Fear, Incompetence & Unethical Behavior
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Dave provides advisory and management services to government and private sector organizations. His focus is on the right control systems that make for highly effective management performance. He also serves as an expert witness for several of the largest law firms in the world.

He retired from the NYS Comptroller's Office. He transformed many of the audit functions within the office to a modern, risk-based approach, using the latest audit, data analysis and data mining techniques to find fraud, waste, and improper transactions. He led a team that transformed an outdated State Expenditures Bureau into a model audit unit that dramatically increased the efficiency and effectiveness of the State’s expenditure audit and payment process.

He is co-author of two books: Government Performance Audit in Action and State and Local Government, Program Control and Audit: Handbook for Managers and Auditors. He is on the faculty of Siena College and The Graduate School USA in Washington DC.

He is an international speaker and in frequent demand in the government audit and financial management community on audit and management-related topics. He is past regional vice president of the Association of Government Accountants and a past president of the New York Capital Chapter of that organization. He was on the Financial Management Standards Board Committee. He is also past president of the Albany Chapter of the Institute of Internal Auditors and a past member of the International Government Relations Committee and the Emerging Issues Committee. Dave contributes articles to various professional journals that challenge the traditional audit approaches that have failed to find the frauds in major organizations. He's listed in Marquis's Who's Who in the World, Who's Who in America and Who's Who in the East. He is a Certified Internal Auditor and a Certified Government Financial Manager.

The Association of Government Accountants recognized Dave in 2005 and 2015 as the Educator of the Year and in 2007 he received the National President’s Award.

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Fear, Incompetence, and Unethical Behavior
The Bugaboo of Auditors

It takes Courage to Develop a Good Audit Finding
Keep this in mind when you are pursuing fraud:

The competent take advantage of the incompetent!

Your challenge:

- How to deal with the petty tyrants thwarting the good intentions of enterprising people in your own organization.
The Real Cause of Fraud

- Control Environment Issues
  - Management’s attitude, philosophy & operating style
    - Fear gets people to do things they do not want to do
  - Ethics & Integrity
    - Or the lack of it
  - Competence
    - Incompetence allows the fraud to flourish

Independent auditors let us down in corporate frauds: Kapil Sibal

In so many of these cases, the auditors involved have been among the major accounting firms in the world. Yet the system as a whole continues to rely upon these ... companies.
Introduction

- The accountability profession is under siege today

- Big 8 - until 1989
- Big 6 - 1989 - 1998
- Big 5 - 1998 - 2002
- Big 4 - 2002 - ???? - It’s going to the Big 0

- As Tom Peters advises other organizations – we need to re-imagine the accountability profession
Indicators of a “Failed” Audit

- Financial audit
  - Client goes bankrupt within one year on a clean opinion
  - Missed obvious fraud of major magnitude
- Compliance audit
  - Do not uncover significant issues of non-compliance
- Performance audit
  - Policymakers ignore the audit

Indicators of a “Good” Audit?

- One that deal with the right issue at the right time
- Gains attention of the policymakers
- Brings about appropriate change
- One that identifies fraud, waste, abuse, inefficiency or poor program results and makes constructive recommendations
The Auditing Profession
Needs Dramatic Change

- Too much focus on process – not enough focus on outcomes
- Auditing individual transactions is not very useful
- Need to study data looking for trends, patterns and outliers

“If you don’t like change, you’re going to like irrelevance even less.”
—General Eric Shinseki, Chief of Staff, U. S. Army
Oops!

- Big Three Auto Makers dominate...
- IBM Rules...
- NBC, ABC, CBS is all you need...
- Sears, Macy’s & Kmart...
- AICPA rules the auditing profession...
- CPA firms...
- And along comes Honda & Hyundai.
- And along comes Microsoft and Intel.
- And along comes Cable, CNN, HBO, FOX
- Damn – Wal’mart and Target now.
- Double damn – PCAOB now!
- Insurance Co. hires auditors????

Kudos to Tom Peters

- Re-imagine: Making the Compelling Case for Radical Enterprise Change ... and then Doing Something about It!
- The Accountability Profession is failing and not meeting the public’s expectation – dramatic change is needed
- All we do is tinker – Incrementalism is the death of innovation Nick Negroponte
We pursue preservation. But the old order is doomed!

5 Challenges to the Accountability Profession

1. Not using due professional care
2. Not properly assessing internal controls
3. Not obtaining sufficient, competent evidence
4. Not obtaining sufficient knowledge about the area being audited – (inherent risk)
5. Not developing an appropriate level of professional skepticism
“Make no mistake about it; our profession was part of the problem and it came to embody the public's perception of the problem.”

Barry Melancon
President & CEO of the AICPA

Not using due professional care

- Possessing the degree of skill commonly possessed by others in the same employment
  - The complexity of today’s organizations creates challenges in understanding what to do
  - Technology drives most organizations and its constantly changing – it’s hard for auditors to keep up-to-date
- Understanding data will enable us to move beyond examining individual transactions
Are You Using Cutting Edge Tools?

IBM Modeler – A powerful tool

Are You Using Cutting Edge Tools?

Mapping Software - for Finding Fraud
Are You Using Cutting Edge Tools?

Accurint – Finding Relationships to Uncover Fraud

Questions
- Do you work through an audit liaison?
- Do you give management a list of transactions you want pulled for audit?
- Do your audits go through so many layers of review and edit, such that, you do not recognize your own work?
- Do you only deal with lower level managers – not the senior-level managers?
Questions

- Do you develop real or potential significant effect?
  - Or are you producing vanilla audits?
- Do you address the root cause of the conditions you identified?
  - Or do you leave it at a lower level cause that will not upset anyone?

Not properly assessing internal controls

- Most large organizational frauds can be traced to the control environment
  - Management’s, attitude, philosophy, operating style – the ethics and integrity of people in the organization – the competence of people. It is the foundation of all other control components
- Auditors shy away from this component because it is more subjective
“Ninety percent of what we call ‘management’ consists of making it difficult for people to get things done.” – Peter Drucker

**Scattergram**

A method to report the mood of an organization – used in conjunction with the Internal Control Survey document
1.75
2.25
2.75
3.25
3.75 Weighted Average Value

15
10
5
0
-5
-10
-15
Statement Number

CE RA PP IC M

Weighted Average Distribution

Good
Improvement

1.75
2.25
2.75
3.25
3.75 Weighted Average Value

15
10
5
0
-5
-10
-15
Statement Number

CE RA PP IC M

Weighted Average Distribution

Good
Needs Improvement
Questions

- Are you afraid, or not allowed, to use testimonial evidence?
- Have you addressed issues of management’s attitude, philosophy or operating style?
- Have you assessed the ethics and integrity of people in the organizations you audit?
- Have you assessed competence of employees?

Not obtaining sufficient, competent evidence

- Documentary evidence has limited value today because of technology
  - Color copiers, color printers, Internet access to corporate logos, scanners and software enable anyone to duplicate and alter original documents
    - Parmalat
      - Phony documents – The auditors accepted phony bank confirmation
    - Equity Funding
      - Numerous problems, including phony documents
    - Madoff
      - Millions of phony documents
Question

- Do you go to the field to verify the substance of the underlying transaction or do you primarily rely on documentation?

Not obtaining sufficient knowledge

- Too many auditors are desk-bound
- The desk is a dangerous place from which to view the world
- Understanding inherent risk requires knowledge of programs, functions and activities
  - GAO – Director – Climbed the bridges
  - Worldcom
    - Betty Vinson – knew accounting for line costs as a capital item was wrong, but did it anyway – 10 months in prison – but why didn’t the auditors find it?
Is your risk management program even in the game …

Question

- Are you constantly asking questions of all levels of managers and staff to better understand the organization?
Not being professionally skeptical

- Too often auditors accept at face value what is told to them
- Challenging management is not in keeping with good relationship management – it’s not what your mother taught you

“Part of the problem is an inclination among many auditors to assume good intent. Most of those who make up the leadership of corporate America are honest, with the interests of their shareholders foremost in mind.”

Barry Melancon
“But an auditor must carry a standard of **professional skepticism** into each and every audit. As President Reagan said of arms negotiations with the Soviets "Trust, but verify." That's our obligation to shareholders.”

AGA Blog comments

In January 2008, I retired after being a Federal Auditor for 25 years. One thing I noticed increasingly toward the end of my career was audit management had moved away from being Junk Yard Dogs (as Ronald Regan called the OIGs) to being milquetoast. I had one audit manager tell me he did not want to get the auditee mad because he had to live around them. This shocked me since this manager's boss was in the room and that individual did not see anything wrong with the comment. Years ago there started to be a call to move away from Gotcha Auditing. I contend there was never such a thing, just auditors doing what they were paid to do - find the problems and report them. Now it is no longer politically correct to report problems that may be embarrassing to the auditee - even though it is important that the taxpayers know about the warts of the program. We need to get the profession back to caring more about reporting issues and less about who will not like the report.
Who is the Customer of Your Audit Report?

- Is it the Organization You Audit?
- Is it the Head of the Branch of Government?
- Is it the taxpayer?
- Is it the citizens?
- Is it the media?
You can’t behave in a calm, rational manner. You’ve got to be out there on the lunatic fringe.”

Jack Welch

Question

- How often do you challenge what you are being told?
  - Do you do it in your personal life?
  - Do you do it professionally?
  - Do you challenge what you read?
PCAOB Inspection Report Results

- 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.

PCAOB

- Firms should design and perform audit procedures that address the fraud risks, including reassessing risk and adjusting procedures as appropriate during the audit. The auditor 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.
Rita Crundwell

- Over 22 years, Rita steals about half the city of Dixon, Illinois’ general fund revenue each year.
- How could the auditors, city council or mayor not catch it?

City Hall – Dixon, Illinois
Rita with one of her more than 400 horses

Rita’s $2.1 million motor home
Rita’s $2.1 million motor home

The Fraud

- Dixon, Illinois is a community of 16,000 people
- It’s the city where President Ronald Reagan grew up, attended school and worked as a lifeguard
- Annual Budget $9 million
- Its taxpayers lost $53 million
- Its auditors did not detect the 22-year fraud
- She stole $181,000 in 1991 and stole $5,637,546 in 2008.
## The Fraud

- On December 18, 1990 she opened a bank account in the name of the City of Dixon at First Bank South (RSCDA account) and maintained the RSCDA account at First Bank South and its successor banks, Grand National Bank, Old Kent Bank and Fifth Third Bank. This account was not authorized by the City Council and was not known to other City employees.

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## The Fraud

- She immediately began to transfer money from authorized City accounts into the RSCDA account and used those funds to pay her own personal expenses and private business expenses. She did this by writing checks on the Capital Development Fund account (an authorized account) made payable to “Treasurer,” signed those checks as “Treasurer,” and had those checks deposited into the RSCDA account.
The Fraud

- She created fictitious invoices purported to be from the State of Illinois to show the auditors for the City of Dixon that the funds she was fraudulently depositing into the RSCDA account were being used for a legitimate purpose.

The Fraud

- In the fall of 2011, while Ms. Crundwell was on vacation, a city employee discovered the account and the checks written from it.
- On November 14, 2012, Ms. Crundwell pled guilty to allegations that she embezzled more than $50 million.
- On February 14, 2013, Ms. Crundwell was sentenced to 19 years and 7 months in prison.
130. On or about May 25th, 2000, Rita Crundwell was allowed by Old Kent Bank, a predecessor bank to Fifth Third Bank, to withdraw $29,032.16 in cash from the Capital Development Fund. (See below)

[Image of a withdrawal and deposit slip]

Audit Partner – Dixon Illinois Audit
Just a reminder from the AICPA Code of Professional Conduct.

06. Independence is defined as:

- Independence of mind—The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

- Independence in appearance—The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.
.16 Familiarity threat—Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client.
- A member of the attest engagement team whose spouse is in a key position at the client, such as the client’s CEO
- A partner or partner equivalent of the firm who has provided the client with attest services for a prolonged period
- A member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member’s firm
- A member of the firm having recently been a director or an officer of the client
- A member of the attest engagement team whose close friend is in a key position at the client
Q: Well, can looking at the paid check help you as an auditor determine whether or not misstatement or fraud has occurred?

A: No.
Q. Let me ask you a different question. To your knowledge, did anyone at any time from Clifton ever go and inspect and review, physically eyeball, any of these fictitious projects that are set forth in all these fraudulent invoices of Rita’s?
A. Not from my knowledge.

Q. If, in fact, someone had gone to the City minutes and identified that there wasn’t specific approval for any of these significant projects that she had, further investigation was required by the standard of care be done by the auditor; is that true?
A. Yes.
Q. Had that been done in your opinion, more probably true than not would the theft have been identified?
A. Yes.
Of the $40 million settlement, $35.15 million was paid by Clifton, $3.85 million by Fifth Third Bank, and $1 million by Janis Card and Associates. In addition, federal marshals and the US Attorney’s Office recovered about $10 million from the sale of assets owned by Ms. Crundwell who is serving 19 years, seven months in prison.

CliftonLarsonAllen LLP is one of the nation’s top 10 certified public accounting firms. Its CEO Gordon Viere said:

“The allegations of fraud committed by City of Dixon Comptroller Rita Crundwell, some of which she pled guilty to, are extremely serious and present an opportunity for all affected parties to evaluate how they occurred. We believe there was a shared responsibility that resulted in Ms. Crundwell’s fraud continuing undetected, and the right thing to do is reduce the harm experienced by the taxpayers of Dixon and put this matter behind us. Reaching a fair settlement for taxpayers is important to CliftonLarsonAllen.”

First - they are not allegations. They are real. $53 million was stolen and Ms. Crundwell went to prison. Second, trying to say there was a shared responsibility that resulted in the fraud going undetected tries to minimize the CPA firm’s responsibility to detect the fraud that occurred. The auditing profession has got to get its act together and begin to find the significant frauds that have brought down major corporations and caused huge losses to government entities.

This was a simple fraud and could have been detected early on if the auditors had simply examined the endorsements on cancelled checks or tried to visit the non-existent capital construction projects that were part of the fraud.

These are basic audit steps and the audit manager admitted they were not done.

This is another black eye for the auditing profession. A profession that is important to the public. It’s time for all auditors to start studying the past frauds that occurred and find the future frauds that will happen.

Other thoughts

- Communicating your findings is critical to your success.
- Are you a great writer? Do you study the craft of writing?
- Most audit reports bore the reader to tears.
Other thoughts

- Are you a kiss-ass auditor?
  - Too many auditors want to be liked
  - Much better to be respected for your professionalism
    – knowing your profession and carrying out your audit in a craftsman-like manner.

- Are you organizationally located properly to allow you to do an independent audit?
Other thoughts

- Is your organization so concerned about complying with audit standards that it hinders your ability to develop high impact audit findings?
  - Hint – no one outside the auditing profession cares about audit standards
- Does it take a year or more to get an audit issued?
  - If so, process is killing you.

Summary

- Bringing accountability to an organization is hard (and thankless) work
- Much of what we are asked to do, requires us to challenge others and to not accept at face value what we are told or the evidence we review
- We need to step up to the plate and accept that some parts of our work are subjective and depends on our professional judgment
Summary

- We need to re-invent the accountability profession to meet the public’s expectations.
- We have to destroy the existing model – blow it up! Start all over.
- It’s about people – not process. People – usually management, commit fraud.
- Sophisticated data analysis – not individual transaction analysis.

Contact Dave Hancox