

The Forensic Audit: An Example from the Public Sector

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Forensic auditing has received increased attention in recent years, as major fraud cases have occurred and as auditors have had to give increased attention to not only fraud prevention, but also fraud detection. While forensic auditing has many applications and takes many forms, one important application is examining allegations of fraud to detect what in fact happened and, perhaps more importantly, why it happened.

Corporate fraud had been often in the headlines since the 2001 Enron scandal, with many reported cases around the world. In 2005, a major case arose in a relatively new arena, local government, specifically a public school district. The Roslyn School District, a relatively small public school district east of New York City, made headlines with the disclosures that top district personnel had diverted over \$11 million of district funds for their personal use, over about a seven-year period.

These findings were the result of an extensive forensic audit carried out by the New York State Comptroller's Office. The Comptroller is an elected official whose office is responsible, among other things, for fiscal oversight of all local governmental entities within the State. Upon receipt of allegations that a major fraud may be occurring, the Comptroller's Office initiated an audit of the Roslyn School District, and issued two major reports on its findings: one critical of the performance of the District's external auditor, and one detailing its findings as to the extent

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and nature of the fraud itself. These two public documents, aggregating over 110 pages, provide rare insight into the details of a forensic audit.

Few forensic audits are made public in the level of detail provided in this situation. Such accounts provide useful insights into the nature and techniques of forensic auditing, and enhance understanding of this critical function.

The Tip of the Iceberg

In September 2002, the Roslyn Union Free School District's external auditor – a small local (Long Island) CPA firm known as Miller, Lilly and Pearce – received information from an undisclosed source that the District was purchasing numerous items from a local Home Depot store, items that did not seem to be of the type that a school district might normally buy. The CPA firm contacted the audit committee chair of the Board of Education, and an inquiry was authorized. Attention immediately focused on Pamela Gluckin, the assistant superintendent for business – the chief financial officer in a school district. Evidence regarding \$30,166 in suspect purchases from Home Depot was found in her files.

CPA firm personnel apparently then spent one day, October 16, 2002, examining district records. While little documentation apparently was retained regarding this review, the CPA later described the process to the state auditors. The audit process involved downloading all transactions that had been personally entered by Ms. Gluckin (rather than by the usual accounting personnel) and examining the supporting documentation. In addition to the \$30,166 of Home Depot charges, this review yielded a list of undocumented payments to 12 additional

vendors aggregating \$192,970, for a total of \$223,136 to 13 vendors. This finding was reported to the Board of Education one week later.

Upon the recommendation of both the CPA firm and an attorney recommended by District superintendent Frank Tassone, the Board agreed to accept restitution of \$250,000 – the \$223,136 loss plus \$26,864 in accounting and legal fees – along with the retirement of Ms. Gluckin and her surrender of her administrator's license. No criminal charges would be pursued, and no public announcement would be made. The matter appeared to be closed.

The Next Step

A little over a year later, in early 2004, further allegations arose that the Roslyn fraud was more extensive and more widespread – both in terms of the time frame and in terms of people involved – than had been determined earlier. The local (Nassau County) district attorney began an investigation and then the State Comptroller's Office began an audit on June 1, 2004. This audit soon determined that the theft exceeded \$11 million. Pamela Gluckin, who had resigned in 2002, was arrested on charges that she stole in excess of \$1 million. Soon thereafter, both Superintendent Frank Tassone and account clerk Deborah Rigano (who happened to be Pamela Gluckin's niece) both resigned. They were later arrested on charges of first and second degree grand larceny.

The forensic audit process is described in two reports issued by the Comptroller's Office – one in January 2005 regarding the performance of the independent auditor and the second in June 2005 regarding the fraud itself. These reports offer a very detailed look at the conduct of a forensic audit, well beyond what is usually publicly available.

The Forensic Audit

The State Comptroller's office faced the need to audit several years of data over a short time frame, due to the public interest in the case. It soon found that many documents and records were missing, complicating its task. The following sections describe in detail how the audit was conducted.

Replicating the October 2002 Forensic Audit

The state auditors first attempted to replicate the October 2002 audit that had determined \$223,136 of undocumented – and presumed inappropriate – payments to 13 vendors. Little existed by way of audit workpapers other than the list of unsubstantiated vendors and amounts. As described above, the CPA verbally indicated the procedures that had been followed.

The District's computerized accounting system was backed up periodically; fortunately, a backup dated October 17, 2002 existed – just one day after the CPA's examination. Applying the process described by the CPA to this backup file, state auditors found \$1.6 million in undocumented transactions from 85 vendors, well above the \$223,000 and 13 vendors identified by the CPA. They could not determine whether the CPA had identified many of these items and eliminated them from the final list, or had never identified them at all. Some of the items on the CPA's list did not agree to the state auditors' findings as to dollar amounts, and other items on the CPA's list were not identified at all by the state auditors. These findings not only called into question the forensic audit performed by the CPA firm in October 2002, but also the firm's work in the annual audits. Miller, Lilly and Pearce had been the District's auditor since 1992. Moreover, the firm, with fewer than ten personnel, served as auditor for over 50 other school districts. Given that all school districts have the same year-end, this posed a near-impossible

work environment for a small firm to complete over 50 quality audits within a few months' time.

The state auditors' list of \$1.6 million in questionable transactions included many payments to banks and credit card companies, as well as direct payments to top management and employees of the District. Even the CPA's \$223,000 total had included some banks and credit card companies as payees. Clearly the CPA had not pursued this, either in the forensic audit or in the subsequent annual audit. As it could readily be determined that the District did not hold credit cards with many of these companies, a direction for further audit work was suggested.

Examination of Internal Controls

Virtually any audit begins with a determination of what controls are supposed to be in place, and how effectively they are functioning.

A school district is administered by a superintendent, who is effectively the CEO; the assistant superintendent for business serves as the CFO. Both hold state licenses credentialing them for such positions. Oversight is provided by a Board of Education, whose members are typically elected from among the community served. Often, the Board is focused on the establishment and approval of the annual budget and the corresponding property tax rate, and on matters of personnel and educational policy. Regular oversight of financial operations often seems to receive little attention, especially given that transactions are numerous and, for the most part, routine. Personnel costs typically comprise the largest component of the annual budget.

The highest level of control is the oversight provided by the Board of Education. Inasmuch as the fraud was apparently perpetrated by top management of the District, Board controls over top management actions were especially critical. The state auditors used inquiry, examination of Board minutes, and evidence (or lack thereof) of controls and procedures

established by the Board to assess what controls were in place and how they were working.

The audit found numerous control deficiencies at the Board level. Though the Board nominally had an audit committee, it did not regularly report to the Board. The Board had authorized the superintendent to approve budget transfers from one appropriation category to another. While the Board was legally allowed to delegate this responsibility, it was required to establish a dollar limitation on the superintendent's authority. This it did not do, nor was there any evidence that the Board either reviewed or approved any budget transfers between July 1, 1998 and June 30, 2004. Thus the superintendent had completely unsupervised authority to make budget transfers for seven years. Further, the Board established virtually no written policies and procedures regarding financial operations.

State education law requires that all vouchers be audited prior to payment. Boards typically delegate this task to an Internal Claims Auditor, a part-time employee not otherwise connected with the district. Though this process was in place, the auditors found that it did not function as intended. The Internal Claims Auditor apparently gave only cursory review before initialing vouchers, and did not review check warrants. Checks were often written and distributed prior to review and approval of the voucher by the Internal Claims Auditor. Finally, no reports of this activity were given to the Board. As will be discussed later, even this flawed process was often circumvented to permit most of the unauthorized disbursements to occur.

The Board also appointed a Treasurer, who is responsible for payment of approved vouchers. However, the Treasurer delegated check-signing authority to the superintendent's secretary, allowed checks to be issued without signed warrants, and did not maintain or examine

a log of checks written. Moreover, the Treasurer rarely attended Board meetings nor did he provide budget status reports to the Board.

Thus, the lack of adequate oversight and control by the Board and its appointees created an environment that greatly facilitated the abuse of disbursements.

Auditing the Accounting System

The District had computerized information systems, including an accounting system known as *Finance Manager*. The audit found that there were far too many users who had authority to access or modify the system. In late 2002, there were 17 users, of whom 6 were designated as administrators of the system (who could add new users, change rights and permissions, etc.). By July 2004, these numbers had grown to 22 authorized users including 8 administrators. The software provider also had remote access to the system to make changes and updates, although there was no notice or record of such changes.

While some controls were built into the software, such as a control to avoid overspending a budget authorization, the audit found that these controls were not enabled.

As the forensic audit progressed, it became evident that concealment of over \$6 million in unauthorized disbursements was accomplished by changing vendor names in the system. The examination of cancelled checks showed payments to certain vendor names (usually banks or credit card issuers) but the reports generated by the accounting system showed these disbursements as being made to other vendors, typically normal district suppliers. Fifteen vendor names were involved, covering numerous checks aggregating over \$6 million. The auditors examined backup tapes of the accounting system that were produced on a regular basis. They found that on the backup tape of February 23, 2004, the original vendor names were still

reflected in the system. The next backup was at 9:39 P.M. on February 25, 2004, at which point 12 of the 15 vendor names had been changed. This backup had apparently occurred as the name changes were being made on the system. An examination of the system log file showed that “fmadmin” (the software company) had logged onto the system at 8:32 that evening and had logged off at 10:28. Moreover, the work had been done from a computer in the District business office, not remotely from the software company. These changes were made around the time the investigation of District finances was beginning, and seemed to be a clear indication of an attempt at concealment.

Transactions Auditing: Disbursements

The audit covered the period January 1, 1996 through June 14, 2004; during this period, some 57,000 checks were written, exclusive of individual payroll checks written by the payroll service company. The audit examined these checks, along with District records (vendor files, etc.). Many documents and records were missing or never existed in the first place. These included general and subsidiary ledgers, bank reconciliations, approved check warrants, and many vendor files. In some cases, the missing records were able to be obtained from original sources, such as banks, credit card companies, and other financial institutions, sometimes by subpoena.

One of the big questions facing the auditors was how so many fraudulent disbursements could have been processed, even given the deficiencies in the Board of Education’s controls. Normally, check warrants were processed twice monthly, with most of the processing done by clerical personnel in the District office. The audit found heavy use of so-called “hand-drawn warrants,” intended as an infrequent emergency procedure when a payment had to be processed

between normal semi-monthly payment cycles. Most of the fraudulent disbursements were processed via these hand-drawn warrants, which did not go through any review by the Internal Claims Auditor. Moreover, these payments were processed outside the usual accounting office, often by the Assistant Superintendent for Business or the Superintendent. The over-delegation of check-signing authority by the Treasurer greatly facilitated the processing of these disbursements, as did the general lack of review and reconciliation in the system.

The extensive forensic examination conducted by the State Comptroller's Office identified \$11,251,365 of misappropriated funds from the Roslyn School District. This amount likely understates the entire extent of the fraud, as the audit report comments:

Despite a rigorous review of existing records by ourselves and the District's current management and staff, we do not believe that we have been able to identify all of the payments made for personal expenses. The volume of the transactions and the amount of missing documentation is just too great to have absolute assurance that all transactions have been uncovered. (p. 29)

Over \$5.9 million was paid on the personal credit cards of Superintendent Tassone, Assistant Superintendent for Business Gluckin, Account Clerk Rigano and at least ten of their friends and family. Any documentation of these expenditures had to be obtained from the card issuers, as there was no documentation to be found in District files. A total of 74 credit cards in the names of 13 individuals, on 54 different accounts, were identified. They were used for cash advances, balance transfers from other personal cards, and a great variety of personal expenditures.

An additional \$1.1 million was identified as being used to make approximately 190 payments on private mortgages and loans for the three individuals named above. These included mortgages on six different properties along with student and personal loan payments.

Over \$600,000 was paid to Home Depot between 1995 and 2003, including \$175,000 during the 2001-02 fiscal year alone. While some of this may have been for legitimate school district purposes, the auditors noted that after Pamela Gluckin resigned in October 2002, payment to Home Depot for the remaining nine months of that fiscal year amounted to only \$4,200. Similarly, much of the \$594,000 spent on food purchases, including many transactions at gourmet stores, were determined to be for other than valid District needs. Almost \$250,000 was spent on over 150 computers and related technology items, nearly all of which were delivered to locations other than District facilities.

Over \$1,250,000 was paid to related-party companies, with little evidence that the District received comparable value in goods and services. The payees included companies owned by Stephen Signorelli, the superintendent's companion (over \$800,000), companies owned by members of the Gluckin family (over \$250,000) and a company owned by the sister of the District's Internal Claims Auditor (over \$200,000).

Transactions Auditing: Payroll and Benefits

The audit found numerous irregularities in the areas of payroll and benefits. Top administrators nearing retirement often had their salaries increased beyond authorized amounts, so as to enhance the base on which their retirement benefits were calculated. Similarly, vacation accruals, which were cashed out upon departure from the District, were enhanced for several top

officials. Contract files and records of authorized changes were generally lacking, and it appeared that the superintendent received far more in travel and other reimbursements than his contract authorized.

The audit identified over \$580,000 in excess salaries and benefits paid to senior staff, over \$130,000 in questionable travel reimbursements, and over \$200,000 for the lease of private automobiles.

Beneficiaries of the Fraud

The auditors determined that Pamela Gluckin, her husband and children were beneficiaries of over \$5.2 million of the misappropriations. Frank Tassone received over \$2.4 million, Deborah Rigano over \$300,000, and Stephen Signorelli nearly \$900,000. Over \$1.5 million could not be identified as to beneficiary. The remaining \$800,000 was received by some 18 individuals. In all, at least 29 individuals were found to have shared in the \$11.2 million fraud.

Auditing the Auditors

As noted earlier, the small local CPA firm of Miller, Lilly and Pearce had been the District's auditors since 1992. Partner Andrew Miller was responsible for the Roslyn audit.

The state auditors' experiences in attempting to replicate the October 2002 forensic examination prepared by the CPA led them to examine more closely the work performed by the independent audit firm. At best, there was substandard performance by the CPAs, and at worst there was complicity in the fraud.

The state auditors issued a separate report on the independent auditor, a most unusual procedure. The report was critical of both the District – for its failure to seek periodic proposals for audit services – and of the audit firm.

One criticism of the firm was its lack of independence, which is required of auditors. The firm had filled the role of the assistant superintendent for business between the dismissal/retirement of Pamela Gluckin in 2002 and the appointment of an interim successor a few weeks later, thus violating the prohibition of holding an executive or policy-making position with a client. More importantly, two of the three CPA firm partners owned 55% of the software company that provided and serviced the District’s accounting software, *Finance Manager*. This program itself was well regarded and was used by over 250 school districts. However, this relationship put the CPA firm in the position of auditing its own software, again a clear violation of independence. Through another partner-owned firm, the District was provided with student information system software. The commissions paid to the partners, in excess of \$200,000, constituted yet another violation of professional standards.

The state auditor’s report found many deficiencies in the conduct of the audits. Perhaps most telling was that workpapers for both the 2001-02 and 2002-03 audits listed payees for certain expenditures that did not correspond to what appeared on the District records at the time. Recall that the state auditors had determined that changes to payee names, from banks and financial institutions to normal school district suppliers, were entered into the system on the evening of February 25, 2004. As the state audit report commented, “we questioned how a CPA workpaper supposedly prepared in August 2002 [and another in July 2003] could have included vendor names that were not placed into the District’s records until February/March 2004.” This

“smoking gun” found by the forensic auditors led to charges against the lead CPA, Andrew Miller; it was alleged that he entered the District office on the evening of February 25, 2004 and changed the names for 15 payees on numerous transactions in an attempt to cover up the fraud. Mr. Miller was indicted by a grand jury on 26 counts of tampering with public records, falsifying business records, and tampering with evidence. He subsequently pled guilty to one felony charge of tampering with public records and received a six-month jail sentence. His CPA license was revoked, and the firm, after agreeing to a near-\$1 million settlement with the District, disbanded.

Outcomes of the Forensic Audit

As a result of the extensive forensic audit, criminal charges were also brought against Superintendent Frank Tassone, Assistant Superintendent for Business Pamela Gluckin, Account Clerk Deborah Rigano, Tassone’s companion and roommate, Stephen Signorelli, and several others. Each of the above four pled guilty; Tassone was sentenced to 4 to 12 years in prison, Gluckin received 3 to 9 years, Rigano 2 to 6 years, and Signorelli 1 to 3 years.

Following the Roslyn case, the New York State Legislature adopted new legislation to strengthen the financial management of school districts, with most of its provisions aimed at the Board of Education. The law provides:

- Each school district must have both an audit committee and an internal audit function
- The board must seek proposals for audit services at least every five years
- All school board members must receive training regarding their financial oversight responsibilities

In addition, the State Comptroller’s Office began an intensive, ongoing program of school district audits, with emphasis on financial controls and operations. Since the beginning of 2005,

over 900 school district audits have been completed.

Conclusion

The Roslyn case was a major fraud in its own right, with losses exceeding \$11 million dollars from a relatively small school district. It also served to trigger a major emphasis on auditing the financial controls and operations of school districts, and it led to legislation to strengthen financial oversight by boards of education.

The two extensive reports issued by the New York State Comptroller's Office provide an excellent and detailed illustration of the conduct of a forensic audit. Starting from vague allegations of financial impropriety, the audit determined the dollar amounts involved, the parties responsible, the control weaknesses that enabled the fraud, and the attempts to conceal it.

These audit reports serve as a useful guide for managers in general, for auditors in particular, and for educators and students who wish to gain an understanding and appreciation of forensic auditing.

Endnotes

1. The information in this paper is drawn extensively from two reports issued by the Office of the New York State Comptroller: (a) “Roslyn Union Free School District: Independent Audit Services: Report of Examination July 1, 2001 – June 30, 2003,” January 2005, and (b) “Roslyn Union Free School District: Anatomy of a Scandal: Report of Examination January 1, 1996 – June 14, 2004,” March 2005). All details and names of individuals are a matter of public record, as disclosed in the State Comptroller’s Audit Reports and various news media coverage.

References

Office of the New York State Comptroller, “Roslyn Union Free School District: Independent Audit Services: Report of Examination July 1, 2001 – June 30, 2003,” Division of Local Government Services and Economic Development, January 2005 (web location: <http://www.osc.state.ny.us/localgov/audits/2005/schools/roslyn.pdf>)

Office of the New York State Comptroller, “Roslyn Union Free School District: Anatomy of a Scandal: Report of Examination January 1, 1996 – June 14, 2004,” Division of Local Government Services and Economic Development, March 2005 (web location: <http://www.osc.state.ny.us/localgov/audits/2005/schools/roslyn2.pdf>)