Fraud Awareness in Public Schools

Yvonne Clayborne and Jennifer Murtha
Internal Audit Function

- Independent CPA Firm – 5th largest in the Country
- Audit Committee of 5 Volunteers
- Reports directly to the School Board
- Risk Assessment and Audit Plan
  - Internal Accounts
  - FTE
  - Cash Reconciliations
  - Self Insurance
  - Property Control
  - Timekeeping
  - Charter School
  - Grants
Do you recognize these faces?????
Ethics Program

- The choice between Right and Right
- Monopoly
- Football Games
- Tough Economic Times
- Not just CASH
- Examples
The Fraud Triangle

- Unrealistic deadlines
- Unrealistic performance goals
- Personal vices

Inadequate or no:
- Supervision & review
- Segregation of duties
- Management approval
- System controls

a.k.a. Rationalization — reconciling behavior with commonly accepted notions of decency & trust.
The Nature of the Industry...

- Fraud can be explained by three factors:
  - A supply of motivated offenders
  - The availability of suitable targets
  - The absence of capable guardians or a control system to “mind the store”

- The opportunity to commit & conceal fraud is the only element over which you (the principal) have significant control.

- What are some of the warning signs?

- What can we do about it?

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
No free lunch...

- According to various fraud surveys, non-SEC companies continue to be disproportionately impacted by fraud & misconduct within their organization

- Business fraud and abuse in the U.S. cost about $990 billion a year
  - Educational organizations lose an average of $58,000 per fraud scheme
  - Average organization loses 7% of revenue

- Street crime only costs the U.S. $4 billion annually
Just the Facts…

- Fraud schemes frequently continue for years before they are detected
  - The typical fraud in the ACFE study lasted 2 years from the time it began until it was discovered
- Frauds are much more likely to be detected by a tip than by audits, controls or any other means
- Lack of adequate internal controls was most commonly cited as the factor that allowed fraud to occur
- Occupational fraudsters are generally first-time offenders
### Statistics by Industry

**Education Industry – 59 Cases**

<table>
<thead>
<tr>
<th>Scheme</th>
<th>Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Billing</td>
<td>33.9%</td>
</tr>
<tr>
<td>Corruption</td>
<td>23.7%</td>
</tr>
<tr>
<td>Expense Reimbursement</td>
<td>23.7%</td>
</tr>
<tr>
<td>Non-cash</td>
<td>16.9%</td>
</tr>
<tr>
<td>Payroll</td>
<td>16.9%</td>
</tr>
<tr>
<td>Skimming</td>
<td>16.9%</td>
</tr>
<tr>
<td>Cash Larceny</td>
<td>15.3%</td>
</tr>
<tr>
<td>Check Tampering</td>
<td>11.9%</td>
</tr>
<tr>
<td>Cash on Hand</td>
<td>6.8%</td>
</tr>
<tr>
<td>Fraudulent Statements</td>
<td>5.1%</td>
</tr>
</tbody>
</table>
Profile of a fraud perpetrator…

- Male, but increasing percentage of females
- Intelligent and in management.
- Married and under some type of significant stress.
- Risk takers and not afraid to fail.
- Rule breakers.
- Long-time employees, hard working

Source: “Fraud Perpetrator Profile: A Short Story” by Nick Brignola, CFE
Perpetrator’s Criminal History

- 87.4% Never Charged or Convicted
- 5.7% Charged but not Convicted
- 6.8% Prior Convictions

Famous last words:

“*It won’t happen here. We’re careful who we hire.*”

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
Famous last words:

“NO WAY it was Mike. He’s over 60 now.”

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
Famous last words:

“Sandra wouldn’t have done that. She’s a mom.”

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
What’s the cost?…

• **Economic costs:**
  – Tangible & measurable
  – Insurable in some cases
  – Provides basis for prosecution and/or litigation

• **Political costs:**
  – Loss of integrity
  – Diminished public confidence
  – Can’t be measured, difficult to recover
What are the Warning Signs?

A **red flag** is a set of circumstances that are unusual in nature or vary from the normal activity. It is a signal that something is out of the ordinary and may need to be investigated further. **Red flags** do not indicate guilt or innocence but merely provide possible warning signs of fraud.

Being able to recognize **red flags** is necessary not only for public accountants but also for anyone working in the public sector where the potential for fraud to occur exists.

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
Just keep in mind... 

**Do not ignore a red flag** – Studies of fraud cases consistently show that red flags were present, but were either not recognized or were recognized but not acted upon by anyone.

**Sometimes an error is just an error** – Red flags should lead to some kind of appropriate action, i.e. an investigation by a measured & responsible person, but sometimes an error is just an error and no fraud exists

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
Employee Red Flags...

- Employee lifestyle changes
- High employee turnover
- Significant personal debt and credit problems
- Refusal to take vacation or sick leave
- Behavioral changes
- Lack of segregation of duties in a high-risk (vulnerable) area

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
More Red Flags…

- Reluctance to provide information to auditors
- Photocopied or missing documents
- Decisions dominated by an individual or small group
- Excessive number of year-end transactions
- Management displays significant disrespect for regulatory bodies
- Excessive number of or frequent changes in checking accounts
- Weak internal control environment
- Unexpected overdrafts or declines in cash balances
- Accounting personnel are lax or inexperienced
- High employee turnover rate
- Compensation is out of proportion
- Decentralization without adequate monitoring
- Frequent changes in external auditors

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
Red flags in cash . . .

- Excessive number of voids
- Presence of personal checks in petty cash
- Unauthorized bank accounts
- Sudden activity in a dormant account
- Parent or teacher complaints that they are receiving non-payment notices
- Discrepancies between bank deposits and postings
- Excessive or unjustified cash transactions
- Large number of account write-offs
- Bank accounts not reconciled on a timely basis
- Abnormal number of expense items or reimbursement to an employee

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
Red flags in payroll…

- Inconsistent overtime hours for a cost center / department
- Overtime charged during a slack period
- Overtime charges for employees who normally would not have overtime wages
- Budget variations for payroll by cost center / department
- Employees with duplicate Social Security numbers, names, and addresses
- Employees with few or no payroll deductions

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
Red flags in purchasing . . .

- Increasing number of complaints about services
- Vendors without physical address
- Lack of physical security over assets / inventory
- Payments to vendors not included on an approved vendor list
- Vendor address matching employee address
- Purchases that bypass normal procedures
- Charges without shipping documents
- Vendor payments picked up rather than having it mailed
- High volume of purchases from new vendors

Source: “Red Flags for Fraud” by Mark P. Pattison, Deputy Comptroller, State of New York
Profile of an organization at risk... 

- Less than 100 employees.
- Management ignores irregularities.
- High turnover with low morale.
- Staff lacks training.

* The education industry has experienced the lowest median losses.

Source: “Fraud Perpetrator Profile: A Short Story” by Nick Brignola, CFE
The Typical Environment in which Fraud Occurs

- Trust is placed in employees
- Employees have detailed knowledge of the accounting systems and their weaknesses
- Management domination subverts normal internal controls
- Management adds pressure to “make the numbers”
- Expected moral behavior is not communicated to employees
- Unduly liberal accounting practices
The Typical Environment in which Fraud Occurs

- Ineffective or nonexistent internal auditing staff.
- Lack of effective internal controls.
- Poor accounting records.
- Related party transactions.
- Incomplete and out of date procedural documentation.
- Management sets a bad example.
Common Themes...

- Skimming Cash from Deposits
- Manipulation of Checks Written
- Petty Cash / Cash on Hand
- Property / Non-cash Losses
  - School Employee Accused of $100K Theft (August 6, 2008)
- PTO’s / Booster Clubs
Internal Accounts

- Large amount of monies received and disbursed collectively
  - Total FY 2008 Receipts: $23,443,167.79
  - Total FY 2008 Disbursements: $23,926,952.05

- What is your responsibility as a principal?
  - To Prevent
  - To Detect
  - To Deter

- How?
  - Safeguarding of assets – Protecting the entity’s assets through an effective internal control system. Assurance must exist that transactions related to assets have been properly processed and that appropriate physical handling and control over assets exist.
Internal Accounts - continued

- An effective internal control system contains:
  - Proper segregation of duties
  - A second party review of the general ledger
  - Proper second party review and approval of transactions

- Internal Accounts Audit – Top 5 issues:

<table>
<thead>
<tr>
<th>Issue</th>
<th>Risk Rating</th>
<th>No. of schools</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monies Collected Forms</td>
<td>High</td>
<td>29</td>
</tr>
<tr>
<td>Segregation of Duties</td>
<td>High</td>
<td>23</td>
</tr>
<tr>
<td>Transfers &amp; Adjustments</td>
<td>Low</td>
<td>17</td>
</tr>
<tr>
<td>General Ledger Review</td>
<td>Moderate</td>
<td>12</td>
</tr>
<tr>
<td>Receipts</td>
<td>Moderate</td>
<td>12</td>
</tr>
</tbody>
</table>
Fighting fraud with words…

“In the current era of “whistleblower” reform, fraud controls and hotlines have become a focus in the media and in the minds of citizens. Auditors in the public sector can enhance fraud detection through employee and vendor communications campaigns specifically designed with fraud prevention as the primary goal.”

Source: “Fighting Fraud with Words: Whistleblower Communication” – March 2006, ALGA
Detection of Fraud

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
## Sox-Related Internal Controls in Government (163 cases)

<table>
<thead>
<tr>
<th>Control</th>
<th>Control in Place?</th>
<th>Median Loss</th>
<th>Months to Detection</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>99</td>
<td>39</td>
<td>23.9%</td>
</tr>
<tr>
<td>Hotline</td>
<td>90</td>
<td>56</td>
<td>34.4%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>77</td>
<td>54</td>
<td>33.1%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>64</td>
<td>84</td>
<td>51.5%</td>
</tr>
<tr>
<td>Management Review of IC</td>
<td>62</td>
<td>71</td>
<td>43.6%</td>
</tr>
</tbody>
</table>

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
### Ranking of Controls vs. Relative Effectiveness

<table>
<thead>
<tr>
<th>Control</th>
<th>Ranking*</th>
<th>Reduction in Median Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Audit / FE Department</td>
<td>1</td>
<td>52.80%</td>
</tr>
<tr>
<td>Surprise Audits</td>
<td>2</td>
<td>66.20%</td>
</tr>
<tr>
<td>Management Review of IC</td>
<td>3</td>
<td>45.00%</td>
</tr>
<tr>
<td>Fraud Hotline</td>
<td>4</td>
<td>60.00%</td>
</tr>
<tr>
<td>Mandatory Job Rotation / Vacations</td>
<td>5</td>
<td>61.00%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>6</td>
<td>28.70%</td>
</tr>
<tr>
<td>Audit of ICOFR</td>
<td>7</td>
<td>47.80%</td>
</tr>
<tr>
<td>Audit of F/S</td>
<td>8</td>
<td>40.00%</td>
</tr>
</tbody>
</table>

*Based on average scores.*

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
<table>
<thead>
<tr>
<th>Primary Internal Control Weakness Observed by CFE</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of Internal Controls</td>
<td>35.2%</td>
</tr>
<tr>
<td>Lack of Management Review</td>
<td>17.4%</td>
</tr>
<tr>
<td>Override of Existing Controls</td>
<td>17.4%</td>
</tr>
<tr>
<td>Poor Tone at the Top</td>
<td>8.6%</td>
</tr>
<tr>
<td>Lack of Competent Oversight</td>
<td>7.2%</td>
</tr>
<tr>
<td>Lack of Independent Checks / Audits</td>
<td>5.5%</td>
</tr>
<tr>
<td>Lack of Clear Lines of Authority</td>
<td>1.3%</td>
</tr>
<tr>
<td>Lack of Employee Fraud Education</td>
<td>1.3%</td>
</tr>
<tr>
<td>Lack of Reporting Mechanism</td>
<td>0.2%</td>
</tr>
</tbody>
</table>

Source: Association of Certified Fraud Examiners, Report to the Nation on Occupational Fraud & Abuse
“Who knew who they were? There was no place for me to voice my concerns, either to the internal audit function or the audit committee. Remember, I was not in the accounting department. But even if I were, I think I would have known it would have been fruitless, because I would have had access to junior auditors who were simply not in the position to raise the flags that would have hurt their senior auditors and account executives.”

- Sherron Watkins
Enron Corporation
An engaging message needs to reach the right person at the right time in order to influence that person to take action.

Fraud losses are reduced by 58% when an effective hotline is in place.

47% of hotline calls happen overnight or on weekends.

Communications that publicize the existence of the hotline should be used as an opportunity to promote ethical behavior as well.

Components of communication strategy:
- Message
- Reach
- Frequency

Source: “Fighting Fraud with Words: Whistleblower Communication” – March 2006, ALGA
Traditional Approach

• Traditionally, fraud investigations have been reactive in nature.
  – Identified from a variety of sources.
  – Conducted after significant losses have been incurred.

• In response, today’s management is developing strategic approaches to proactively identify material fraud within their organizations.
  – Forming tactical teams of forensic accountants and investigators.
  – Investing in resources to address fraud before it occurs.
Prevention First

- Educate your employees
- Implement strong controls
- Explain consequences
- Have a clearly written policy
- Make the employees sign the policy
- Let them know you’re monitoring
Summary

• Fraud happens throughout our organizations – regardless of industry, size and culture
• Greater the skill and education greater the losses
• Management must be proactively engaged in fraud preventive and detective controls
• Ethics programs are a key component in an effective internal controls
• If the workforce and vendors know they are being monitored the occurrence of fraud is generally lower
Questions?
Comments?

Progress Through Sharing...
Yvonne M. Clayborne, CPA
Director

RSM McGladrey Inc.
7351 Office Park Place
Melbourne, FL 32940
Tel: (321) 751-6200
Fax: (321) 751-1385
E-mail: yvonne.clayborne@rsmi.com