How a $53 Million Fraud Went Undetected for 22 Years

Learning from Past Mistakes

By David R. Hancox

In December1990, Rita Crundwell, comptroller of the City of Dixon, Illinois, opened a bank account. This began a 22-year fraud scheme that finally ended in February 2013, with Crundwell in prison for stealing a total of $53 million from the city. After stealing $181,000 in 1991, her theft reached $5,640,518 in 2010.

Dixon—a community of 16,000 people that is best known as President Ronald Reagan's hometown—lost millions of dollars because the mayor, the city council, the bankers, and the auditors all failed to detect the fraud. Year after year, as Crundwell's scheme continued, auditors issued unqualified opinions on Dixon's financial statements and the fraud went undetected. This case study should remind auditors to remain vigilant and demonstrates what kind of frauds might be lurking within an entity.

The Fraud Scheme

On December 18, 1990, Crundwell opened an account, Reserve Sewer Community Development Account (RSCDA), at the First Bank South in the name of the City of Dixon. The bank opened the account with no consent or authorization from the city council or other city authority. First Bank South was taken over by other banks, and the RSCDA account was ultimately acquired by the Fifth Third Bank. At no time did the successor banks attempt to obtain documentation to validate the continuation of the account. In June 2011, Fifth Third Bank asked Crundwell for a signature card; the terms and conditions of the signature card referred to "resolutions," but there were no resolutions from the City of Dixon for this "government" account (Fourth Amended Complaint filed in Lee County, No. 12 L 12, May 23, 2013, p. 22).

Crundwell began to write checks from the city's Capital Development Fund account (an authorized account) and deposited them into the RSCDA. The checks were made out to "Treasurer." Crundwell created fictitious invoices purported to be from the State of Illinois to show the city's auditors that the funds she fraudulently deposited into the RSCDA were supposedly being used for a legitimate purpose. Once the money was in the RSCDA, she wrote personal checks and made withdrawals for her own personal gain (Fourth Amended Complaint, pp. 23–36).

Two transactions almost defy belief. Crundwell went to the Old Kent Bank, a predecessor of Fifth Third Bank, and withdrew nearly $50,000 in cash from the city's Capital Development Fund in two separate transactions in 2000. On May 27, she completed a cash withdrawal request form and received $29,032.16; on July 19, 2000, bank employees gave her another $19,080.55 in cash. No questions were asked.

The City of Dixon's Auditors

Three audit firms were involved with the City of Dixon. Firm A was a large CPA firm, Firm B was a sole practitioner whose work was eventually taken over by her son (Firm C), who was also a sole practitioner. Firm A performed the audit of Dixon from 1990 to 2005. In 2005, it asked Firm B (and subsequently Firm C) to perform the audit while it did the compilation work. Firm A made this request because it believed there was an independence issue. From January 1, 1990, to April 30, 2005, Firm A acknowledged that it had prepared the city's financial statements, printed checks for payment to third parties, and audited the financial statements (http://www.scribd.com/doc/128751692/Auditor-s-Response-to-City-of-Dixon-s-Lawsuit, Mar. 1, 2013, para. 22).

In its lawsuit seeking to recover the lost funds, the City of Dixon alleged that Firm A continued to do the audit work and Firm B (and subsequently Firm C) simply signed the report. In his deposition, the owner of Firm C was asked, "[Firm A] is coming to you and saying, 'Look, we have an independence problem. We want you to come in and sign the report. We will do all the work,' true?" The owner agreed that it was true (Deposition of [Firm C], Oct. 9, 2012, p. 46, lines 20–24). He also acknowledged in the deposition that he lacked the resources and expertise to do an audit of this magnitude (Deposition of [Firm C], p. 38, lines 6–9).

Firm A denied this and claimed it only performed the compilation; the firm also claimed this lessened the responsibility that it owed to the city to find fraud or misstatement. Although this might be true, amended Statement on Standards for Accounting and Review Services (SSARS) 1, *Omnibus Statement on Standards for Accounting and Review Services—2005*, made specific changes regarding the consideration of fraud and illegal acts in compilation and review engagements: CPAs are not required to assess the risk of fraud, but they must still inform a client of incorrect, incomplete, or otherwise unsatisfactory information discovered during an engagement (J. Russell Madray, "New Fraud Guidance: Communication Is the Name of the Game Where Fraud Is Suspected," *Journal of Accountancy*, January 2006).

The auditors gave an unqualified opinion on the financial statements:

> We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. … In our opinion the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities. … No instances of noncompliance material to the financial statements of the City of Dixon, Illinois, which would be required to be reported in accordance with Government Auditing Standards, were disclosed during the audit.

The auditors made these statements despite the following facts:

- A bank confirmation showed the unauthorized account in 2010.
- Fictitious invoices raised several red flags that might (or perhaps should) have alerted the auditor to examine the transaction further.
- The City of Dixon's procedures required a purchase requisition and approval by an appropriate employee to support an invoice; none of the bogus invoices had this purchase requisition.
- Purchased capital assets were not verified to ensure their existence; the bogus assets did not exist.

In its amended complaint accusing the banks and auditors of not finding the embezzlement as they should have, the city said that the partner at Firm A sent an engagement letter to the city on April 1, 2010, indicating that its fee for the "city audit" would not exceed $33,500 in 2010, $34,750 in 2011, and $37,000 in 2012. The bill from Firm B (subsequently Firm C) for its work was $7,000 in 2010 and 2011 (Fourth Amended Complaint, p. 20).

Crundwell's fraud was simple: create a phony invoice, write out a check, deposit it into an account she controlled, and take the money.

Fraudulent Documents

Invoices. Crundwell's fraud was simple: create a phony invoice, write out a check, deposit it into an account she controlled, and take the money. She did this by using fraudulent invoices purportedly from the Illinois Department of Transportation; however, these differed from the real invoices in several material respects:

- None of the false invoices had the Illinois Department of Transportation logo at the top of the page.
- The false invoices misspelled the world "section" as "secton."
- The false invoices did not have the same font as the real invoices.
- The false invoices created did not provide a contact name and phone number of an employee at the Illinois Department of Transportation if the recipient had any questions.

In addition, many of the invoices created by Crundwell were for even dollar amounts—a widely recognized indicator of fraud. The custom and practice at the City of Dixon for the bill payment process was as follows: Each invoice received would be approved by the city department head or commissioner in charge. A requisition would be created for each invoice. This paperwork would be sent to Firm A for entry into the city's ledger, which was kept on the computer system at Firm A. Firm A would print a check to pay the invoice, which would then be signed by a secured signature machine with three signatures (Tara Becker and Derek Barichello, "Fake Invoices, Missed Signals from Crundwell," SaukValley.com, Jan. 12, 2013). But this process was not followed for the false invoices that Crundwell created.

Should an auditor have noticed the indications that a fraud was being perpetrated? The auditing standards actually give auditors some wiggle room. Statement on Auditing Standards (SAS) 99, *Consideration of Fraud in a Financial Statement Audit* (codified in AU section 316, "Consideration of Fraud in a Financial Statement Audit") contains several crucial concepts:

> **.06** … Fraudulent financial reporting may be accomplished by the following:
> — Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared …
> … **.09** … An audit conducted in accordance with GAAS rarely involves the authentication of such documentation, nor are auditors trained as or expected to be experts in such authentication. …
> … **.11** Although fraud usually is concealed and management's intent is difficult to determine, the presence of certain conditions may suggest to the auditor the possibility that fraud may exist.

Despite the transactions lacking approval by the city department head or commissioner in charge and a requisition for each invoice, the auditors did not detect the fraud. Depositions provided by the auditing staff revealed that the auditors did not inspect any of the fraudulent capital projects for which Crundwell submitted false invoices. In addition, they did not speak to the city engineer, any city employee responsible for capital projects, or anyone at the Illinois Department of Transportation regarding any of the capital projects set forth in the fraudulent invoices. The auditors did not locate and verify the approval by the city council of any of these specific fraudulent capital projects in the council's meeting minutes. Finally, they didn't review any contract, bid, diagram, sketch or other contract related documents for any of the fictitious projects (Fourth Amended Complaint, p. 17).

Checks. The audit manager at Firm A, who was doing the work at Dixon, was asked in a deposition whether looking at the paid check can help an auditor determine if misstatement or fraud has occurred; the audit manager said no. But knowing how to read a check is a basic skill for an auditor and can be a way to determine whether a fraud may have occurred. For example, years ago, this article's author examined checks from patient accounts at Utica Psychiatric Center in New York and noticed large checks supposedly made out to the patients' relatives after the patient passed away. Examining the back of the checks revealed that many were cashed at the same local bank (by the same teller) and that the endorsers' signatures were similar. This ultimately led to the discovery of a business office employee who was stealing from patient accounts.

Consider the checks that the audit manager from Firm A had access to in Dixon, Illinois. A $250,000 check, for example, was made out to "Treasurer," but not to any specific treasurer, even though the invoice supporting it said to make the check out to the treasurer of the State of Illinois, with a Springfield, Illinois address. Moreover, the back of the check was the real give away: the endorsement showed that it was being deposited into the Fifth Third Bank in Dixon, Illinois. The account number, which was available to the audit manager, was for the phony account that Crundwell had established. These checks were supported by phony invoices from the State of Illinois to reimburse the state for capital project expenditures that were a shared city/state responsibility.

Thus, there were some clues that this check might be fraudulent, including the following:

- A vague payee
- An endorsement that didn't match the payee
- An endorsement that showed the money was going to an account in Dixon, Illinois, rather than to the Illinois state treasurer located in Springfield, Illinois.
- A round dollar amount, similar to many of the other fraudulent checks.

Simply examining the checks—an essential task—could have exposed this fraud.

The Fraud Indicators

This embezzlement could have been uncovered at several points in time, including the following:

- The mayor or the city council could have stopped the fraud if they had investigated the budget shortfalls and challenged the explanations received from Crundwell. The city was fiscally strapped during the period of the fraud.
- The bank could have stopped it in December 1990 by not opening the RSCDA when it did not get an appropriate resolution from the City of Dixon.
- The bank could have stopped the fraud again on May 27, 2000, when Crundwell obtained $29,032.16 in cash from the city's Capital Development Fund, or on July 19, 2000, when bank employees gave Crundwell another $19,080.55 in cash from the same account.
- The auditors could have stopped it at any time if they had identified any of the phony invoices, discovered that the endorsement didn't match the payee on the phony checks, or realized that none of the capital projects actually existed.

The Internal Control Breakdowns

The Committee of Sponsoring Organizations of the Treadway Commission's (COSO) framework, *Internal Control–Integrated Framework*, identified five components, supported by 17 principles, that help ensure effective internal control. These include control environment, risk assessment, control activities, information and communication, and monitoring.

Unfortunately, auditors and managers often place too much emphasis on the wrong control components under the misguided belief that control activities (i.e., policies and procedures) represent the most critical elements of an organization's success. This can cause managers to respond with strong preventive controls over day-to-day activities, which ultimately frustrates efforts to correct an organization's real problems. In Dixon, the control environment, risk assessment, and monitoring components were the key components of internal control that failed.

Control activities tend to be easier to assess than control environment issues. It is easy to read existing policies and procedures and to spot situations where duties should be segregated. It also is easy for auditors to review documents to determine whether policies and procedures were followed by asking specific questions: Was approval obtained when needed? Were bids sought when required? But it is much more difficult to evaluate management's philosophy and operating style. It is also difficult to review and assess the integrity, ethical values, and competence of employees.

It is important to be clear on this issue, because control activities and the corresponding policies and procedures are essential components of a robust control system. Unfortunately, the focus on control activities is often done for the wrong reasons. Auditors routinely recommend that management segregate duties with the explanation that it is necessary to provide a check and balance on employees' work. But this sends the message that employees are not to be trusted. When an organization segregates duties, shouldn't it be to help ensure efficiencies in the process and allow employees to monitor their own work as a team, correcting any errors before the transactions are complete? This accomplishes several objectives, such as increasing the efficiency of operations, monitoring operations, and helping to prevent improper activities—all while creating the right control environment. If a good communication system is in place, it will allow staff to report unusual and suspicious transactions to management for resolution.

The mayor and city council. The mayor and city council of Dixon, Illinois, did not effectively assess risks and did not create a control system that would effectively negate the power and influence that Crundwell exercised. Furthermore, they failed to effectively monitor the financial statements and budget or raise questions that might have uncovered the fraud. They simply did not assign competent staff to advise them when they might not have possessed the financial acumen to challenge Crundwell.

The banks. The banks did not properly process banking transactions. The RSCDA should never have been established—there was no city resolution for the account even though one was required before opening the account. Bank employees should never have given $50,000 in cash to Crundwell based on a handwritten bank withdrawal slip from the city's authorized Capital Development Fund.

There were other shortcomings that lawyers identified in the city's lawsuit against the banks, including accepting large checks with a vague payee and allowing checks for personal expenditures from a supposed city account (the RSCDA). All of these were control environment issues that allowed the fraud to continue.

The auditors. During the deposition process, the lawyer asked one of the partners in Firm A about professional skepticism. Their dialogue proceeded as follows:

Q. Do you know what the concept of skepticism is?
A. No.
Q. Ever heard of that?
A. Yes.
Q. Have you heard that in the context of the practice of accounting?
A. Not that I can recall.

The following is a conversation during the deposition between the lawyer and the audit manager:

Q. If you accept that all [Firm A] did to verify these payments to the tune of many millions of dollars was simply to look at the face of these invoices, do you believe and agree that [the auditor] deviated from the standard of care?
A. No.
Q. Why do you say that?
A. Because I think invoices are sufficient evidence of an expenditure.
Q. Ma'am, looking back, do you think that [the auditor] should have done something more to vouch and verify these fictitious invoices?
A. No.
Q. Looking back, ma'am, do you think that [Firm A] should have called IDOT [Illinois Department of Transportation] or walked down the hall to ask the City engineer, whoever it may have been, as to any of these numerous capital projects?
A. No.

Based on the deposition above, the audit manager believed that an invoice was sufficient evidence of an expenditure. At no time did anyone examine the capital project to see if Dixon got what it paid for. This simple step alone would have uncovered the fraud.

In February 2013, the PCAOB issued Release 2013-001, "Report on 2007–2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies." Although PCAOB standards apply to publicly traded companies, some of the areas of deficiencies that the release identified were relevant to the Dixon fraud, including the following:

- A lack of technical competence in a particular audit area
- A lack of due professional care, including professional skepticism
- Insufficient testing of the completeness and accuracy of source documents
- Ineffective or insufficient supervision
- Ineffective engagement quality reviews.

The release noted that the risk of material misstatement due to fraud is an integral part of the audit under PCAOB standards and that firms have failed to 1) sufficiently test journal entries and other adjustments for evidence of possible material misstatement due to fraud; 2) consider the risk of material misstatement due to fraud relating to revenue recognition; 3) make inquiries of the audit committee, management, and others as to their views about the risk of fraud; 4) conduct a brainstorming session by members of the engagement team to discuss fraud risks; 5) obtain an understanding of the issuer's controls over journal entries and other adjustments; and 6) assess the risk of management override of controls.

The release concluded that auditors should exercise professional skepticism and conduct the audit engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present.

Resolution of the Lawsuit

The city of Dixon, Illinois, announced on September 25, 2013, that it would receive a $40 million settlement from Firm A ($35.15 million), Fifth Third Bank ($3.85 million), and Firm C ($1 million) for the fraud that Crundwell committed. In addition, the U.S. Marshals Service and the U.S. Attorney's Office recovered about $10 million from the sale of assets owned by Crundwell, who is serving approximately 19 years in prison.

A Vital Role

Unfortunately, for many reasons, the auditors never uncovered the long-term fraud perpetrated in Dixon, Illinois. It would appear from the public record, however, that there were many opportunities for the fraud to have been uncovered and terminated. This is why auditors have a vital role to play in the public accountability process. In this author's opinion, auditors must begin to learn the lessons of the past, sharpen their level of professional skepticism, and use due professional care in their daily work. ❑

David R. Hancox, CIA, CGFM, *is on the faculty of Siena College, Loudonville, N.Y., and Graduate School USA, Washington, D.C.*