How much fraud could an auditor catch, if an auditor could catch fraud? A different look at the Dixon, Illinois fraud case.

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ABSTRACT

This case explores the responsibility of auditors to detect fraud under the normal course of conducting a standard financial statement audit. Statement on Auditing Standard 99 is referenced and used to frame the general standard and then specific facts from an egregious instance of fraud in local government, within a small municipality in Dixon, Illinois. The case has been discussed in several different formats in the past but never discussed with respect to the complete failure of the auditing firms to detect one of the biggest and longest sustained frauds in history. The comptroller of the city was eventually convicted of embezzling millions of dollars from the small town over the period of many years. The fraud took place over the course of more than 20 years, and, during that time period, the city contracted with separate CPA firms to, both prepare the financial statements, and audit the financial statements of the city.

Keywords: Rita Crundwell, Dixon, Illinois, comptroller, fraud, audit, SAS, case, auditor's responsibility, professional responsibility

INTRODUCTION

The auditing profession is a valued one in modern society. An auditor stands as a verifier of truth. He or she is a stamp of approval on the veracity of the documents or items under his or her scrutiny. The profession of accounting and auditing is one that is looked upon favorably within society and provides a comfortable lifestyle. It requires extensive time, training and education to become licensed and qualified to be an auditor. Even in times of economic turmoil and strife there always seem to be opportunities available for accountants and specifically auditors. According to an article from an expert in the employment and Human Resources field, Accountant and Auditor occupied #'s 5 and 6 respectively of the top ten most stable jobs in America (Glassdoor, 2016). The remuneration for doing the work is good. According to the aforementioned article and many others, Accounting is consistently one of the best paying entry level jobs out of college. According to PayScale's College Salary Report, 11 of the top 15 best paying jobs for college business majors list accounting as the specialty of choice for the job. (Pay Scale, 2017).

HOW MUCH FRAUD SHOULD AN AUDITOR CATCH?

Many of these characteristics of the accounting/auditing profession are fairly common knowledge as are the stereotypical personal characteristics of many of the individuals who seem to gravitate towards the profession. However, while the general characteristics of the profession, it's practitioners, and maybe it's lack of flare, are well known. Much of the work done by accountants, in general, and auditors specifically, is often completely foreign and unknown to the non-accountant. One often fears what is unknown. Auditors are frequently feared when they arrive to perform an audit because rank and file employees at most firms don't understand what an auditor's purpose is or at best misunderstand it. Anecdotally, most people would probably tell you that they are scared of auditors because they don't want them hunting around looking for trouble to stir up with the books. This is a common misconception. According to an article that was published and directed towards assuaging the fears of would be audit recipients, these are the main differences between a fraud examination, which is what many people often mistake as the main function of an audit, and an actual audit: (1) Timing – audits are conducted on a regular basis; fraud examinations are only conducted with sufficient predication; (2) Scope – audits are a general examination of financial data; fraud examinations are conducted to resolve specific allegations; (3) Objective – audits are conducted to express an opinion of the financial data; fraud examination's goa is to determine whether fraud has/is occurring and to determine who is responsible; (4) Relationship – auditing by nature is non-adversarial; while fraud examination is adversarial as the fraud examiner's efforts are to affix blame; (5) Methodology – audits examine financial data; fraud examination use techniques to collect evidence, review outside data (i.e. public records) and interviewing. (6) Presumption – auditors are required to approach the audit with professional skepticism; fraud examiners approach the resolution of a fraud to establish sufficient proof to support or refute an allegation of fraud (Kaiser, 2013).

IF AN AUDITOR SHOULD CATCH FRAUD

All of these differences between a fraud examination and an audit notwithstanding, an auditor is under an obligation to detect material misstatements in the financial statements. Clearly, depending on the level of materiality of the amounts involved in a fraud or in any other case of wrongdoing that causes a material misstatement, an auditor cannot complete his or her audit responsibilities in a competent manner without noticing and thereafter reporting egregious instances of fraud or wrongdoing. For further guidance on the matter of an auditor's general responsibility with respect to detecting fraud, Statement on Auditing Standards 99, Consideration of Fraud details an auditor's general responsibility with respect to performing an audit and detecting fraud within the course of that audit. The main points are as follows: (1) auditor must conduct a brainstorming session about how and where the auditee's financial statements may be subject to material misstatement due to fraud; (2) must meet with and inquire with management and employees about fraud potential; (3) must review analytical procedures, fraud risk factors and other pertinent information available (determined on individual basis); (4) must have detailed conversation with management specifically addressing management's understand of fraud and the various risk factors for it; (5) must evaluate entity's programs and controls in place for detecting fraud and opine on their sufficiency; (6) must start the fraud assessment consideration toward the beginning of the audit and continue throughout the audit with the risks and issues in mind throughout (Auditing, 2002).

Essentially, though there are some suggested procedures for accomplishing these guidelines, the basic idea is that if the fraud is large enough to cause a material misstatement of the financial statements if discovered, then it should probably be discovered through the course of the audit. In a 2003 featured article from the Journal of Accountancy website, Michael Ramos takes an exhaustive look at the requirements in SAS 99 for auditors and essential comes to the same conclusion, that material fraud should be detected by an auditor doing his or her due diligence on a normal financial statement audit (Ramos, 2003). So, the standards say that an auditor should catch fraud if the amounts involved are material to the overall financial statements, because if the fraud isn't caught, the auditor has failed in his/her professional responsibility by providing a clean audit opinion without catching the material fraud that is festering within the depths of the presented financial statements. Though the steps in SAS 99 are stated as suggestions, the underlying due diligence that is exemplified in the outlined suggestion, is a requirement. The suggested steps give a good place to start though, when evaluating whether an auditor has met his/her professional responsibility of competence, after an omission has occurred. With that in mind, the following facts illustrate a case of egregious fraud that was undetected through a quantity of audits measured in decades rather than years.

AN AUDITOR SHOULD CATCH ALL THE FRAUD IT COULD

The following facts are relevant to the case of Rita Crundwell, a comptroller in a small town that committed the largest municipal embezzlement in the history of the United States:

- Rita Crundwell, 59 worked as the Comptroller of Dixon, IL from 1983 until the news of her alleged embezzlement broke in 2012.
- Rita Crundwell made about $80,000 per year (in her best year with the town), yet lived a very lavish lifestyle including owning over 400 race horses.

- Locals just assume she came from money or was otherwise independently wealthy from being successful with horses or some other unknown venture.
- The town started having severe financial hardships around the time of the worldwide financial crisis that began to reach critical mass in 2008.
- The financial problems forced many substandard conditions on the employees and citizens of the city, including: budgets being cut, personnel being furloughed and/or dismissed outright, and others.
- In 2009, $350,000 worth of checks were funneled into a personal account for Crundwell, she justified the shortfall by claiming delayed tax allotments from the State of Illinois. Yet, the town received a clean audit for the year.
- Crundwell eventually admitted to all of the charges. She admitted to moving money around from several semi-legitimate accounts in the Town's name that only she had authority to access, before finally depositing the money in a private account that she could use to finance her lavish horse farm and racing horse playgirl lifestyle.
- The total amount that she admitted embezzling over the course of about 12 years was nearly 54 million dollars.
- Over the same time period that Crundwell admitted to embezzling 54 million dollars, the overall operating budget of the town, from which she was funneling the money, was on average a total of less than $10 million per year. The overall budget (including all town funds) was $23 million the year she was arrested.
- She was eventually caught and arrested because she begrudgingly took a vacation and the person who picked up the mail for her, in her absence, discovered the bank statement to one of her "personal" city account slush funds and began to piece things together.
- The embezzlement began in 1990 and continued escalating almost constantly until she was arrested in 2012.
- Her method of embezzlement was through fictitious invoicing and fictitious de minimis type cash transactions. During that time, there was nearly 160 fictitious invoices created and used along with a plethora of de minimis petty cash type transactions the aggregate totals of which were in the 10's of thousands of dollars during many periods.
- No evidence or investigation of fraud was brought up or discussed or documented at all in the audit opinion and/or accompanying back up documentation for any of the 12 audits that were conducted to attest to the representational faithfulness of the city's financial statements during the years when the fraud was being committed.
- (US Attorney's Office, 2012)

IF AN AUDITOR SHOULD CATCH FRAUD

Not a lot is known or publically available information with respect to the documentation contained within the audit papers of this case. However, it is known that the amounts were incredibly material. The financial statements were all clearly materially misstated. The city definitely felt like it was let down professionally by the auditors in this case. The city sued the auditors and the bank and eventually settled for $40 million for the lack of professional responsibility shown here. So, the court system also sided with the city that the auditors (and bank) had let down the city and owed recompense.

Knowing that the auditors were guilty of negligence or incompetence is only part of the story in this case. It's pretty obvious that the end conclusion will be negligence or incompetence on the part of the auditing firm, but where did it fail in its actions that led to the incredibly harsh financial consequences that the auditing firms ultimately suffered?

DISCUSSION QUESTIONS/ASSIGNMENT

(I) Of the 6 main requirements listed above describing the requirements set out in SAS 99, which one(s), if adhered to strictly and competently should have, own its own or with another, detected a fraud of the magnitude described in this case study? Why?

(II) After looking at the Code of Professional Conduct and potential punishments for violations set out by the AICPA (which can be found here: http://www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx), and ratified by the State of Illinois, and the Manual of Procedures related to procedure for investigating and punishing allegations of misconducted by Illinois CPAs (which can be found here: http://www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/DownloadableDocuments/JEEPManual.pdf), do you think the CPA firms in charge of auditing the city of Dixon, Illinois during the 22 years and 54 million dollars of embezzlement that occurred between 1990 and 2012, that repeatedly failed to catch the egregious embezzlement, should have been subject to sanctions greater than those received in this case (which were none)? Why or why not?

(III) What steps could be taken by the accounting firm(s) and/or the city to insure that this does not occur again?

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