Is your entity at risk for fraud?
About the presenters

Carla A. Gogin, CPA
Partner
carla.gogin@bakertilly.com
608 240 2460

Amanda Blomberg, CPA
Senior Manager
amanda.blomberg@bakertilly.com
608 240 2386
Part I.
> Historical Perspective
> Dixon – What Really Happened?
> Do any of the Red Flags Sound Familiar?

Part II.
> A Financial Audit – What Should You Expect?
> The Private Sector – What Can Governments Learn?
> Lessons Learned
> Q & A
1. fraud

/frÔd/  Noun

- Wrongful or criminal deception intended to result in financial or personal gain. A person or thing intended to deceive others, typically by unjustifiably claiming or being credited with accomplishments or qualities

Synonyms
- Cheat – deceit – deception – swindle – humbug - fake
Then – lavish lifestyle!

Now – 20 years in prison!
Rita Crundwell and the Dixon Embezzlement

1991
$181,000 stolen

1990-2006
$23 million stolen

2006-2012
$30 million stolen
The Dixon story

Population: 15,511

Budget:
Total Revenues and Transfers for 2012/13 - $9,700,000+

Question: How does your community compare?
The Dixon embezzlement

Over $53 million stolen – the largest municipal fraud in US history

- Average of $5 million per year, more than half of Dixon’s operating budget
- More than the police and fire budgets combined
- How the Board explained away the poor financial results of the community
  - Tax – capped community
  - Sharp decline in revenues from certain operations (landfill)
  - Cash flow issues at the state level
  - Increase in health care costs (they are self-insured)
  - Investments in infrastructure
- **Red Flag:** Does this sound like your community?
Money financed Crundwell’s lavish lifestyle

- $2 million luxury motor home
- Over 400 prize winning horses worth millions
- Florida home and Dixon ranch worth millions
- $56,000 Corvette for boyfriend
Money financed Crundwell’s lavish lifestyle

Jewelry and gold bars worth over $1,800,000

Lavish parties
People did not question how a City worker could afford this

> Dixon residents thought her horse ranches produced income

Instead, they cost her millions to maintain

> Others on the horse circuit thought she inherited wealth
> People knew her since childhood

People at City Hall trusted and respected Crundwell.

**Potential Red Flag:** Does this sound familiar (trusted and respected employee)?
Crundwell spent her entire adult life rising through the ranks at City Hall

> Part-time City Hall worker during high school
> Known to be a smart, hard worker
> Worked full-time at City Hall after high school
> Rose from Secretary to Treasurer
> Appointed to fill Comptroller vacancy in 1983

Secure, non-elected position
Crundwell was almost solely responsible for the city’s finances

By the late 1980s, she essentially controlled all of city’s funds

Crundwell’s duties included:

> Balancing the books
> Writing the checks
> Making the deposits
> Requesting funds
> Funding projects

**Potential Red Flag:** Does your organization have the proper segregation of duties in place?
Crundwell retrieved all mail from the P.O. Box where financial statements were sent

- Including statements for her secret fund
- A relative picked up the mail when she was away

- Closed-loop system
- No segregation of duties
Crundwell shifted funds between Dixon city accounts and finally into a secret account.
Reliance on CPA firms

> 21 audits never identified the fraud
> As part of the audit, there were no material weaknesses identified
> **TIP:** Material weaknesses, significant deficiencies and or control deficiencies are a good place to start when performing a risk assessment
> Two accounting firms involved
  - One CPA firm compiled the monthly data
  - Another sole proprietor performed an annual audit
Dixon’s unusual form of government: Commission Form

Outdated form of government dating back over a century

Used by only about 50 of the 1,300 municipalities in Illinois

Power is divided among five people

> Mayor and four part-time commissioners who oversee their own function of government

- Public property
- Public health and safety
- Streets and public improvements
- Finance
How did it happen?

Mayor earns $9,600 a year
Commissioners earn $2,700
Most officials have full-time jobs in addition to their part-time duties at City Hall
  – Only one commissioner charged with financial oversight, with little time devoted to the job
  – City officials did not monitor books closely enough to notice large amounts of tax dollars missing

**Potential Red Flag**: Are your Board / Council members providing the appropriate level of financial oversight?
Masking missing money

Crundwell created 159 **FAKE** invoices (contained errors / misspellings)

**Red Flag – Where was the appropriate oversight?**

Illinois payments to municipalities were often up to one year late

> Crundwell claimed these late payments caused revenue shortages

She also blamed a bad economy

"This had to be the perfect storm of embezzlement"
- Dennis Czurylo, former IRS agent for 25 years
Dixon, Illinois: How Crundwell got caught

> 16 weeks of vacation in 2011
> City Clerk noticed strange bank account
> Mayor notified
> Mayor contacts FBI
Dixon, IL to receive $40M in settlement of fraud case

> $35.15M from the accounting firm who provided the monthly compilation services
> $3.85M from the bank where the “secret” account was located
> $1M from the audit firm (auditor since 2006)

City to also receive approximately $10M from the sale of Rita Crundwell’s assets
Part II. A Financial Audit – What should you expect?
A financial audit - what should you expect?

Why are Governments Susceptible to Fraud?

Responsibility for the Prevention and Detection of Fraud
  - Management
  - Governing Body
  - Internal Audit
  - External Audit

Dixon, IL – Management/Form of Government

Financial Audit Services v. Forensic Audit Services

Fraud Risk Assessment

The Importance of Professional Skepticism

Internal Control Opportunities

Final Thoughts/Questions
Fraud triangle

**Motive**
Someone needs a reason to steal

**Rationalization**
Someone determines that it’s ok to steal

**Opportunity**
Someone can steal, potentially without detection

Management CAN control
Management and governing body are often more trusting.

Cost restrictions may result in:

- Limited or no segregation of duties due to understaffing
- Limited resources to develop risk assessments and maintain anti-fraud programs and controls
- Lack of internal audit and/or anti-fraud departments in-house

A lack of financial expertise and natural turnover in governing bodies.

A belief that external financial audits will catch any fraud.
Per the “2012 Report to Nations – Association of Certified Fraud Examiners, Inc.”:

| The most frequent type of fraud is asset misappropriation =‘s approximately 86% | The public sector ranks second in the frequency by industry with a median loss of $100,000 | The findings demonstrate that no organization is safe from the harmful effects of fraud |
Who has the primary responsibility for the prevention and detection of fraud?

“The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.”

AU-C Section 240 - .02
Management’s role in the prevention and detection of fraud:

“It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior, which can be reinforced by active oversight by those charged with governance.”

AU-C Section 240 - .02
Dixon’s Management – Audit Risk Assessment

> They had one person who was in-charge of everything – the appropriate internal controls i.e. segregation of duties were not in place

> There were many red flags present
  > Poor financial results
  > Lack of segregation of duties
  > Lack of oversight
  > No control deficiencies identified
What is the governing body’s role in the prevention and detection of fraud?

“Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of financial statement users regarding the entity's performance and profitability.”

AU-C Section 240 - .02
Monitoring the risk of management override – Key steps for governing bodies and audit committees

Understand the entity and industry, including:

- Key drivers of revenue and related benchmarks
- Factors that may threaten management’s ability to achieve the budgeted results

Brainstorm with department heads, other key members of management, external auditors, and internal auditors to identify fraud risks

- Review any material weaknesses, significant deficiencies and control deficiencies related to the financial audit
- Review any compliance findings related to the single audit
- Consider segregation of duties
- Consider decentralized operations

Assess the tone at the top and the entity’s culture

Create a whistleblower policy

- Consider setting up a whistleblower hotline

**Adapted from “Management Override of Internal Controls: The Achilles’ Heel of Fraud Prevention, American Institute of Certified Public Accountants, 2005.”**
“Board members should be a little more skeptical and less trusting. Not that they don’t trust the company’s management. But they should do their own due diligence and recognize they have to keep their eye on these things by spending more time making judgments, connecting the dots and following through by asking more questions.”

- Peggy Foran, Vice President, Chief Governance Officer, and Corporate Secretary, Prudential
Dixon’s form of government – audit risk assessment

- Commission form of government
- Was designed so that no one person had overruling power
Weaknesses of commission style government

Equity
• A single Commissioner makes decisions for an entire department

Transparency
• Decisions made by a board, operating in full public view will be seen as more ethical than the same decisions made by a single commissioner

Unity
• Commissions are divided groups
• Each commissioner has their own “turf”
• Commissioners are not as inclined to see the big picture

Leadership
• It is more difficult for a single community leader to come from this form of government
Dixon, IL government

Elected officials need to juggle full time jobs along with their office duties for the city.

- Limited time spent by these officials on the job
- Less time to be thorough and understand the details
- Commissioner qualifications

Significant reputational impacts related to any fraud at a public entity
Responsibility for the prevention and detection of fraud – internal audit

What is internal audit’s role in the prevention and detection of fraud?

The International Professional Practices Framework (IPPF) of the Institute of Internal Auditors (IIA) specifically requires that internal auditors address the risk of fraud:

> “The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.” (IPPF 2010.A2)

> “The internal audit activity must evaluate the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.” (IPPF 2210.A2)
In addition, the IIA recently issued a practice guide that identifies the following specific internal audit responsibilities related to fraud:

- Consider fraud risks in assessing internal control design and determining audit steps to perform
- Have sufficient knowledge of fraud to identify red flags that fraud may have been committed
- Be alert for opportunities for fraud, such as control deficiencies
- Evaluate whether management is actively retaining responsibility for oversight of the fraud risk management program
- Evaluate any indicators of fraud and recommend investigation when appropriate
- Communicate with the board regarding fraud risks and prevention and detection programs, as well as any incidents of actual fraud

*Internal Audit and Fraud Practice Guide, The Institute of Internal Auditors, 2009
What is an external auditor’s role in the prevention and detection of fraud?

“An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.”

AU-C Section 240 - .02
“As described in section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, the potential effects of inherent limitations are particularly significant in the case of misstatement resulting from fraud.

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error.“

AU-C Section 240 - .06

Why?
Sophisticated and carefully organized schemes - Concealment
Collusion
Relative size of individual amounts manipulated
Seniority of those individuals involved

“Although the auditor may be able to identify potential opportunities for fraud to be perpetrated, it is difficult for the auditor to determine whether misstatements in judgment areas, such as accounting estimates, are caused by fraud or error.”

AU-C Section 240 - .06
What is the likelihood that a financial audit will discover fraud?

The Association of Certified Fraud Examiners reports that less than 10% of frauds are discovered as a result of an audit by an independent accounting firm.
## Closing the expectation gap – financial audit services v. forensic audit services

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<th>ISSUE</th>
<th>FINANCIAL AUDIT</th>
<th>FRAUD EXAMINATION</th>
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| Timing    | Recurring
Audits are conducted on a regular basis
(typically annually)               | Non-recurring
Only conducted with sufficient prediction               |
| Scope     | General
The scope is a general examination of financial data | Specific
The fraud examination is conducted to resolve specific allegations |
| Objective | Opinion
An audit is generally conducted for the purpose of expressing an opinion on the financial statements | Affix Blame
The fraud examination’s goal is to determine whether fraud has / is occurring, and to determine who is responsible |
| Relationship | Non Adversarial
The audit process is non-adversarial in nature | Adversarial
Fraud examinations, because they involve efforts to affix blame, are adversarial in nature |
| Methodology | Audit Techniques
Audits are conducted primarily by examining financial data | Fraud Examination Techniques
Fraud examinations are conducted by (1) documentation examinations; (2) review of outside data such as public records; and (3) interviews. |
| Presumption | Professional Skepticism
Auditors are required to approach audits with professional skepticism. | Proof
Fraud examiners approach the resolution by a fraud by attempting to establish sufficient proof to support or refute an allegation of fraud. |

**Adapted from the ACFE Fraud Examiners Manual**
The responsibility is yours – conduct an internal fraud risk assessment!

1. Identify where fraud could occur (e.g. decentralized departments).
2. What could go wrong (financial risk, regulatory risk, compliance with laws and regulations)?
3. What is the likelihood that something could go wrong?
4. What is the potential magnitude (high, medium, low)?
5. What internal controls already exist / what controls are lacking?
6. Are the internal controls functioning?
7. What new internal controls should be put in place (need to consider cost v. benefit)?

Our experience is that governments have not taken this very important first step.

Resource for you – Internal Control Framework Established by COSO (Committee of Sponsoring Organizations).
The responsibility is yours – conduct an internal fraud risk assessment!

Environments with Biggest Risks of Fraud

- Too much reliance on an individual employee
- Decentralized locations
- Lack of appropriate oversight by management or governing body
The responsibility is yours – conduct an internal fraud risk assessment!
COSO Elements
According to COSO, there are five elements of the COSO framework:

- **Control Environment**
  - Foundation, discipline, and structure of internal control system

- **Risk Assessment**
  - Identification and analysis of risks by management

- **Control Activities**
  - Policies, procedures, and practices to carry out management objectives

- **Information and Communication**
  - Support all other control components by communicating control responsibilities to employees

- **Monitoring**
  - External oversight of internal controls by management and other parties outside the process
The importance of professional skepticism!

Six characteristics of professional skepticism

- Questioning Mind
- Suspension of Judgment
- Search for Knowledge
- Interpersonal Understanding
- Autonomy
- Self Esteem

This applies to your external auditors, management, governing body, audit committees, and internal audit.

Top internal control opportunities your organization should be implementing

There are many internal control opportunities, the following is a partial list for your consideration:

1. Multiple layers of approvals and signatures
2. Require backup documentation
3. Never pre-sign checks / controls over wires / ACH payments
4. Segregation of duties (one individual should not be responsible for an entire financial transaction)
5. Conduct background checks
6. Capital asset inventories
7. Board/Council involvement/oversight
8. Encourage whistleblowers
9. Automated controls
10. Educate employees using discussion of fraud risks and internal controls
Common practices in the private sector

- Employee Theft Insurance
- Bonded and Insured Financial Officers/Key Employees
- Required, Mandated Time Off (Vacation)
Surprised, periodic rotation of job responsibilities

- A/P, A/R, Cash, G/L, and Various Funds, Capital v. Operation

Regular background check of financial employees
Basic internal control structure:
Separation of roles and functions

Segregation of Duties

> Separate people overseeing accounting and treasury responsibilities
  - More officials overseeing the books
  - It is possible that an approved vendor list would have made it harder for Crundwell to create fake invoices

> Understand what controls are in place at the banks being used by the entity

> Do not allow entities to use your federal ID number
Final thoughts

> No matter how small the municipality – internal controls must be in place…..it is possible!
> Odds are a financial audit is not going to detect fraud
> Simple “blind faith” in a trusted employee alone is not sufficient
> Even a small amount of internal controls can go a long way
> Exercise skepticism
> Tone at the top is crucial
Final thoughts

Trust but Verify
Thank you for your attendance and participation!
Sources:
- Deterring and Detecting Financial Reporting Fraud – A Platform for Action, October 2010, Center for Audit Quality
- AU-C Section 240 – Consideration of Fraud in a Financial Statement Audit – AICPA U.S. Auditing Standards (Clarified)
- 2012 Report to the Nations – Association of Certified Fraud Examiners, Inc.

You can also access our original webinar on fraud entitled: Common Fraud Schemes in Governments by going to www.bakertilly.com/State-Local-Government-Webinars
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