



Public Servants "Serving" Themselves: Occupational Fraud In Government

By: Ronald J. Daigle, Philip W. Morris, and **Dwayne N. McSwain**

Abstract

From 1990 to 2012, Rita Crundwell committed the largest municipal embezzlement in U.S. history, stealing more than \$53 million from the city of Dixon, Illinois. As city comptroller and treasurer, she secretly opened a bank account in the name of Dixon that only she controlled. Crundwell transferred money from city bank accounts into her illegitimate account, concealing the movement through fictitious invoices she submitted to the city. She used the money to finance a lavish lifestyle that included multiple residences, numerous vehicles, jewelry, and multiple horse-farming operations for her championship show horses. After another city employee accidentally discovered the secret account, Crundwell admitted her guilt and received a 20-year sentence. Crundwell's fraud was alarming, audacious, and attention-getting — enough to be the subject of television episodes (such as CNBC's *American Greed* and the Canadian Broadcasting Corporation's *The Fifth Estate*) and a documentary movie (*All the Queen's Horses*). However, it was not an isolated event. Occupational fraud in government is such a common occurrence that it should be a major concern to all government organizations and constituents.

Daigle, R., Morris, P., & **McSwain, D.** (2017). Public Servants "Serving" Themselves: Occupational Fraud In Government. *Internal Auditing*, September/October 2017. 5-14. NC Docks permission to re-print granted by author(s).

PUBLIC SERVANTS “SERVING” THEMSELVES:

This article assists internal auditors in better understanding occupational fraud and how it is commonly committed in government.

OCCUPATIONAL FRAUD IN GOVERNMENT

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From 1990 to 2012, Rita Crundwell committed the largest municipal embezzlement in U.S. history, stealing more than \$53 million from the city of Dixon, Illinois.¹ As city comptroller and treasurer, she secretly opened a bank account in the name of Dixon that only she controlled. Crundwell transferred money from city bank accounts into her illegitimate account, concealing the movement through fictitious invoices she submitted to the city. She used the money to finance a lavish lifestyle that included multiple residences, num-

erous vehicles, jewelry, and multiple horse-farming operations for her championship show horses. After another city employee accidentally discovered the secret account, Crundwell admitted her guilt and received a 20-year sentence.

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EXHIBIT 1 Top 10 Occupational Fraud Schemes in the Government and Public Administration Industry

Scheme	Percentage
1. Corruption	38.4%
2. Billing	25.3%
3. Expense Reimbursement	15.7%
4. Non-Cash	14.8%
5. Skimming	14.0%
6. Payroll	13.5%
7. Cash on Hand	10.5%
8. Check Tampering	9.2%
9. Cash Larceny	7.9%
10. Financial Statement Fraud	7.9%

Data source: "Report to the nations on occupational fraud and abuse," Association of Certified Fraud Examiners (2016). Available at: <https://www.acfe.com/rtnn2016/docs/2016-report-to-the-nations.pdf>.

such a common occurrence that it should be a major concern to all government organizations and constituents.

According to the Association of Certified Fraud Examiners (ACFE), government and public administration ranks second to banking and financial services as the industry most victimized by occupational fraud.² The ACFE notes that 18.7 percent of the 2,410 occupational fraud cases reported in a survey of certified fraud examiners (CFEs) occurred in government, with a median loss of \$109,000. This industry ranking is consistent with that reported by PricewaterhouseCoopers (PwC) as well. Based on survey results gathered from 6,337 respondents in finance, executive management, audit, compliance, and risk management, PwC reports that government/state-owned is second to financial services as the industry most susceptible to economic crime.³ Marquet International reiterates this when ranking government entity second to financial services in frequency of embezzlement cases by industry.⁴

Such findings emphasize a matter noted by a KPMG survey. Of those respondents in the government and public sector industry, 79 percent either had "personally seen" or had "first-hand knowledge" of misconduct, which includes occupational fraud.⁵ To make this mat-

ter even more disconcerting, 62 percent of the respondents perceived that the misconduct seen or known could cause a "significant loss of public trust if discovered." These grave concerns are obviously borne out by cases such as Rita Crundwell's and others.

This article assists internal auditors in better understanding occupational fraud and how it is commonly committed in government. We also highlight actual cases that serve as examples, such as Rita Crundwell's. We provide suggestions for preventing and detecting the schemes discussed. Our goal is to aid internal auditors in helping government organizations reduce their risk of occupational fraud so that they can combat the very real threat of public servants (i.e., government employees) "serving" themselves (i.e., committing fraud) at the expense of constituents.

Occupational fraud schemes in government: Let me count the ways

The biannual ACFE *Report to the Nations on Occupational Fraud and Abuse* provides excellent insight into the most common fraud schemes committed by employees in many industries, including government. The ACFE published its first report in 1996 and has published it every two years since 2002. Survey results are quite consistent across the years. The clear implication is that occupational fraud has been and continues to be a substantial problem in government as well as private organizations. This continuance also means it is imperative that internal auditors understand occupational fraud in government and act to reduce its presence and cost.

The 2016 ACFE *Report* defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organizations resources or assets." In other words, occupational fraud occurs when an employee steals or commits abuse at the employer's expense. Occupational fraud is often referred to as "insider fraud" because people inside an organization perpetrate it. Exhibit 1 lists the top 10 schemes and their respec-

tive frequencies of occurrence in the government and public administration industry, per the 2016 ACFE *Report*.⁶

Note that the sum of percentages in Exhibit 1 (157.2 percent) far exceeds 100 percent. This is not an error but an insight into the typical commission of occupational fraud. The sum shows that many fraudsters perpetrate multiple schemes simultaneously. Internal auditors should keep this insight in mind when investigating suspected fraud. Like an iceberg where only the tip can be seen above the water line, an investigation of a “small” fraud may lead to the discovery of the larger nature of the fraud hidden below the surface (i.e., deep in an organization’s operations and records).

Corruption, billing, and expense reimbursement schemes

The most common occupational fraud scheme in government is *corruption*. Employees committing this scheme abuse their influence over business transactions for personal benefit at the employer’s expense. Corruption includes bribery, kickbacks, and conflicts of interest. Former Mississippi state legislator Irb Benjamin and former state corrections commissioner Christopher Epps were both recently found guilty of corruption.⁷ Benjamin bribed Epps for support of certain jails (including prisoner placements, thereby increasing prison funding) that Benjamin helped develop. Epps was also bribed for drug and alcohol rehabilitation programs that Benjamin’s company ran at certain inmate work centers (a conflict of interest personally enriching Benjamin, and likely at the state’s expense through inflated costs). In total, Benjamin paid Epps between \$180,000 and \$225,000. Benjamin has been sentenced to 70 months in prison, a fine of \$100,000, and forfeiture of \$260,782. Epps faces up to 23 years in prison.

Another example of corruption involves trustee Larry Marshall of the Houston Independent School District in Texas. Gil Ramirez successfully sued Marshall and other co-defendants, including competitors, who conspired to award construction contracts.⁸ A federal court

jury agreed with Ramirez’s assertion that “if you weren’t willing to hand over bribes...you could count on losing out on construction contracts with the school district.” Ramirez was awarded more than \$4 million, with Marshall ordered to pay approximately \$2.1 million.⁹

The second most common occupational fraud scheme in government is the *billing scheme*. An employee may perpetrate this scheme by deceiving the employer into making payment on fictitious goods or services to a false vendor (a “shell company”) under the employee’s control. As a variation, the shell company may provide actual goods or services to the employer at an inflated cost. As another variation, the employer may directly pay a vendor for an employee’s personal items. In each of these situations, the employee deceives the employer into making a disbursement to either a false vendor under the control of the employee or a vendor with the employee benefiting at the expense of the employer.

This is the scheme perpetrated by Rita Crundwell, who transferred money from legitimate city bank accounts to the illegitimate city account that only she controlled. She covered up her theft by creating false invoices for the transfers. Another example of this scheme is seen in the case of Brandi Moody, a former employee in Michigan State University’s College of Osteopathic Medicine.¹⁰ Moody embezzled nearly \$150,000 by making personal purchases, including gift cards and computer technology, with her department-issued credit card paid for by the university. Moody received five years of probation and avoided further prison time by making restitution.¹¹

The third most common occupational fraud scheme in government is *expense reimbursement*. Like a billing scheme, an expense reimbursement scheme involves an employee deceiving the employer into making a fraudulent disbursement. In this scheme, however, the disbursements are made directly to the employee for fictitious or inflated business expenses. An example of this scheme is present in the case of Christine King, former city clerk in Masonville, Iowa.¹² King issued herself expense reim-

bursment checks for nonexistent expenses she claimed to have incurred on behalf of the city. Her case also illustrates the point that fraudsters often commit multiple schemes when defrauding their employers. For instance, King also issued herself fraudulent payroll checks (see #6 in Exhibit 1) and misreported bank account balances on financial reports to the city council and Auditor for the State of Iowa (see #10 in Exhibit 1) as a means of covering up her fraud. King received a 21-month sentence and was ordered to make restitution of \$82,594.81 to Masonville and \$10,000 to an insurance company that had made partial restitution to the city for the theft.

Non-cash, skimming, and payroll fraud

The fourth most common occupational fraud scheme in government is *non-cash theft and abuse*. This scheme may involve stealing inventory, supplies, or fixed assets, and may also involve the misuse of assets or company data for the personal benefit of the employee. The case of Terry Lee, David Herre, and Edward Lawson — all former mechanics employed by the Department of Public Works in Marion County, Indiana — provides an example of non-cash theft.¹³ Together, the three stole and sold scrap metal for personal gain. Each pleaded guilty to theft, received a one-year suspended sentence, and was ordered to provide 80 hours of community service and make restitution to the city of Belmont, Indiana.

The fifth most common occupational fraud scheme in government is *skimming*. This scheme involves the theft of incoming payments to an organization by an employee before the receipts are recorded. An example of this scheme is seen in the case of Melissa Ann Arnold, former treasurer and tax collector for Spring Garden Township, York County, Pennsylvania.¹⁴ Arnold admitted to stealing more than \$300,000 in taxpayer money. She received tax-payment checks written out to her as the township's tax collector. Instead of depositing the money into the township's bank account, she deposited them into her own personal account. Arnold received five years of probation and was ordered

to make restitution. Another example of skimming involves the case of Shelia Marie Jerry, a former Deer River, Minnesota city employee.¹⁵ Jerry stole more than \$100,000 from the city over a five-year period by keeping the fees and paperwork for titles on new automobiles. In a similar example, former Michigan State Police officer Seth Swanson received a one-year sentence for embezzling approximately \$170,000 by pocketing the \$100 fee from 1,701 salvage vehicle inspections.¹⁶

The sixth most common occupational fraud scheme in government is *payroll fraud*. This scheme involves an employee making false claims for compensation, such as for overtime not worked. A variation of this scheme involves an employee stealing paychecks made out to a “ghost” employee that is either fictitious or a former employee. Christine King (see previous discussion about expense reimbursement) committed payroll theft as part of her means of defrauding the city of Masonville, Iowa. Another example of payroll fraud involves the case of Tammy Gomillion, Jill Watkins, and Julie Faye Russell.¹⁷ The three former Neshoba County, Mississippi, employees pleaded guilty to embezzling \$1.3 million over seven years through claiming fraudulent overtime hours. Each received a sentence of 25 years with orders to make restitution. Gomillion was employed as a payroll clerk, Watkins as a bookkeeper, and Russell as a purchasing clerk. In their respective roles, they colluded to commit their embezzlement and likely did so at a greater amount than any of them could have done individually because of their collusion. This is an important point because fraud committed through collusion is typically costlier and takes longer to detect than that perpetrated by an individual.

Cash on hand theft, check tampering, and cash larceny

The seventh most common occupational fraud scheme in government is *cash on hand theft*. This scheme involves the theft

of cash kept on hand by the employer (such as from a vault or from petty cash). This scheme is one of three committed by Amber Ransom, former city clerk of Alburnet, Iowa.¹⁸ Ransom admitted to taking from petty cash and writing extra unauthorized paychecks to herself (another example of payroll fraud). She also admitted that the city paid for personal items either directly or through a city credit card (two variations of the billing scheme). An audit confirmed that \$102,980 was misappropriated during Ransom's employment. She received a five-year sentence and an order to pay \$37,013 in restitution. In another example of petty cash theft that caused a substantial change in a city's operations, several Las Vegas, Nevada city departments discontinued maintaining petty cash funds after the conviction of former city worker Christine Drew, who stole nearly \$8,000 in petty cash.¹⁹

The eighth most common occupational fraud scheme in government is *check tampering*. Employees commit this scheme when stealing, forging, or altering the amount or payee of a check or electronic payment. This scheme may involve the theft of blank checks or checks made out to vendors/employees for legitimate disbursements, which are then cashed or deposited in the fraudster's bank account. This scheme resulted in the firing of Andreina Santiago, a former city employee of Union City, New Jersey.²⁰ A police investigation took place when a payroll check was found missing from the city's Community Development Agency, where Santiago worked. The check for approximately \$1,600 had been taken from a cubbyhole. A check to a second employee in the amount of \$230 was reported missing a few days later. Police determined that both checks had been taken by Santiago, who had forged her coworkers' signatures and deposited both into her personal bank account.

The ninth most common occupational fraud scheme in government is *cash larceny*. In this scheme, an employee steals an incoming payment after it has been recorded by the employer but before it is deposited in the bank. Because there is an audit trail of the cash, this scheme

does not occur as often as skimming (see #5 in Exhibit 1), but it can still be a threat to organizations. An example of both cash larceny and skimming can be seen in the state audit results of Healdton, Oklahoma.²¹ Based on a request by the Healdton City Council, the state audit found that \$79,757.96 had been embezzled. Approximately \$37,000 of the embezzlement was stolen from cash receipts that were recorded but never deposited. The rest was taken in a check for cash scheme, which is a type of skimming scheme in which cash in a drawer is stolen and replaced by an incoming check. Since the drawer balances, this theft is difficult to detect. The audit noted that the embezzlement stopped after the City Treasurer Karen Karaleff had been suspended. Karaleff was later put on leave and then terminated for failing to attend a hearing about the embezzlement allegations.

The costliest of all schemes — Financial statement fraud

The tenth most common occupational fraud scheme in government organization is *financial statement fraud*. This scheme involves the intentional misstatement or omission of material information from the financial statements or reports of an organization. Some examples include recording fictitious revenues or expenses, understating revenues or expenses, misstating asset or liability balances, and misstating or omitting footnote disclosures. This scheme is typically referred to as "management fraud" because executive managers typically have the greatest opportunity to perpetrate it. However, as seen in the case of Christine King (see previous discussion about expense reimbursement), a lower-level employee can also commit this scheme. As a reminder, King did so by misreporting bank account balances on financial reports to the city council and Auditor for the State of Iowa to hide her embezzlement.

As another example of this scheme, the city of Miami, Florida was found liable for securities fraud from the sale of more than \$150 million in municipal

bonds.²² A lawsuit by the Securities and Exchange Commission alleged that the city and Michael Boudreaux, former city budget director, did not tell credit rating agencies and investors that money had been moved between municipal accounts. The movement was to keep the general fund above a city-mandated level of \$100 million, thereby making the city appear to be more financially stable.

As an additional set of comments about the top 10 occupational fraud schemes in government, schemes numbered 2 through 9 are categorized as “misappropriation of assets.” This category of fraud involves the theft or misuse of assets, and as seen by the eight schemes, there are many ways for employees to do so. Because of this, misappropriation of assets is commonly referred to as “employee fraud.” The other two categories of fraud are those at the top and bottom of the list — corruption and financial statement fraud. As seen by summing the frequency percentages in Exhibit 1 for schemes numbered 2 through 9, misappropriation of assets is the most commonly occurring category of fraud, followed by corruption and then financial statement fraud. This frequency of occurrence is generally true regardless of industry.

In terms of losses *per occurrence*, however, the first and third categories flip, with financial statement fraud costliest, followed by corruption and then misappropriation of assets, as shown in the examples provided in this article. The financial statement fraud by the city of Miami, Florida is the costliest of those noted, as it involved enticing investors to purchase more than \$150 million in municipal bonds. Because corruption typically involves some level of management authority or oversight, this category of fraud tends to have a higher cost per occurrence than misappropriation of assets. This is seen in the bribery examples provided in this article. One involved bribes up to \$220,000 to secure business (likely of a far greater amount than the bribe) while the other case involved a settlement of more than \$4 million. The one misappropriation of asset example

provided that is comparable in terms of losses is that of a \$1.3 million payroll fraud because it involved collusion over seven years. Understanding the nature of each scheme discussed and the categories of occupational fraud can help internal auditors comprehend the threats posed to government organizations.

Tips on fighting occupational fraud in government

After reading about the top 10 schemes and examples of each in government, the question that should naturally be asked is: How do internal auditors and their auditees combat occupational fraud? To begin answering this question, we believe it is first important to note the ways occupational fraud is most often detected. Per the 2016 ACFE *Report*, tip (in 39.1 percent of cases), internal audit (in 16.5 percent of cases), and management review (in 13.4 percent of cases) are the top three methods, resulting in the detection of 69 percent of the cases covered in the ACFE’s findings. These three have consistently been the top three methods in several consecutive biannual reports published by the ACFE and should therefore be leveraged to combat occupational fraud.²³

Regarding tips, the ACFE notes that employees are the most common source (slightly more than half of all tips, with other sources including vendors and customers). This finding means that while some employees are defrauding their employers, other employees are trying to help their employers. Employees should therefore be leveraged to *fight* occupational fraud by government organizations formally training employees on how to prevent, detect, and report fraud. A fraud hotline should also be implemented so anyone (not just employees but also customers, vendors, and citizens) can formally report suspected fraud. With the variety of technology available, the hotline should make use of one or more communication methods, such as telephone, email, Internet, or mail. The hotline should be monitored by a party independent of the operations of the government organization, such as inter-

nal audit, law enforcement, or the district attorney's office. The fact that internal audit is one of the primary sources for detecting fraud makes internal auditors an excellent choice to receive hotline tips and then follow up on suspected fraud. Doing so should only further strengthen internal auditors as a primary source for detecting occupational fraud.

The third primary source of occupational fraud detection is that of management review. The importance of management's role in combating fraud cannot be overstated, especially when considering the primary internal control weaknesses identified by the ACFE in cases covered in its report. Regardless of the category of fraud (financial statement fraud, corruption, misappropriation of assets), the top five internal control weaknesses are:

1. lack of internal controls;
2. lack of management review;
3. override of existing internal controls;
4. poor tone at the top; and
5. lack of competent personnel in oversight roles.

Each of these five weaknesses can be reduced by management. Internal auditors should explain to managers that it is management's responsibility to implement, oversee, and maintain internal control. The lack of internal controls can be very challenging to overcome in many government organizations (especially small ones) because of a lack of resources to hire enough employees to allow proper separation of duties. For this reason, management review becomes even more crucial as a primary means to combat fraud, and internal auditors should stress this to managers. Internal auditors should also explain that while management review procedures are a primary source for detecting fraud, this source can be even stronger because a lack of management review creates one of the leading opportunities to commit fraud.

Internal auditors should keep in mind that overriding of internal controls is mainly a management issue because those with authority can "turn off the switch" of internal control. Internal auditors

should explain to managers that they need to be cognizant of the tone they portray to employees. A loyal manager can lead to loyal employees. Internal auditors should also stress to government organizations that they must be cognizant of hiring qualified and competent managers who can project a positive and ethical tone and fulfill their duties. Internal auditors should not only communicate these suggestions to management, but also keep them in mind when performing risk assessments of auditees. The presence of one or more of these weaknesses should be strongly factored in by internal auditors as they judge how often and to what extent to audit a government unit, organization, or program. Doing so can further strengthen internal audit as a primary source of detecting occupational fraud.

Besides stronger management review, we also suggest rotating duties among accounting and finance personnel, as well as requiring that time be taken off for vacation. For example, when Rita Crundwell took time off to attend horse show competitions, she continued to maintain control of bank statements while she was away. Only by accident did a fellow employee receive the bank statement of the illegitimate account that Crundwell controlled. It is therefore important that fellow employees assume accounting and finance duties while an employee has taken time off for work.

Suggestions for fighting misappropriation of assets schemes

Some schemes discussed in this article involved embezzled check disbursements (billing scheme, expense reimbursement, payroll scheme, and check tampering). It is therefore important to have strong controls over check disbursements. This begins with having strong physical controls over unused checks (as an aside, strong physical controls are also essential to reduce non-cash theft). This also means requiring two signatures on checks, especially those for more than a certain amount. One signer should be from outside finance and accounting, while the other can have management responsi-

bility in finance and accounting (such as the treasurer), but not record-keeping (such as the accounts payable clerk). Check-signers should also review the documentation supporting the disbursement before signing the check. Check-signers should know the vendors and employees of the organization to help detect billing and payroll schemes. Bank reconciliations should be performed by someone who does not make deposits (thereby helping detect cash larceny) or have check processing and signing responsibilities. The person performing the reconciliations should carefully study bank activity for any check tampering.

Additionally, internal auditors should consider auditing bank reconciliations for multiple months during the year. Internal auditors could also perform certain types of audits, such as petty cash, expense reports, and credit card charges, on a surprise basis. In each audit, a thorough review of documentation should be performed to ensure that all disbursements are valid. Internal auditors should compare the addresses of vendors in the master file to the addresses of employees. Some fraudsters may commit a billing scheme using their own personal address.

Suggestions for combating corruption and financial statement fraud

Corruption is very difficult to detect because those committing this scheme tend to have management authority and oversight that allows them to override controls and personally take advantage of a business transaction. This scheme is also difficult to detect because the bribe, kickback, or conflict of interest is not easily or directly identifiable in the financial records of the employer. Despite this difficulty, internal auditors can focus on certain measures to reduce corruption.

Internal auditors should make sure government organizations have ethics policies, covering such topics as the acceptance of gifts and presence of conflicts of interest. Employees should be required to disclose conflicts of interest on a regular basis. Internal auditors should advise government organizations to have a for-

mal, sealed bidding process for specific contracts. A clear, transparent process can lead to a reduction in corruption. Just as certain kinds of audits can reduce the threat of misappropriation of assets, specific audits can also reduce corruption. As corruption is the most common occupational fraud scheme, internal auditors should perform compliance audits over policies and procedures dealing with corruption as well as the bidding process on contracts. Internal auditors should also audit vendors to ensure that the best vendors in terms of quality and cost of products and services are being provided to the government organization.

Like corruption, financial statement fraud is very challenging to detect, and even more so because it involves managers at the top of the organization with fewer eyes looking over their shoulders. Despite this, internal auditors should be proactive with helping detect this type of fraud. Referring again to the case of Rita Crundwell, the external audit firm that performed the annual audit of Dixon, Illinois failed to follow up on obvious red flags that should have caught their attention. For example, when the city's bank completed the external auditor's account confirmation requests, the bank added the illegitimate account in its written responses. Unfortunately, the external auditors did not follow up on this discrepancy — a bank account in the city's name not showing up in the city's records.

Dixon's external auditors also did not carefully study fictitious invoices created by Crundwell to hide her embezzlement. A comparison of the invoices with actual invoices from the same vendors would have identified different invoice formats, as well as incomplete and inaccurate information (including typographical errors). Crundwell's creation of fictitious invoices serves as a perfect example of another ACFE finding — the most common method of trying to hide occupational fraud regardless of fraud category is the creation of fraudulent physical documents. Other common methods of concealment include:

- altering physical documents;
- altering transactions in the accounting information system;

- creating fraudulent transactions in the accounting information system; and
- destroying physical documents.

Internal auditors should be aware of these tactics and keep them in mind when performing audits. Internal auditors should carefully study documentation and transactions in the accounting information system for inconsistencies. Internal auditors should focus on unusual adjusting of entries at the end of the fiscal year and entries that suspiciously end with “000” or “000,000.” Reflecting on the case of financial statement fraud by the city of Miami, Florida, internal auditors should step back and make sure they understand the business purpose of transactions and that they comply with the policies and procedures of the government unit. A professionally skeptical mindset is needed to ensure transactions are proper and make sense for the government organization’s operations.

An old Russian proverb about professional skepticism

We began this article by referring to the most notorious citizen of Dixon, Illinois, Rita Crundwell, and her unbelievable embezzlement of more than \$53 million. We used her example and those of others in this article to show the very real threat many government organizations face from the many ways fraud is commonly committed by employees. We also provide advice to assist internal auditors in helping government organizations combat the schemes discussed.

As we conclude this article, we provide one last piece of advice, and it comes from Dixon’s most famous citizen, President Ronald Reagan, who lived in the city from age 10 until age 22. President Reagan was fond of quoting a certain old Russian proverb when discussing the agreed-upon mutual monitoring of nuclear arsenals to comply with a treaty between the United States and the Soviet Union. That proverb is the perfect mantra for all internal auditors: *doveriyai, no proveryai*, which translates as *trust but verify*. Keeping these words in mind can help internal auditors maintain the pro-

fessional skepticism and mindset needed to help reduce the risk of occupational fraud in government organizations. ■

NOTES

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