

Fraud Detection Methods Focusing on Lifestyle

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In November 2012, former Comptroller, Rita Crundwell of Dixon, Illinois pleaded guilty to embezzling \$53 million from City accounts. Crundwell worked as Comptroller of this small City since the early 1980s, and "was the only person who controlled the City's finances and funneled public money to her secret, private accounts." Crundwell had spent primarily, in part, these monies on a \$2 million custom RV, a Florida vacation home, and a world-class horse breeding farm with 400 horses.

For more than two decades, the former Comptroller continued to siphon the town's money to her own coffer unnoticed, until her vacation in October 2011. At that time, a replacement worker called the bank regarding certain confusing paperwork and stumbled upon the Comptroller's other bank account. According to a complaint filed in the Northern District Court of Illinois in April 2012, Crundwell earned an annual salary of \$80,000. It's regretful that over the years no one had raised the red flags given her lavish lifestyle.

There are many causes leading to what took place. Three key factors are pressure, opportunity, and rationalization. Crundwell had the personal financial pressure or motive to maintain the horse farm, among other luxuries; and she had full access/opportunity over the City's funds. There had been insufficient supervision, nor a system of checks or balance mechanisms to monitor the proper use of these funds; and last but not least, her lack of ethics in realization/justification of accessing the funds.

Could this crime be detected earlier? It is possible, if closer attention to certain warning signs had been followed through with. In order to conceal misappropriations, perpetrators generally manipulate financial records such as misstating expenses. There could also be troubling financial trends and irregularities, to note. For example, there could be customer or vendor complaints for payments not credited or contracts not received. There could also be indications that the employee's lifestyle appears inconsistent with the salary of the person and/or known sources of income. Experienced auditors or reviewers could raise questions while conducting analysis and gathering evidence through fund tracing and other forensic investigation mechanisms.

There are several forensic accounting methods to uncover suspect's funds that cannot be explained by known sources of income. Two of these methods are known as the expenditure method and the net worth method.

Under the expenditure method, examiners compare total expenditures of cash of a period to total sources of income during the same period. If total income is significantly lower than the total cash expenditures, there is possibly additional, unreported income. A hypothetical case illustrating the expenditure method is as follows:

Cash Sources :

Beginning bank balance	\$	10,000
Salaries		80,000
Interest and dividend income		2,000
Gambling income		2,000
Business income		6,000
Gross rental		10,000
Assets sold		10,000

<u>Total Cash Sources</u>	\$	<u>120,000</u>
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Cash Uses:

Ending bank balance	\$	15,000
Gambling loss		20,000
Car payments		8,000
Mortgage payments		20,000
Credit card payments		40,000
RV payments		60,000
Rental expenses (less depreciation)		18,000
Horse purchases		2,000,000
Other expenses		19,000

<u>Total Cash Uses</u>	\$	<u>2,200,000</u>
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<u>Estimated Funds from Unknown Sources</u>	\$	<u>2,080,000</u>
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This method utilizes the format of the Source and Use of Funds in a person's account. The Internal Revenue Service has also utilized this approach over the years.

Under the net worth method, examiners compare the known net worth of an individual at the beginning and ending of a period, and calculate the amount of change during this period. Net worth can be rolled

forward using the formula of: beginning net worth (cost basis) +/- reported net cash earnings for the period +/- gifts received or made and inheritances received during the period +/- living expenses for the period = ending net worth (cost basis). The difference between the known beginning and ending net worth is then compared to income from known sources. The following is an example of this method:

Increases (Decreases) in Net Worth

	2001	2002	Change
<u>Assets (at cost)</u>			
Bank account balance	\$ 10,000	\$ 15,000	\$ 5,000
Stocks and bonds	20,000	10,000	(10,000)
Residence	500,000	500,000	-
Rental property	250,000	250,000	-
Automobile	40,000	40,000	-
RV	2,000,000	2,000,000	-
Horses	15,000,000	17,000,000	2,000,000
<u>Total Assets</u>	\$ 17,820,000	\$ 19,815,000	\$ 1,995,000
<u>Liabilities</u>			
Mortgage	\$ 220,000	\$ 200,000	\$ (20,000)
Automobile loan	28,000	20,000	(8,000)
RV loan	1,260,000	1,200,000	(60,000)
<u>Total Liabilities</u>	\$ 1,508,000	\$ 1,420,000	\$ (88,000)
Net Worth	\$ 16,312,000	\$ 18,395,000	\$ 2,083,000

As demonstrated in the example, the changes in lifestyle or financial status cannot be explained by the known sources of income such as one's salary. The next step an investigator usually takes is to interview the suspect to explain how the net worth increase, asset acquisitions or payments of debts were financed or incurred. The investigator may also obtain bank records, trace the flow of transactions, observe the suspect's residence, or tour the business activity site.

Many embezzlement and other types of frauds start out slowly in small increments at first. When there are no repercussions for the early pilfering, the violator becomes more and more emboldened and the unlawful activities go into high gear. To deter and detect fraud, it is important for businesses and government agencies to establish strong internal controls, such as implementing clear and anti-corruption policies, code of conduct and compliance

procedures; regular training of employees on the policies; bonding of certain employees; segregation of duties and effective oversights; tip hotline for confidential reporting; periodic due diligence testing and review; and the periodic analytical review of the entity's financial statements.

When there is a significant change in lifestyle or spending habits of a key employee that cannot be reasonably attained by an employee's salary, wages, or other known sources of income, the company or government agency should apply the above forensic methods focusing on the lifestyle and seek information as to: when and where the assets were acquired; how much did the assets cost; where did the individual(s) obtain the funds to purchase the assets; when were the liabilities incurred; from what sources were the liabilities paid; what were the amounts of funds or income during the targeted period; what were the total amounts of expenditures; what were the

purposes of the expenditures; from what sources were the expenditures made; etc. The company or government agency may want to hire forensic accountants or advisors to develop effective strategies, identify risk factors and vulnerable areas that need attention, and follow the audit trail to prevent or discover loss of assets and other fraud schemes. These measures among others are tools to be implemented in order to reduce fraud and corruption risks in businesses and governments and to regain investor faith and public trust.

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