

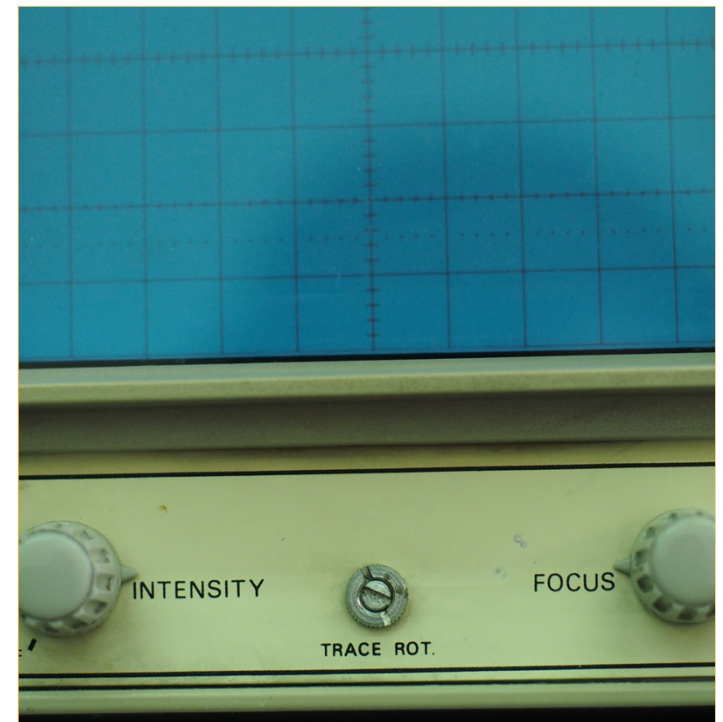
# Why Internal Controls Don't Always Prevent Fraud

2022 Kansas GFOA

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# Agenda

- A brief history of internal controls
- High level overview/refresher of internal controls
- Why internal controls don't always prevent fraud
- How to identify internal control weaknesses
- High target areas & case studies
- Lessons learned



# History of internal controls

- It is conceivable that internal control preceded auditing and other elements of the accounting profession. Internal control emerged as a common sense, natural product of the profit motive.
- Early beginnings
  - 3600 BC
  - Egypt
- 1850-1940 - the Industrial Revolution
- 1940 to the present



# What are internal controls?

- Rules, mechanisms, and procedures to safeguard:
  1. Financial information
  2. Promote accountability
  3. Prevent and detect fraud
  4. Comply with laws and regulations
- Help the government operate more efficiently by ensuring your financial reporting is accurate and timely and prevent fraud



What are internal controls designed to do?

“Reduce risk by  
avoiding, detecting,  
or correcting things  
that introduce risk.”



# Internal control review

## Internal controls include

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- Authorization
- Documentation
- Reconciliation
- Segregation of duties
- Security (I.T. & PII data)
  - Physical controls
  - Procedure controls
  - Technical controls
  - Legal and regulatory controls

## Divided into three categories

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- Preventive controls
- Detective controls
- Corrective controls



# Internal control review

## The COSO Framework

- Control environment
- Risk assessment
- Control activities
- Information & communication
- Monitoring



# Why internal controls don't always prevent fraud

## Common weaknesses of internal controls

- Poor judgment
- Human error
- Turnover or changing roles
- Deliberately circumventing
- Management override
- Unforeseeable circumstances
- Collusion





# How to identify internal control weaknesses

- Catalog internal control procedures
- Conduct a risk assessment
- Conduct an internal audit
- Train and educate staff
- Examine departmental reports (includes budgets)
- Institute a fraud hotline



# Lack of internal controls



## The signs

- Absenteeism
- Low rate of employee retention
- Employee dissatisfaction



# Lack of internal controls



## The symptoms

- Waste
- Inefficient use of resources
- Poor management decisions
- High rates of product errors
- Loss of records
- Carelessness and mistakes



# Lack of internal controls



## The results

- Inability to track performance against budgets, forecasts, and schedules
- Lack of attention to information security leads to privacy concerns
- Unauthorized access to financial data and customer records, including sensitive information, results in security breaches and compromised accounts



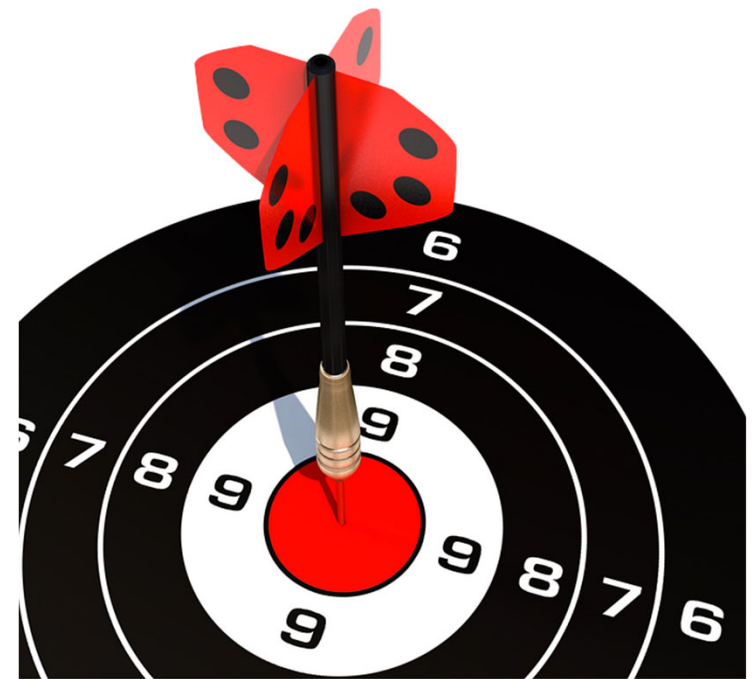
# What can happen when internal controls fail?

- Expose the government to risk
- Negatively affect your audit results
- Costly data breaches
- Organizational disruptions
- Reputation damage
- Revenue loss
- Violations of laws and/or regulations
- Target for fraud



# High target areas

- P-cards
- Vendor banking information
- Wire transfers
- Payroll
- Fictitious invoices
- Procurement
- Cash points



# Case studies

- Rita Crundwell, \$54 million, Dixon, IL
- Michael Minh Nguyen, \$5 million, Placentia, CA
- Claudia Viles, \$500,000, Anson, ME
- Randall Whited, \$1.3 million, Austin Public Library
- James Rupard, \$200,000, Stewartsville, NC



## Slide 15

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**NMG0** You have Anson, ME here, but Skowhagen, ME on her slide. Which is it?  
Nicole M. Grimes, 2022-10-04T16:53:22.877



# Rita Crundwell



- Stole nearly \$54 million over two decades in Dixon, IL - city of less than 16,000 people
- Opened a fake bank account in 1990
- Highly trusted
- Used funds to support an elaborate lifestyle and 2 horse farms with 400 prize winning quarter horses
- **How did she do it?**



# Michael Minh Nguyen



- Stole nearly \$5 million in Placentia, CA - population of 50,000 people - financially strapped city
- Grew up in the city and was highly trusted
- Opened a fake bank account
- Bad debts, bad investments, and parents had filed bankruptcy
- **How did he do it?**



# Claudia Viles



- Stole \$500,000 from Anson, ME - population of 8,000
- County tax collector
- Well-loved and trusted in the community
- Elected each year for 42 years
- **How did she do it?**



# Randall Whited



- Stole \$1.3 million from the Austin Public Library
  - Purchased printer toner and resold it online
  - Misuse of credit card
  - Took advantage of poor purchasing reviews
- 
- How did he do it?



# James Rupard



- Stole \$200,000 from North Carolina fire department
- Became treasurer of the fire department
- President of the firefighters' charitable organization
- How did he do it?



# Lessons learned from shocking municipal fraud cases

The most common denominator of a municipal fraud is the **chokepoint person** - an individual within the organization who controls all aspects of financial management

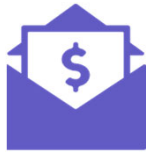
- Never take vacations
- Control freaks
- Helpful and knowledgeable but in reality they want control
- Highly trusted
- Single individual with hands on all the different levels of finance



# Lessons learned from shocking municipal fraud cases



Lack of oversight



Lack of financial literacy among elected officials



Culture of blind trust



Turnover

All contribute to a system of weak internal controls!



# What can we do?

- Prevent the chokepoint person
  - Segregate duties as much as possible
- Trust the system, not the people!
  - Value the systems of checks and balances over personnel
  - Without the right systems in place, municipalities risk creating an embezzlement opportunity, even for the most trusted employees
- Clear division of responsibilities with a process of independent verification
- Employee and municipalities need to know that their work is seen, double-checked and understood by everyone involved
- Be proactive!





# The expectation gap

- Significant deficiencies and material weaknesses
- Report fraud or suspected fraud identified
- Responsibility of municipalities, not auditors, to create controls

“Administrators and citizens often believe that everything is fine because the town is being audited without understanding the purpose and limits of an audit.”



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