Fraud Risk Assessment

Eric Kinsherf, CPA
MMAAA Conference
June 12, 2018
Agenda

- Overview
- What is Fraud?
- How does Fraud happen?
- How to Detect and Prevent Fraud
- Summarize
Objectives

- Gain better Understanding of Fraud Risk
- Illustrate examples
- Understand process of Conducting a Fraud Risk Assessment
WHAT IS FRAUD?
MUNICIPAL Fraud Cases

MASSACHUSETTS ALLEGED MUNICIPAL THEFT

<table>
<thead>
<tr>
<th>Recent alleged municipal thefts</th>
<th>Amount allegedly stolen, period of theft, named perpetrator and position by town</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hubbardston</td>
<td>Tax collector Cynthia Washburn-Doane 2004 to 2014 $500,000+</td>
</tr>
<tr>
<td>Barre</td>
<td>Tax collector Marcia Langleier 2005 to 2011 $307,353</td>
</tr>
<tr>
<td>Brimfield</td>
<td>Treasurer Kirsten Weldon 2006 to 2013 $80,868</td>
</tr>
<tr>
<td>Brookfield</td>
<td>Municipal Clerk Beth Conant 2013 to 2014 $43,947</td>
</tr>
</tbody>
</table>

Source: http://www.telegram.com/article/20160102/NEWS/160109825

BIGGEST MUNICIPAL EMBEZZLER IN UNITED STATES HISTORY

Rita Crundwell and the Dixon Embezzlement

THE $5.5 MILLION BAMBOOZLE: How the trusted comptroller of a small Illinois town became the biggest municipal embezzler in U.S. history, according to the feds—and no one noticed

BY BRYAN SMITH

Published: Sept 24, 2012

Rita Crundwell leaves a Rockford, Illinois courthouse after a hearing on her embezzlement case in August 2012. PHOTO BY W. J. BENNETT.

UPDATE (11/14/12): Rita Crundwell pleaded guilty to fraud on November 14 in federal court in Rockford.

What is Fraud?

- Association of Certified Fraud Examiners definition of Occupational Fraud:

  “The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of employing organization’s resources or assets.”
### 3 Main Fraud Categories

<table>
<thead>
<tr>
<th>Asset Misappropriation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Theft of Cash</td>
</tr>
<tr>
<td>Skimming</td>
</tr>
<tr>
<td>Theft of Inventory or Assets</td>
</tr>
<tr>
<td>Fraudulent Disbursements thru Invoices, Payroll, Expense Reports, Voids, Refunds, Check Tampering</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bribes</td>
</tr>
<tr>
<td>Conflicts of Interest</td>
</tr>
<tr>
<td>Illegal Gratuities</td>
</tr>
<tr>
<td>Economic Extortion</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Statement Fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intentionally misrepresenting the values such as:</td>
</tr>
<tr>
<td>Revenue</td>
</tr>
<tr>
<td>Expenditures</td>
</tr>
<tr>
<td>Assets</td>
</tr>
<tr>
<td>Liabilities</td>
</tr>
<tr>
<td>Equity</td>
</tr>
<tr>
<td>Improper Disclosures</td>
</tr>
</tbody>
</table>
89% of ACFE Cases involved Asset Misappropriation.

Source: 2018 ACFE Report
EXAMPLES OF FRAUD

DO YOU HAVE A GHOST EMPLOYEE?

Larceny Schemes

• Theft from other registers
  – Using another cashier’s register or access code
• Death by a thousand cuts
  – Stealing small amounts over an extended period of time
• Reversing transactions
  – Using false voids or refunds
  – Causes the cash register tape to balance to the cash drawer
• Altering cash counts or cash register tapes
• Destroying register tapes
3 Fraud Category with Examples of Fraud

Source: 2018 ACFE Report
## ACFE United States Fraud Scheme Statistics

### Source: 2018 ACFE Report

**Figure 85: What are the most common occupational fraud schemes in the United States?**

<table>
<thead>
<tr>
<th>Fraud Scheme</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corruption</td>
<td>30%</td>
</tr>
<tr>
<td>Billing</td>
<td>26%</td>
</tr>
<tr>
<td>Noncash</td>
<td>21%</td>
</tr>
<tr>
<td>Expense reimbursements</td>
<td>17%</td>
</tr>
<tr>
<td>Cash on hand</td>
<td>15%</td>
</tr>
<tr>
<td>Check and payment tampering</td>
<td>15%</td>
</tr>
<tr>
<td>Skimming</td>
<td>14%</td>
</tr>
<tr>
<td>Cash larceny</td>
<td>11%</td>
</tr>
<tr>
<td>Payroll</td>
<td>10%</td>
</tr>
<tr>
<td>Financial statement fraud</td>
<td>9%</td>
</tr>
<tr>
<td>Register disbursements</td>
<td>3%</td>
</tr>
</tbody>
</table>

**Asset Misappropriation is the Largest Category!**
Common Fraud Themes

- **Smaller Organization** typically have **fewer anti-fraud controls** which increase the risk of fraud.

- Median **duration** of a fraud scheme is **16 months**.

- **Internal Control weaknesses** were responsible for **over 50% of Fraud**!

- Only **4% of fraudsters** had a prior conviction.

- Majority of Victim organizations **recovered nothing**.

Source: 2018 ACFE Report
HOW DOES IT HAPPEN?
FRAUD TRIANGLE

RATIONALIZATION

I will pay it back and no one will notice.
No one will get hurt.
I’m underpaid and deserve more money.

INCENTIVE

Unable to Pay Personal Bills

OPPORTUNITY

Weak Internal Controls - Signs checks, records all transactions, and reconciles the bank statements.
HOW DID IT HAPPEN?
City of Dixon Case

Worked at the City of Dixon for 21 years before setting up a secret bank account.

Took Money for 20 years before discovered.

<table>
<thead>
<tr>
<th>Exhibit 1. Timeline of Events in Rita Crundwell's Life</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Date</strong></td>
</tr>
<tr>
<td>January 10, 1953</td>
</tr>
<tr>
<td>1970</td>
</tr>
<tr>
<td>1974-1986</td>
</tr>
<tr>
<td>1971-1983</td>
</tr>
<tr>
<td>1983-2012</td>
</tr>
<tr>
<td>December 18, 1990</td>
</tr>
<tr>
<td><strong>January 1991</strong></td>
</tr>
<tr>
<td><strong>October 2011</strong></td>
</tr>
<tr>
<td>April 17, 2012</td>
</tr>
<tr>
<td>November 14, 2012</td>
</tr>
<tr>
<td>February 13, 2013</td>
</tr>
<tr>
<td>February 18, 2013</td>
</tr>
<tr>
<td>October 16, 2013</td>
</tr>
<tr>
<td>March 5, 2030</td>
</tr>
</tbody>
</table>

Source: JOURNAL OF FORENSIC AND INVESTIGATIVE ACCOUNTING VOL 7, ISSUE 1 JAN – JUNE 2015
FRAUD TRIANGLE

RATIONALIZATION

RITA’S RATIONALIZATION? WE CAN ONLY SPECULATE

RONA CONTROLLED the WHOLE CASH PROCESS FROM PICKING UP THE MAIL TO BANK RECONCILIATIONS

OPPORTUNITY

INCENTIVE

PASSION FOR RAISING AND SHOWING QUARTER HORSES WHICH IS VERY EXPENSIVE!
Fraud Risk at the City of Dixon

- No Segregation of Duties. One person controlled the process.

- Rita picked up the mail, made all deposits, updated the journals and ledgers, prepared and signed checks, moved investment monies, and did the bank reconciliations.

- Rita had no supervisor and earned complete trust from the Mayor, Council, and Colleagues.

- Unqualified Audit opinions were given each year.

Source: JOURNAL OF FORENSIC AND INVESTIGATIVE ACCOUNTING VOL 7, ISSUE 1 JAN – JUNE 2015
WHAT DID RITA DO?

OPENED A SECRET BANK ACCT
Checks Imprinted with RSCDA Account c/o Rita Crundwell

NO INTERNAL CONTROLS RITA COULD
• All Bank Transfers
• Drafted Checks from Other Accounts & Payable to Treasurer and Deposited in RSCDA
• Created Fictitious Projects and Invoices
• Complete control of the cash process

RSCDA ACCOUNT
Wrote Checks for her Personal Expenses.

Source: JOURNAL OF FORENSIC AND INVESTIGATIVE ACCOUNTING VOL 7, ISSUE 1 JAN – JUNE 2015
Issues with the Auditors

- Lack of Independence
- Noted Material Weaknesses but no enhanced audit procedures done and no audit report on Internal Controls over Financial Reporting
- Other Issues

<table>
<thead>
<tr>
<th>Dates</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993-2005</td>
<td>CliftonLarsonAllen\textsuperscript{11} (Clifton) audits City of Dixon and provides unqualified opinions each year</td>
</tr>
<tr>
<td>2006-2011</td>
<td>Samuel S. Card, CPA participates in arrangement with Clifton to audit City of Dixon\textsuperscript{12} and renders unqualified opinions each year</td>
</tr>
<tr>
<td>2011-2012</td>
<td>FBI initiated investigation leading to April 17, 2012 arrest of Rita Crundwell</td>
</tr>
<tr>
<td>2012 to present</td>
<td>Wipfli LLP retained to audit Dixon after the fraud</td>
</tr>
</tbody>
</table>

\textsuperscript{11} CliftonLarsonAllen
\textsuperscript{12} FBI

Source: JOURNAL OF FORENSIC AND INVESTIGATIVE ACCOUNTING VOL 7, ISSUE 1 JAN – JUNE 2015
HOW WAS IT DISCOVERED?
VACATION

- Rita took a 12 week vacation

- City clerk assumed responsibility and contacted bank for a routine request of all bank statements
HOW TO PREVENT FRAUD
UNDERSTANDING FRAUDSTERS
Understand what Fraudster Do

Ranking of Top 8 Concealment methods used by Fraudster

1. Created Fraudulent Physical Documents
2. Altered Physical Documents
3. Created Fraudulent Transactions in the Accounting System
4. Altered Transactions in the Accounting System
5. Altered Electronic Documents and Files
6. Destroyed Physical Documents
7. Created Fraudulent Electronic Documents or Files
8. Created Fraudulent Journal Entries

Source: 2018 ACFE Report
Employee Red Flags of Fraud

- Unexplained increases in wealth
- Living beyond their means
- Close employee association with vendor etc..
- Personal Issues such as legal, financial, substance abuse
- Never takes a vacation
- Unwilling to share duties
- Lack of transparency
- Financial decisions made by one person

Source: 2018 ACFE Report
UNDERSTANDING INTERNAL CONTROLS
INTERNAL CONTROLS

Accounting term, is a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies.

Why Important?

- **Reduce** Risk of Asset Loss
- **Ensure** Accurate and Complete Information
- **Reliable** Financial Reporting
- **Compliance with** Laws, Regulations and Policies
EVALUATE INTERNAL CONTROLS AND UNDERSTAND RED FLAGS
City of Dixon do Afterwards?

INTERNAL CONTROL CHANGES

- REDUCED BANK ACCOUNTS TO **ONE** BANK ACCOUNT
- NO PAPER CHECKS ALLOWED
- SEGREGATION OF DUTIES
- INDEPENDENT PANEL TO OVERSEE FINANCIAL REPORTING (CPA, BANKER, ATTORNEY)
- ANNUAL AUDITED FINANCIAL STATEMENT PRESENTED TO CITY COUNCIL AND POSTED ON WEBSITE

Source: JOURNAL OF FORENSIC AND INVESTIGATIVE ACCOUNTING VOL 7, ISSUE 1 JAN – JUNE 2015
EXAMPLE: DISBURSEMENTS
Disbursement Red Flags

- Altered or Incomplete Supporting Documentation
- Invoices from same vendor look different
- Unexplained increases in expenses
- Vendors with no physical addresses or no W9
- Employees picking up vendor checks
- No Segregation of Duty – one person sets up vendor, entering invoices, approving the warrant, printing and mailing checks.
Example: Disbursement Internal Controls

- Follow Chapter 30B Procurement Laws.
- Purchase Order Approval Process.
- W9 to ensure valid vendor. Also Google, Research, Call the Vendor.
- Invoices are signed off by the department head.
- Review Invoices to ensure not fraudulent, excessive or unlawful.
- Segregation of Duties: Review the process who has too much control.
- Train staff on the importance of Internal Controls and Fraud Prevention.
- Keep check stock in a locked and secured area.
- Do not allow hand written checks.
- Signed vendor checks should not be returned to those who authorized the payment.
- Restrict Check signer access to accounting records, cash receipts, bank reconciliations.
- Restrict access to the vendor master file.
- Department Heads review Expenditure Reports
- Accounting, Town Manager review Expenditure Reports.
- Review the Vendors annually. Inactivate Old Vendors.
- Compare Employee Addresses to Vendor Addresses.
- If something doesn’t feel right, investigate further.
Understand the Detection Methods
Detection Methods

TOP 3 are 68% of how Frauds were Detected!

1. TIPS 40%
2. INTERNAL AUDIT 15%
3. MANAGEMENT REVIEW 13%

Source: 2018 ACFE Report
DETECTION - #1 TIPS
MOST COMMON INITIAL DETECTION METHODS

- **Tips** are the most common method of detection, accounting for 40%.
- **Internal Audit** comes in at 15%.
- **Management Review** is at 13%.

**Tips** can come from customers, vendors, anonymous, etc., providing over half of tips, and nearly 1/3 come from outside parties.

**Organizations with hotlines** detect fraud by tips more often, with 46% of cases detected by tip.

**Hotlines** vs. **No Hotlines**: 30% of cases detected by tip.

**What do you have in place so people can report suspicious or fraudulent behavior?**

Source: 2018 ACFE Report
Examples of Fraud Hotline Websites

OIG Fraud Hotline

Contact the Office of the Inspector General’s 24-hour Fraud Hotline to confidentially report corruption, fraud, waste or abuse related to government funds or property.

Report fraud, waste and abuse of government funds or property 24 hours a day. Complaints are confidential and can be made anonymously.
Do you have:

1. Fraud Policy
2. Whistleblower Policy

Do Employees know what to do if they suspect Fraud?

Do Employees feel safe reporting Fraud? Biggest fear is retaliation.

Don’t assume Employees know what to do.

Don’t let Policies just sit in the book.

Make sure the Policies are communicated and reviewed with staff on an ongoing basis.

Source: 2018 ACFE Report
DETECTION – #2 INTERNAL AUDITS
INTERNAL AUDITS

- Routinely check and test the internal controls of a process.
- Hire an outside firm to do Internal Audits.
DETECTION – #3 MANAGEMENT REVIEW
MANAGEMENT REVIEW

- VERY IMPORTANT FOR MANAGEMENT TO BE ENGAGED IN THE FINANCIAL MANAGEMENT OF THE CITY OR TOWN.

- Are they really reviewing the invoices, revenue and expenditure reports?
- Or are they trusting someone else to do it?
SUMMARY
Importance of Understanding, Preventing and Detecting Fraud:

1. Fraud Categories and Fraud Statistics – Where is your Town, City or School at Risk?
2. How does it Happen? Fraud Triangle – Incentive, Rationalization, Opportunity (50% due to WEAK INTERNAL CONTROLS).
4. Detection and Prevention – Tips, Internal Controls, Management Review. What do you have in place? Where are you at Risk?
Conducting A Fraud Risk Assessment

- Assess perceived fraud risks in a "brainstorming" session with Management
- Develop questions and a matrix for each department in Town or City
- Identify Fraud Risks, Controls in Place to mitigate risks, and recommendation for improvement for each department
- This should be an ongoing process after the initial assessment