When Management Override Negates Common Sense

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ABSTRACT

Write "OK per big boss" across the invoice and everything is fine! Or is it? This paper analyzes the human factor link related to the Debra Valice Case. The human factor is the weakest link of any internal control system. Understanding the human factors that cause people to "not follow the rules," is key to strengthening this link. This research will utilize the human factors adapted from the Independence Education Program to analyze the Debra Valice Case. Valice was responsible for ensuring a secure internal control system. The Chief Executive Officer was able to manipulate this system and unauthorized payments were made to him or on his behalf. Valice's lack of good judgment allowed this to happen. The human factors allowing this breach were professional character, business culture and environment, the ability to recognize there is an issue and the quality of the decision-making process as outlined by the Independence Education Program.

INTRODUCTION

How many employees are under the impression they are safe when they write "ok per big boss" across an invoice to be paid? It happens all the time; there is always one "big boss" that has the authority to override internal controls. It sounds ludicrous for a company to pay for personal legal fees for the Chief Executive Officer in the amount of $750,000, nearly half of a million for his racing hobby, $150,000 for a home security system for the Chief Executive Officer and two million in bonus advances to the Chief Executive Officer and Chief Financial Officer. When these things are analyzed after the fact it seems crazy, but how is it that these things occur with internal controls in place?

HUMAN FACTORS-THE INDEPENDENCE EDUCATION PROGRAM

This research will utilize the human factors adapted from the Independence Education Program (2000, 15) to analyze the Debra Valice Case. The Independence Education program outlines human factors that lead to the use of poor judgment.. These factors are professional character, business culture and environment, ability to recognize there is an issue and the quality of the decision process. The human factor is the weakest link in any internal control system.

CASE

Debra Valice was the Chief Financial Officer for Seitel, a Houston-based, publicly-traded company. Along with her duty of managing the accounting department, Valice was responsible for maintaining internal controls and ensuring the company was in compliance with the terms of executives contracts. According to the Securities and Exchange Commission Cease-and-Desist Order, Valice was the Chief Financial Officer from 1987 until June of 2002 and served on the Board of Directors from 1995 until June of 2002. Incidentally, Valice was a Certified Public Accountant licensed by the State of Texas.

Paul Frame is the former Chief Executive Officer for Seitel. He was Chief Executive Officer during the time that Valice was the Chief Financial Officer. His management style created an environment that allowed many breaches of internal controls, mostly on his behalf.

During 2001 and early 2002 Valice allowed unauthorized payments to be made by Seitel to, or on the behalf of top executives (mainly Frame, and in one case, to Valice herself). One payment was for Frame's personal legal expenses. In April and July of 2001 Frame directed the accounting department to pay invoices totaling $750,000 in legal fees. These legal fees were personal legal fees for Frame; he advised the accounting department that these legal fees were for the company. In fact, the legal fees were incurred personally due to a lawsuit brought against him by a former girlfriend. The girlfriend was also suing Seitel. Seitel advised Frame to retain separate counsel and pay his own fees. When the invoices arrived for his personal legal fees they were addressed to Valice. Valice did not inquire about the legal matter or details of the fees. She asked Frame if they should be paid. He said "yes" so she marked the invoices "Approved per Paul Frame" and gave them to the accounting department for payment. Asking Frame about the invoice was the only investigating she did for this payment. The invoice had "retainer fees" written on it, which should have clued Valice that there was a problem since Seitel already had an attorney on retainer in which the company paid $75,000 a month.

Valice also allowed payments to be made to fund Frame's race car hobby. Frame gave the accounting department a "sponsorship" agreement to pay. In actuality, there was no agreement; just a form letter from the Ferrari dealership requesting a $75,600 "support" payment. The accounting department did not question this payment since Frame was the one making the request. There was no documentation to show how this payment related to Seitel's business. This should have been a red flag that something was amiss. This proves the powerful position the Chief Executive Officer holds within a company.

Collusion is a very hard method of fraud to prevent, detect and stop. In this case Valice, for whatever reason, seemed to support Frame's decisions. Was it his power and management style, or did she really think he would take the fall?

Seitel's accounting department also paid $179,000 to sponsor a race car when in fact Frame was actually purchasing the car. Frame asked for the money to buy the race car; however when Valice questioned him about the title to the car, he backtracked and said it was a sponsorship, not a purchase. Frame explained that it was advertising for the business and that the company would receive a $130,000 residual payment when the car was sold in two years. Valice did at least question this action, but still did not demand proper documentation. Neither did she investigate how this benefited Seitel.

During the remainder of 2001 Frame personally approved and submitted over $150,000 in invoices for track rentals, tires, fuel, race entry fees and other costs associated with racing. The accounting department paid these invoices though they were beginning to get suspicious. Frame was marking the invoices approved and to be charged to advertising. Frame charged over $30,000 for racing expenses on his corporate credit card, which was paid by Seitel. The expenses were either charged to advertising or entertainment. Frame would advise the accounting department which account should be used. Who would argue with the Chief Executive Officer? The Chief Financial Officer should have. The accounting department did not investigate whether the expenses were for his personal racing or actually for business development. It came to be known that Frame was racing and participating in a private race club. Due to the fact that the club was private, Seitel was not really getting any public advertising. Valice did not seem to know these facts.

In February 2002 the accounting department received a check request for $148,000 for a security system. When questioned by the accounting department, Frame claimed that the system was for a new data facility being built by Seitel. The accounting department requested the invoice from the vendor and found that it showed the security system was for Frame's residence. When it was brought to Valice's attention, she approved it to be paid anyway. There was nothing in Frame's contract allowing for a personal security system for his home.

Seitel made payments of almost 2 million dollars to Frame as advances on the bonus he anticipated he would receive for 2001. According to Frame's contract his annual bonus was calculated as a percentage of Seitel's pre-tax profits above $10 million. Valice also received advances totaling $375.000 on her bonus for the same period. Her contract stated that her bonus would be set at the Board's discretion. Neither contract, Valice's or Frame's, made any allowance for the bonuses to be paid in advance. According to Frame's contract, his bonus was to be paid only after Seitel's outside auditor certified that the pre-tax profits exceeded the $10 million threshold. Valice allowed these unauthorized payments to be made to Frame and to herself.

It is interesting to note that Seitel did not meet the $10 million pre-tax threshold for the year. This meant that neither Valice nor Frame would have received a bonus. The Board of Directors did not award a bonus to either employee for 2001. The Board of Directors determined that the advances would be repaid and made both employees sign promissory notes. The face value of the promissory notes exceeded the amount of the advances for each employee. Based on this fact, Valice ordered the accounting department to issue checks to Frame and herself for the difference. Frame received $176,844 and Valice received $159,437. These were unauthorized payments as well. The bonus related payments were the only payments that Valice actually benefited from personally.

During the time these payments were made they were not disclosed to the Securities and Exchange Commission. These filings were approved by Valice. This nondisclosure prompted the Securities and Exchange Commission to reprimand Valice. The Securities and Exchange Commission initiated a Cease-And-Desist Order against Valice on June 6, 2003. She agreed with the order, but did not admit guilt. This in turn got her into trouble with the Texas State Board of Public Accountancy for violating Rule 501.90(7), Discreditable Acts.

O'Gare contends that "management fraud is the largest single area of loss resulting from conflict-of-interest corruption." Conflict-of-interest is based upon the idea that a manager looking out for his own best interest can not also look out for the best interest of the company.

PROFESSIONAL CHARACTER

Valice's lack of professional character allowed this fraud to be perpetrated. She did not uphold the professional standards to which she was obligated as a Certified Public Accountant in the State of Texas. Not only were the unauthorized disbursements made, they were not properly reported to the Securities and Exchange Commission. Valice did not follow through with her professional duties to create an effective internal control system for Seitel. She allowed the Chief Executive Officer to negate internal control systems and did not attempt to override him.

This type of fraud is not typically committed by executive management according to O'Gara. That was not the case for Paul Frame.

BUSINESS CULTURE AND ENVIRONMENT

It appears that the business culture within Seitel was accommodating to this type of behavior. It is believed that organizational behavior comes from the top down. Frame, being at the top in this case, created a culture that prevented the accounting department or Valice from stopping the payments. The accounting department was unable to act on their suspicions. The department did not have the power to stop the payments. The accounting department was overridden by Valice. Valice in turn felt like she was safe when writing "ok per Paul Frame." Was it difficult for her to forecast the ramifications of her behavior, or did she just not care?

ABILITY TO RECOGNIZE AN ISSUE EXISTS

Did Valice lack the ability to recognize these were major decisions that required considerable thought, or did she view them as everyday issues that were part of everyday business? She did not investigate the payments. Valice was obligated by her position to protect Seitel's assets. She was charged with a duty and did not fulfill it. Valice should have confirmed that these payments were beneficial to Seitel. Valice appears to have believed she was safe in allowing disbursement as long as Paul Frame approved payment. She did not serve her duty to protect the assets of Seitel and therefore was not protecting the investor's interest.

QUAILITY OF DECISION PROCESS

Valice did not go through the proper decision process to arrive at her decision to allow these payments. Had she properly analyzed and investigated the payments, it can be assumed she would not have allowed the payments. Valice approved payments that the accounting department she supervised was leery of making. She should have given this more careful consideration.

CONCLUSION

It is easy to see that internal controls were ignored when payment requests were made or approved by Paul Frame. This is an example of how humans make internal control systems weak. When an invoice has to be manually approved it should be thoroughly investigated before being paid. The Board of Directors had advised Paul Frame to retain his own counsel in the lawsuit involving his former girlfriend. Valice was on the Board of Directors at the time. Had she brought the payment question to them, without a doubt they would not have supported it.

One of the steps recommended in the article "When the Boss Trumps Internal Controls is to scrutinize the expense account of executives. The article also points out that some CPAs assume that there is a difference in the level of honesty between executives and the rank and file, but there is not. Paul Frame proves this point, however he was not using his own expense account, he was bold with fraud.

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