Fraud Cases and Lessons Learned

Fraudsters continue to astonish and confound victims in their ability to find ways of embezzling funds without being detected. The bad news for CPA firms is that the public expects CPAs to detect fraud, and fraud drives the largest losses in terms of significant professional liability claims, or claims over $150,000 (see chart on “What Causes the Big Claims?”).

The largest embezzlement of 2012 appears to be among the top 10 embezzlements in modern U.S. history. It involved the city of Dixon, Illinois, where the 59-year-old municipal comptroller and treasurer pleaded guilty on Nov. 14, 2012, to siphoning public money into a secret bank account she controlled for several years.

When arrested and charged in April 2012, the amounts embezzled appeared to be more than $30 million, stolen over a six-year period. But by the time Rita Crundwell was indicted in November, the figure had grown to $53 million embezzled since 1990.
Her scheme was discovered only because a co-worker was filling in during her vacation and stumbled across the secret account and multiple six-figure transactions, according to prosecutors.

Dixon, a city of about 16,000 people and an annual budget of about $20 million, was especially vulnerable because Crundwell had control over all of the city’s finances for some 30 years, according to the Associated Press.

Trying to explain how that much money could disappear unnoticed, the mayor of Dixon said the town has struggled financially with reduced revenues and cash flow problems, made worse by the state of Illinois being behind on income tax disbursements. That provided plausible reasons to think the extra hole in the budget was related to those financial problems, he said.

Embezzlements tend to occur when there are gaps in organizations’ internal control systems, and those gaps can be created by personnel layoffs or reduced expenditures on fraud prevention measures. Embezzlements can then further deplete an organization’s resources and fraud prevention measures, fostering a self-perpetuating cycle of theft.

It also appeared that Crundwell’s extravagant lifestyle, including a $2.1 million motorhome and a horse-breeding ranch, was financed by her success as a quarter horse breeder. Her ranch produced 52 world champion horses and likely served as an effective cover for her lavish personal expenditures.

Nevertheless, one of the first rules of effective internal controls is to:

Separate the financial duties among different staff members to provide potential checks and balances on each member.

Giving one person unquestioned authority over an entire entity’s finances makes organizations even more vulnerable to fraud.

**Jumbo Fraud, More Lessons**

Other frauds teach other lessons. For example, when Jerome Kerviel caused some $7.2 billion in losses for the French bank Societe Generale in January 2008, the subsequent investigation showed that at least three basic rules of internal control had been broken, enabling the securities trader to avoid the attention of his managers.

One of them was described by Kerviel himself when he spoke with investigators, according to Bloomberg.com:

“The simple fact that I didn’t take vacation days should have alerted my managers. That’s one of the first rules of internal controls.”

Note that Crundwell’s embezzlement was discovered while she was on vacation. Someone who doesn’t take vacation is someone who doesn’t want to leave his or her books to someone else.
Other rules were broken when Kerviel knew the specific days when checks on trading activity were conducted to detect large and overly risky trading positions. He would hack into the bank’s computer systems to get around the checks when they occurred. The rules that apply here are:

*Do not be predictable in audit procedures, adjust to client schedules, or announce the timing, location or nature of the procedures.*

*Make it harder for anyone to determine the mechanisms used by the auditor in detecting fraud.*

**Classic Small-Business Fraud**

The classic small-business embezzlement scenario has occurred so many times over the years that CAMICO Loss Prevention specialists have it memorized:

The client is a small business owner who is too busy running the business to supervise the bookkeeping and banking activities. On top of that, there aren’t enough employees for the separation of the cash and checking-related functions.

The duties of receiving and disbursing funds and reconciling the bank accounts are all handled by one trusted employee who uses an accounting software program to stay on top of a lot of financial activity.

The client somehow thinks that the off-the-shelf accounting program contains some safeguards to help protect the business from fraud, but the reality is just the opposite: the program enables one person to control all of the business’s funds and bank accounts, thereby facilitating the perpetration of fraud.

The client first engages a CPA to prepare tax returns and to compile financial statements, and when the CPA offers to perform bank reconciliations as well for a nominal fee, the client accepts the offer. The CPA’s engagement letter addresses the tax work and compilations but not the bank reconciliation services. The CPA performs standard bank reconciliations but does not do “proof of cash” or other internal-control type procedures.

The client then discovers an embezzlement by the trusted employee and is, of course, extremely disappointed that the CPA did not uncover the fraud as part of the bank reconciliations. Since the CPA’s engagement letter does not define the scope and limits of bank reconciliations, the client appears to be justified in the expectation that the CPA was examining the bookkeeping and bank records for fraud.

Jury studies show that most jurors will agree with such an expectation. Client, jury and public expectations of CPAs have increased in recent years to the point where CPAs are expected to: 1) always detect fraud; and 2) advise and warn clients about their fraud exposures.

The expectation to always detect fraud can be extremely difficult to meet, but the expectation to advise and warn is much less difficult. By advising and warning clients of their defalcation exposures, CPAs are able to minimize liability stemming from the expectation to detect fraud.
Loss Prevention Tips

Advice to clients about their exposures to defalcation is best provided in an advisory letter that: 1) warns about the general risks; 2) suggests steps clients can take to reduce the risks; and 3) offers annual CPA services to help address the risks. An informed client is better able to avoid defalcation. If a defalcation is later uncovered, the CPA has documented evidence of the warning. Clients should also be notified of “loose ends” such as sloppy bookkeeping and late bank reconciliations.

CAMICO also recommends offering clients a two-tiered approach to bank reconciliation services. In the following “Addendum to Engagement Letter for Bank Reconciliation Services,” Option 1 describes the limited nature of standard bank reconciliation services, and Option 2 describes “Bank Reconciliation Plus Services,” which include added protection against embezzlements if the client agrees to specific activities in cooperation with the CPA.

Addendum to Engagement Letter for Bank Reconciliation Services

Option 1: “Standard Bank Reconciliation Services”
Our “standard bank reconciliation services” are performed solely to reconcile the amount of Cash in Bank on your books with the amount of Cash in Bank shown on the bank statement.

This service is limited in scope and is neither designed nor intended to deter or discover fraud, embezzlements or any other irregularities.

When performing the “standard bank reconciliation services” we DO NOT:

- Look at individual checks,
- Examine signatures, payees or any other information on any individual check,
- Examine the signature cards on file with the bank or determine if the correct authorized individuals have signed the check,
- Determine whether payee information matches what is shown in your books,
- Perform any procedures to determine whether the checks are for appropriate expenses, or
- Supervise, audit or review accounting work.

Because we do not perform any of the steps described above, we are able to perform our “standard bank reconciliation services” quickly and at low cost. Our fees for this service will be specifically defined price.

Option 2: “Bank Reconciliation Plus Services”
Our “bank reconciliation plus services” are performed to reconcile the amount of Cash on your books with the amount of Cash in Bank shown on the bank statement and to help protect against embezzlements.

While there can be no guarantee that embezzlements or other irregularities will always be uncovered, the consistent and timely application of our “bank reconciliation plus services” can help protect you.
When performing the “bank reconciliation plus services” we **WILL**:

- Look at individual checks (or electronic images of individual checks or substitute checks),
- Examine the signatures on each check and compare them to a copy of the signature card on file with your bank (we are not handwriting or forgery experts),
- Examine the payee on the check and match it to the payee name appearing in your cash disbursements journal,
- Examine the signature cards on file with the bank or determine if the correct authorized people have signed the check, and
- Provide you with a written report detailing all checks posted against the account and appearing on the bank statement or your books for the time period covered by the service.

To obtain the added protection provided by the “bank reconciliation plus service,” **YOU WILL**:

- Make sure we have a current version of the bank signature card for the account,
- Provide us with copies of the checks (or access to electronic images of the checks),
- Timely review and sign off on the written report we provide you. This report details all checks posted against the account and appearing on your bank statement or your books (only you can verify whether payments are for an appropriate expense).

Because we do perform all of the steps described above, our “bank reconciliation plus services” cost more than the “standard bank reconciliation services.” Our fees for this service will be [specifically define price].

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By your signatures below, please acknowledge which bank reconciliation service you desire by accepting or rejecting the options identified (signature required twice).

I    **ACCEPT**    **REFUSE**    the “standard bank reconciliation services.”
(Circle one)

Date    Signature

I    **ACCEPT**    **REFUSE**    the “bank reconciliation plus services.”
(Circle one)

Date    Signature