet approved and signed five checks payable to herself for the same amount during April 2011. Each check appears in correct numerical sequence, one check of every ten checks written during the month. Kevin was surprised because if these were payroll checks, as he had suspected because they were for the same amount, it was highly unusual. This is because the payroll is processed once a month for all employees of

Supreme Designs. In fact, he found only one canceled check for each of the other employees including himself.

Curiosity gets the better of Kevin and he decides to trace the checks paid to Janet to the cash disbursements journal. He looked for supporting documentation but couldn't find any. He noticed that four of the five checks were coded to different accounts including supplies, travel and entertainment, books and magazines, and two to miscellaneous expenses.

After considering what his findings might mean and whether he should contact Janet, Kevin decided to expand his search. He reviewed the bank statements for January through March of 2011. In all, there were fifteen additional checks made payable to Janet, each for the same amount as the five in April. These twenty checks totaled \$20,000. Kevin still thought it was possible these amounts represented Janet's salary because he knows her annual salary is \$50,000. Perhaps she took out a little more this year.

Kevin doesn't know what to do. He could contact Janet but he knows she would be unhappy that he opened the bank statement and went so far as to reconcile cash even though she specifically told him not to do it. Perhaps he should contact the three stockholders. Then again, it may be best if he keeps quiet about the entire matter.

Because the manager of a small business has made checks out to herself on a regular and routine basis suggests that the possibility of material irregularities exist in this case. The case is further complicated by the fact that the manager is the daughter of one of the owner of the business. Misappropriation of resources is the primary issue of this case. The ethical dilemma is presented from the point of view of Kevin Greenberg, the young accountant who discovers the irregularity.

Instructors may want to extend the discussion in this case and provide some information to the students on the existence and cost of fraud to U.S. Business. The Association of Certified Fraud Examiners puts out a Report to the Nation in even numbered years. The summary of the 2006 Report to the Nation is in chapter 3.

### **Ethical Issues**

The financial statements of Supreme Designs for the current year will be materially misstated if corrective action is not taken, assuming that the improper checks have been written by Janet Hoffman all year long. The misappropriation of funds by Janet Hoffman seems to constitute an illegal act. Additional information may be needed in order to make this determination with certainty because it appears that Hoffman has the authority to do almost anything that she wants. Nevertheless, the seriousness of the act raises concerns about the integrity of management and reliability of internal controls. The latter clearly are inadequate because there is no separation of duties in that both the disbursement function and the reconciliation of the bank statement with the general ledger cash account are performed by one person, Janet Hoffman.

This case deals with the basic issue of honesty. Janet Hoffman has engaged in a dishonest act by fraudulently writing checks that are payable to herself. Consequently, she has violated the trust placed in her by her father. Kevin Greenberg becomes involved because he assumed some of Janet's responsibilities while she was hospitalized. Greenberg seems to know what the right thing to do is, but he may feel constrained by the fact that he reports to Janet.

Greenberg owes his ultimate allegiance to the owners of Supreme Designs. Janet is not an owner. It is her father that is part owner of the business. Greenberg should consider how Gary Hoffman might feel about knowing that his trusted daughter has stolen from the company. He has a right to be informed about this, and the other owners should know as well.

### **What Actually Happened**

Greenberg disclosed his findings to Gary Hoffman who did not believe him at first. A meeting was called of all the owners. Eventually, Hoffman was persuaded to accept what happened because of the convincing evidence presented by Greenberg, and he fired his daughter. Years later it was discovered that Gary Hoffman was selling miscellaneous inventory and company equipment that had little or no value on the books. This created a great deal of tension between the owners. In discussions with Janet Hoffman it was determined that she felt justified in her actions because she knew that her father had engaged in similar activities.

### **Questions**

**1. Do you think Kevin did the “right” thing by opening the bank statement and reconciling it to the general ledger? Why or why not?**

Kevin was not authorized to open the bank statement and reconcile it to the general ledger. He had good intentions and had lucky results. Ask students what they think would have happened if Kevin opened the bank statement and had not found misappropriations by Janet.

**2. Explain what Kevin should do if he reasons at each of the six stages of Kohlberg’s model of moral development.**

Kevin is first faced with the fact that he cannot tell anyone without first admitting that he disobeyed his instructions. Stage 1: Kevin would stay quiet as speaking up will cause trouble. Stage 2: Kevin would tell partners or Janet in hope of reward money or hush money. Stage 3 and 4: Kevin would stay quiet as the amount is not threatening the business nor continuing while Janet is on sick leave. Stage 5: Kevin would ask Janet about her actions. Stage 6: Kevin would talk to partners as they ought to know.

**3. Evaluate what steps should be taken in each of the following independent situations:**

**(a) If you were Janet and Kevin dropped by the hospital to tell you about his discovery, how would you react?**

Janet may consider the following actions once Kevin tells her he knows about the misappropriations: 1) fire him so he cannot tell without looking like disgruntled, revenge

motivated fired employee; 2) try to spin on him an excuse to claim the checks are legitimate; or 3) ask or threaten him not to tell so she can make it right and turn herself in.

**(b) Assume Kevin contacts Janet's father because he did not want to upset her after the surgery. Hoffman talks to his daughter who informs him that she had a shortage in her personal funds and planned to repay the \$20,000 after she returns. What would you do now if you were Gary Hoffman? Why?**

Gary may want to give Janet a chance to reform herself. Gary may plan to pay the money back to the company so the partners do not find out. Gary owes an obligation to his partners but he also has loyalty to his daughter.

Gary now would help his daughter by covering her losses. The harder and ethical thing to do beyond that is to remove Janet from the firm.

**(c) Assume Hoffman does nothing because of his daughter's explanation.**

**Janet returns to work and fires Kevin Greenberg. What would you do if you were Kevin? Why? How do you think Kevin's action (or inaction) might affect his opportunity for other jobs? Should that matters in terms of what he decides to do?**

Kevin's choices are narrowed. Now if he tells anyone further, it will hurt his chances of getting another job. Hopefully Kevin documented all that happened and all that he's done in the situation before or right after he was fired. Once he has secured another job, Kevin can consider whether he should report the situation to the other partners, to the police or to the press.