Stop the Crooks
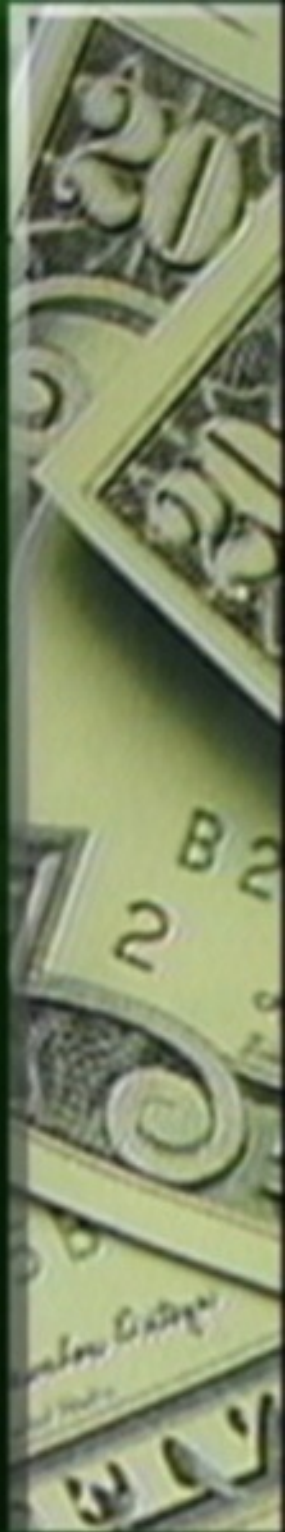
Fraud and abuse and how to stop it
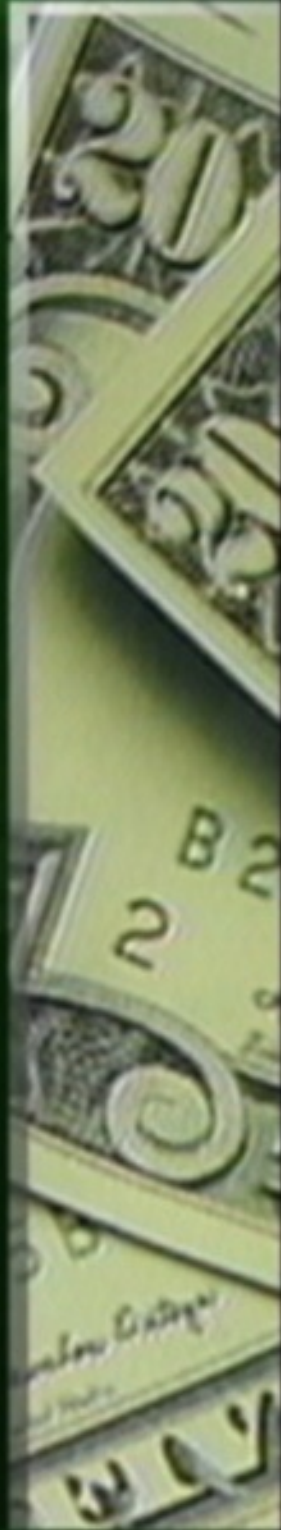
Mary E. Johnson, CPA
Mary E. Johnson & Associates PLLC

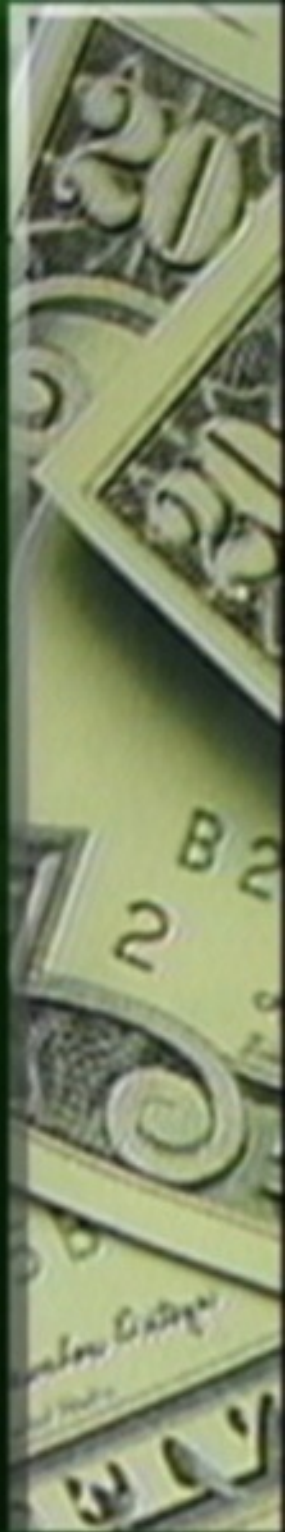# AGENDA

- What is Fraud?
- Fraud Indicators
- Definition and objectives of internal control
- Internal control components
- Occupational Fraud
- Federal Aid Fraud
- Where in the World is the Fraudster?
- Prevention and Detection

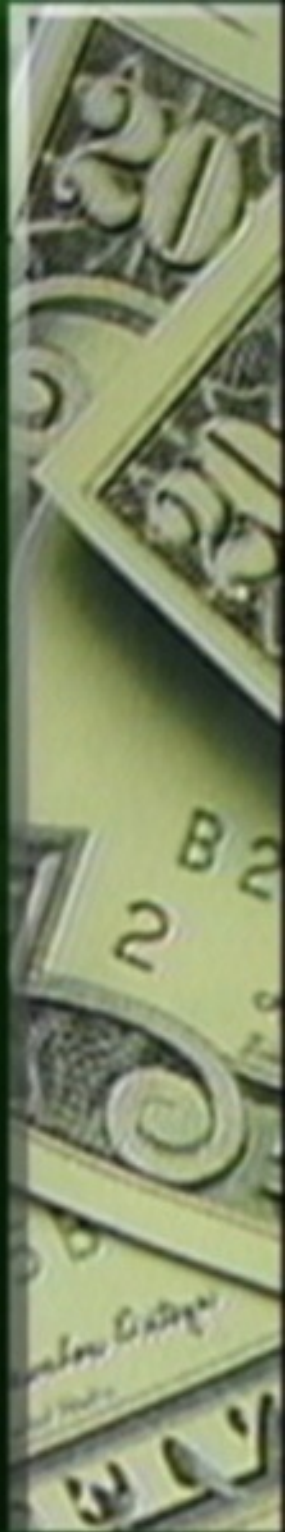# What is Fraud?

- A deliberate distortion of the truth in an attempt to obtain something of value.

  - OR

- Lying and cheating!

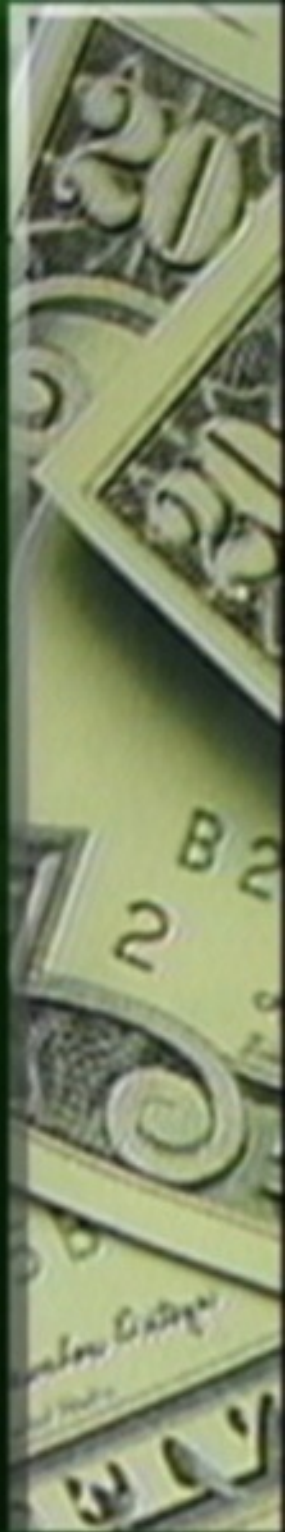# Why are schools a target?

- $$$$$: Schools handle millions every year
- "Customers" do no consider fraud to be a risk
- You have sensitive information
- Infrastructure may not be configured for detection, prevention and deterrence

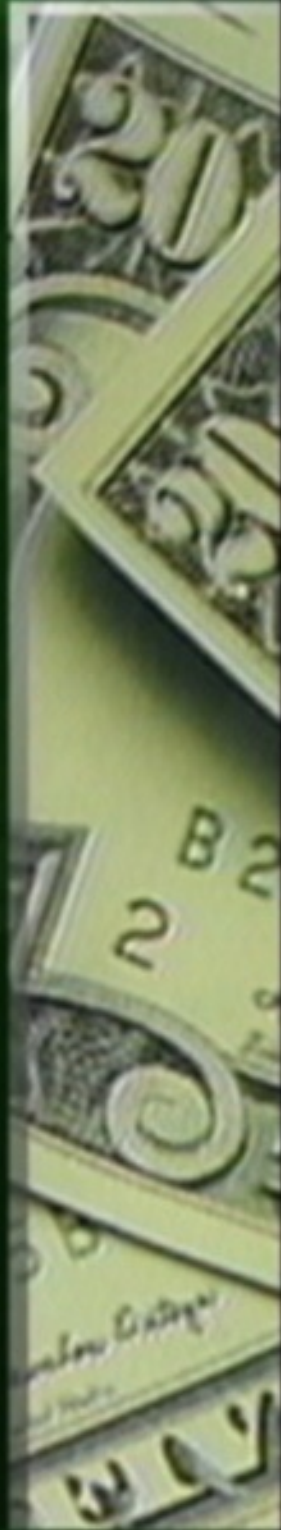# Why are you important?

- Eyes and ears to help detect and prevent fraud

Fraud Risk Indicators

- One person in control
- No separation of duties
- Lack of internal controls/ignoring controls
- Repeat audit findings
- High turnover in personnel
- Unexplained entries in records
- Unusually large amounts of cash payments
- Inadequate or missing documentation
- Altered records
- Unauthorized transactions
- Related party transactions

Fraud Triangle

- Weak controls

- Little or no oversight
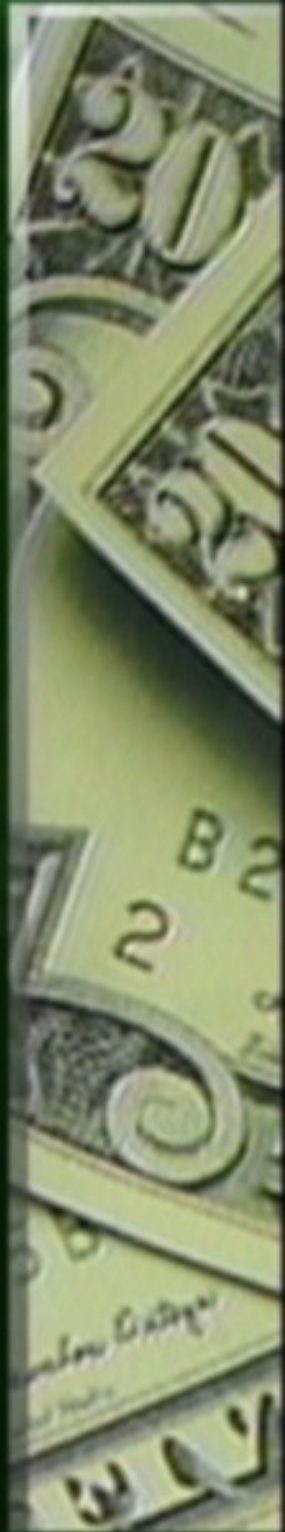
- Lax rules

Opportunity

Motivation

Fraud Triangle

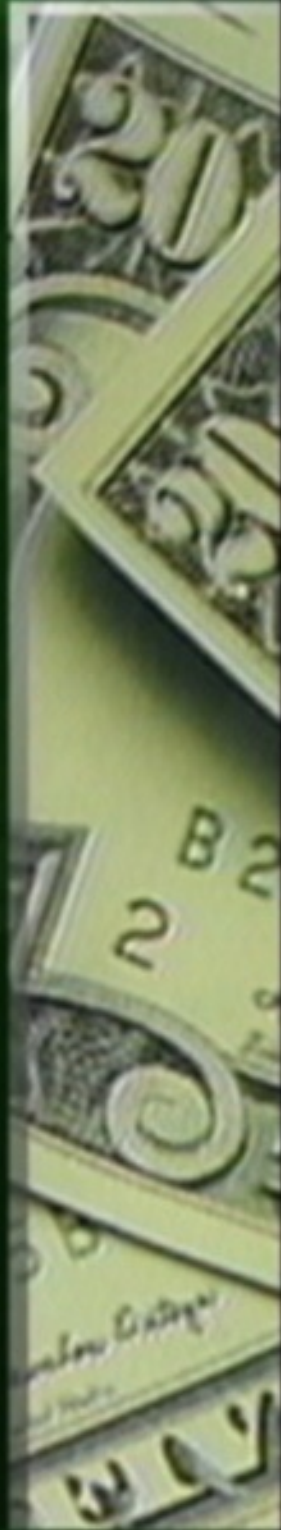- Debt

- Addictions

- Status

- Greed

Rationalization

- Everyone does it.

- I was only borrowing the money.

- I was underpaid and deserve it.
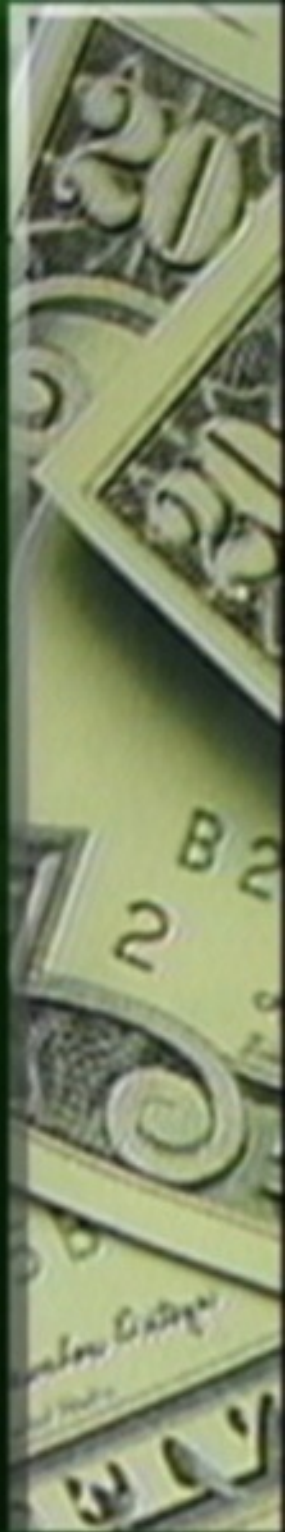
Fraudulent Activity

- Ghost students
- Theft/Embezzlement
- Obstruction of a Federal Audit or Program Review
- Compromise system privileges or protected information
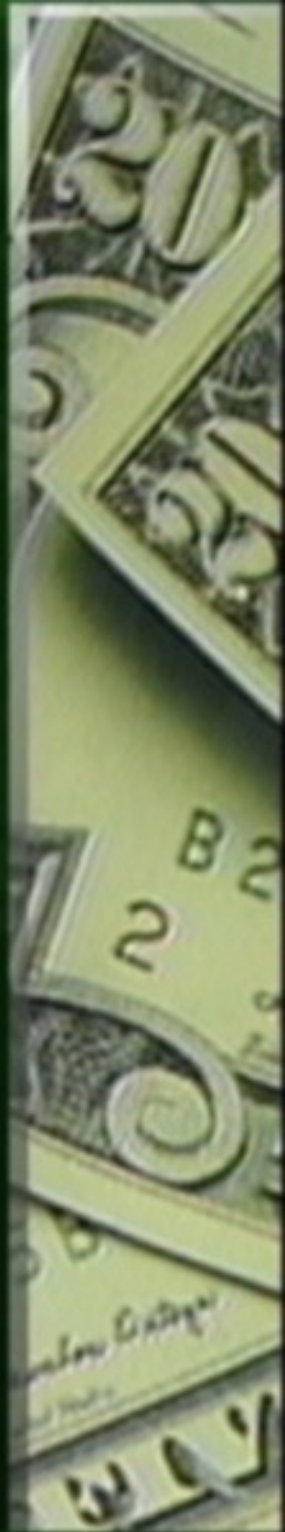- Unauthorized or exceeding authorized access to IT systems or protected data

Internal Control

- Definition: Process affected by the entity's board , management and other personnel designed to provide reasonable assurance regarding the achievement of objectives.
  - Effectiveness and efficiency of operations
  - Reliability of financial reporting
  - Compliance with applicable laws and regulations

Why We Need Controls

- Reduce opportunities for fraud
- Assure compliance with laws and regulations
- Prevent loss of funds
- Eliminate adverse publicity
- Assure public confidence

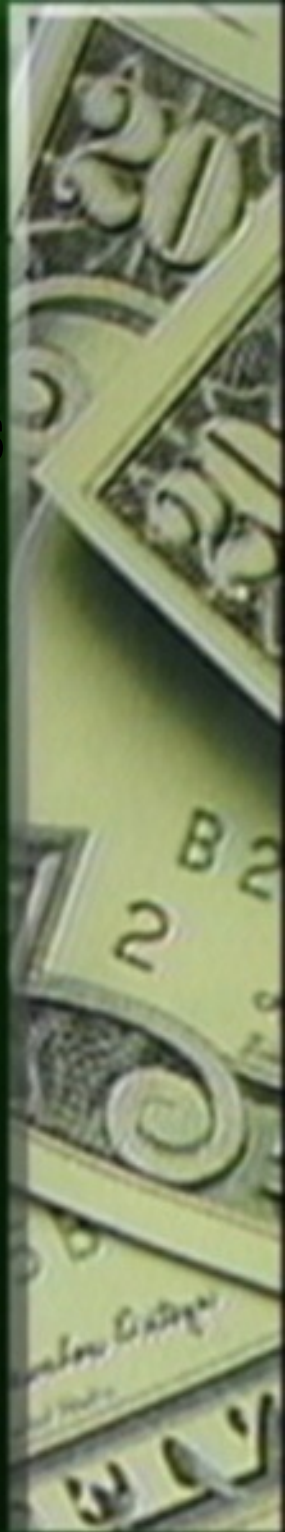# Internal Controls
Balancing Risk and Controls

Excessive Risks

- Loss of assets, public support, grants
- Poor business decisions
- Non-compliance
- Increased regulations
- Public scandal

Excessive Controls

- Increased bureaucracy
- Reduced productivity
- Increased complexity
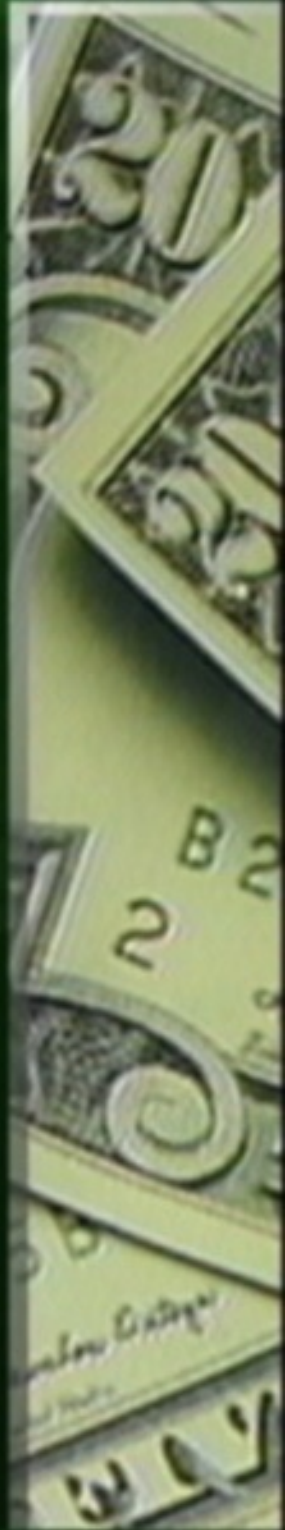- Increased time
- Increase of no-value added activities

Who is responsible?

- Board of education

- Superintendent

- School site administrators, treasurer, financial clerks, financial secretary and sponsors

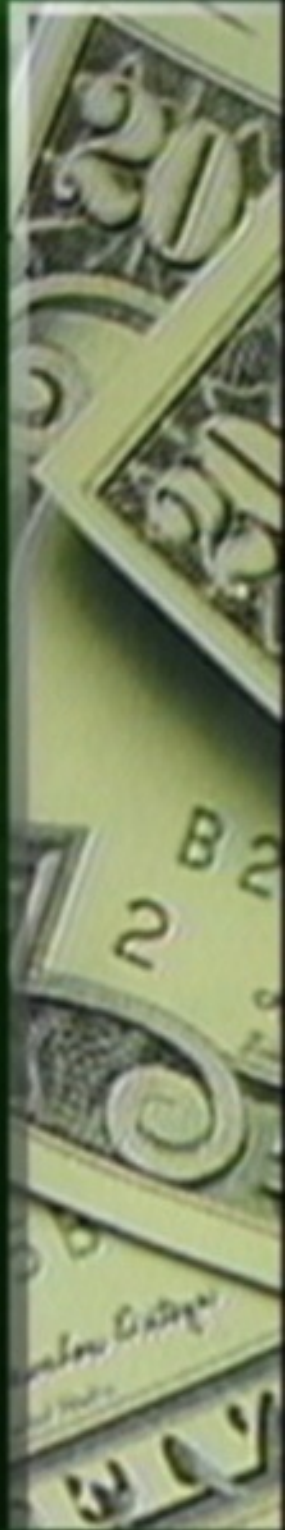# Internal Control Components

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

Internal Control Components

- Control Environment:
  - Mitigate risks
  - Build control-consciousness
    - Philosophy & operating style
    - Commitment to integrity & ethical values
    - Competency
    - Authority & responsibility
    - Organization & development

Internal Control Components

- **Control Environment Sample controls**
  - **Code of conduct**
  - **Regular internal control leadership meetings**
  - **Job descriptions**
  - **Competent individuals**
  - **Performance Review**

Internal Control Components

Risk Assessment

- Strategic: High-level goals to support the mission
- Financial: Safeguard assets
- Operational: Processes that achieve goal
- Compliance: Laws and regulations
- Reputation: Public Image

Internal Control Components

Risk Assessment Sample controls

- ❑ Policy
- ❑ Identification
- ❑ Participation
- ❑ Action plans
- ❑ Fraud

Internal Control Components

Control Activities: Actions, supported by policies and procedures that, when performed timely and properly, manage or reduce risk.

Internal Control Components

Control Activities Sample controls

- ❑ Policies and Procedures
- ❑ Segregation of duties
- ❑ Access restrictions
- ❑ Exceptions
- ❑ Technology changes
- ❑ Backups

Internal Control Components

Information and Communication

All organizations must identify, capture and communicate pertinent information in a form and timeframe that enables people to carry out their responsibilities.

Internal Control Components

Communication Sample Controls

- Policies and procedures
- Training
- Communication mechanisms
- Master service agreement
- Method of communicating change
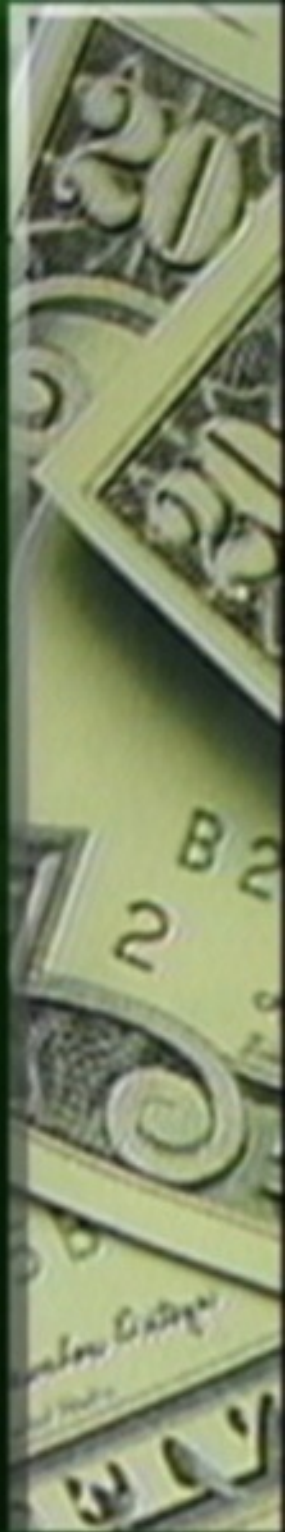
Internal Control Components

Monitoring: Consists of

Ongoing monitoring

Separate evaluations

Reporting deficiencies

Internal Control Components

Monitoring Sample controls

- ❑ Key activities
- ❑ Alerts
- ❑ Action plans

Internal control
Effective System

- Ethical tone at the top

- Written policies and procedures in place, understood and followed

- Organization-wide commitment to strong internal controls, effective risk management, and to meeting expectations of all stakeholders

Internal control Limitations

- Cannot ensure success if :
  - Bad decisions
  - Poor managers
  - Unethical behavior
  - Collusion
  - Override of controls
  - Competition

Internal control
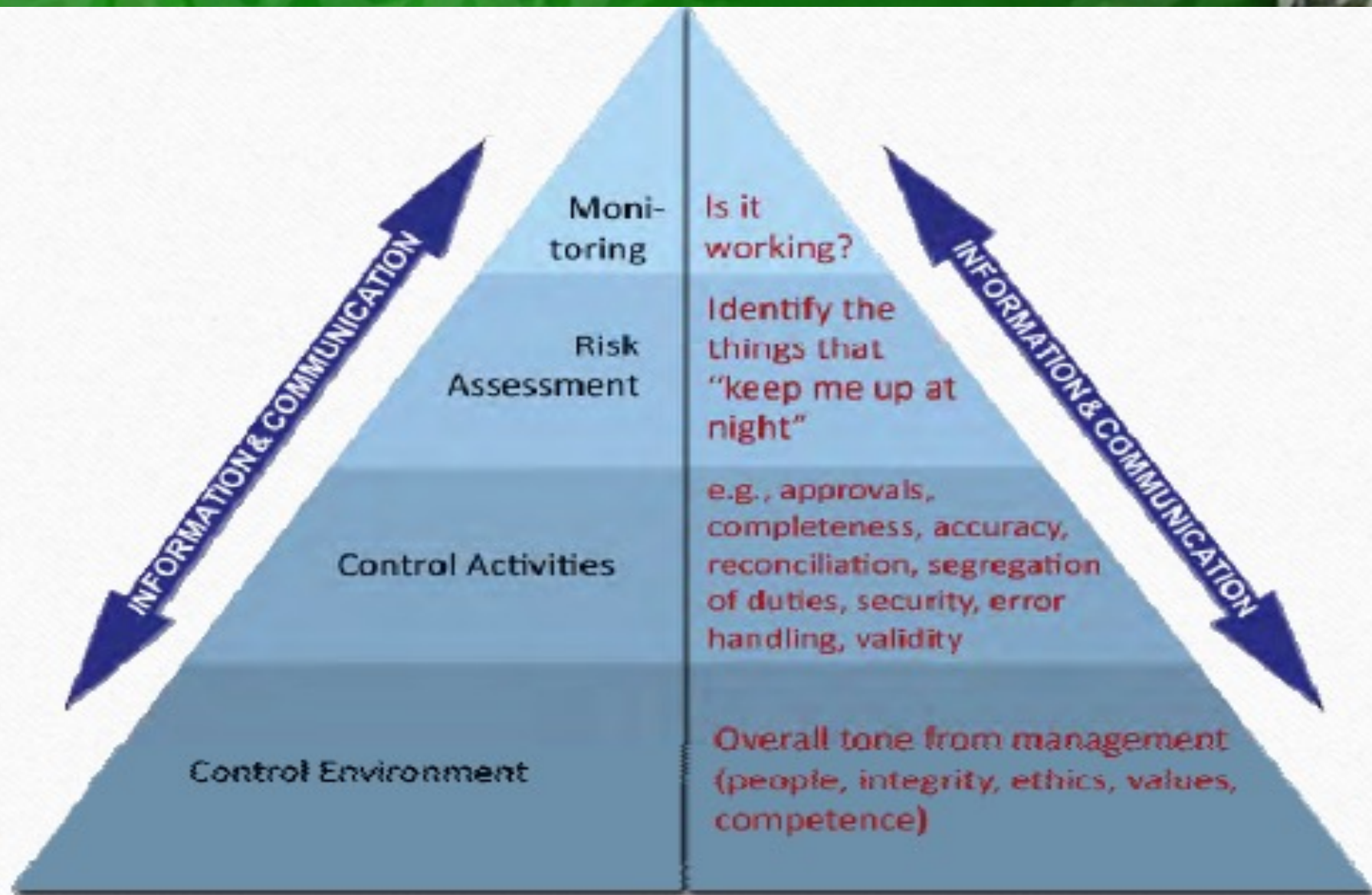
Internal control
Control Activities

Three Types of Internal Controls

1) Preventative   2) Detective   3) Corrective

Internal Controls

- **Preventive: Stop an unwanted outcome before it happens.**
  - Segregation of duties
  - Pre-approval of actions
  - Physical controls over assets
  - Tech controls over access to electronic records
  - Employee screening and testing

Internal Controls

- Detective: Find a problem before it grows.
  - Physical Inventory observations
  - Account reconciliations
  - Budget to actual review

Internal Controls

- Corrective: Take corrective action on discovered mistakes.
  - Credit card blocked when unauthorized charges occur
  - Bank puts hold on account when unauthorized withdrawal occurs
  - Training programs and penalty systems

The Internal Control Shield
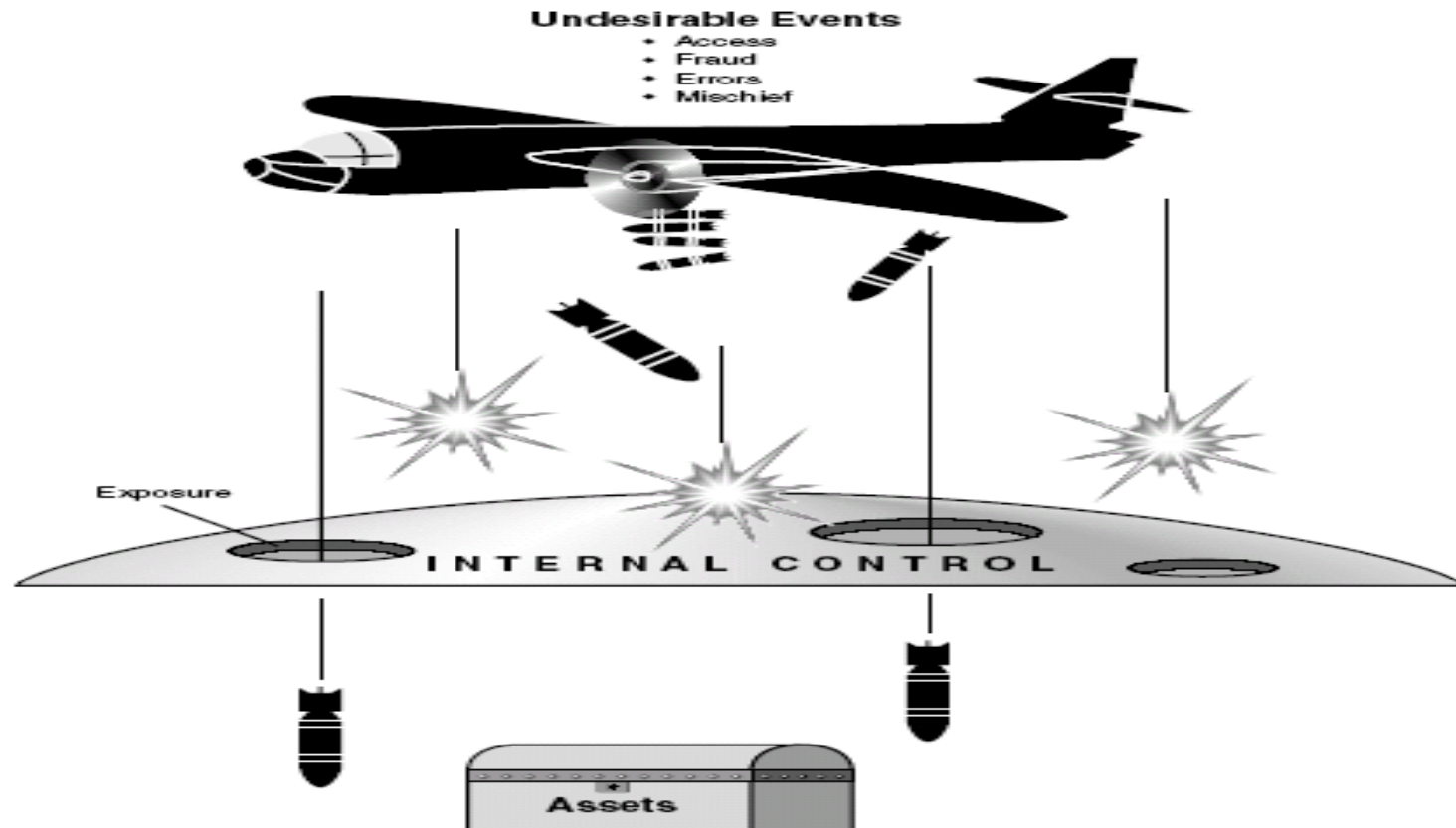
Preventive Control Segregation of Duties

Responsibility	Duty Category	Good (3 person)	Minimal (2 person)
Cash receiving and counting cash as part of balancing process	Asset Handling	Staff 1	Staff 1 and 2
Deposit preparation and recording of cash receipt	Booking/Recording	Staff 2	Staff 1 and 2
Corrections or adjustments review and approval.	Booking/Recording	Staff 3	Initiate: Staff 2 Approval: Staff 1
Make the Cash Deposit	Asset Handling	Staff 1	Staff 1
Compare cash deposits per the general ledger to those amounts appearing on deposit forms	Comparison/Review	Staff 3	Staff 2 with review preferably by treasurer who is not one of these 2 staff

Detective Controls

- Cash counts of deposits and bank reconciliations.

- Review payroll reports or , on a personal level, your pay stub.

- Compare transactions on reports with source documents.

- Monitor actual expenditures against budget.

Benefits

- Protect the weak from temptation.
- Protect the innocent from false accusations.
- Protect all others from opportunity.

Excuses?

- There is not enough staff to have adequate segregation of duties.
- It is too expensive and time consuming.
- The employees are trusted.

Occupational Fraud

"2022 Report to the Nations" Association of Certified Fraud Examiners

- Typical organization lose 5% of revenue annually to fraud.
- Most likely detected by tip than any other method (42%), followed by Management review (12%), Internal audit (16%), by accident (5%)
- Government entities rank as most commonly victimized.
- 49% of victims never recover any losses.
- 87% are first-time offenders
- 81% displayed behavioral red flags
  - Living beyond means (42%)
  - Financial difficulties (26%)
  - Unusually close association with vendors or customers
  - Excessive control issues
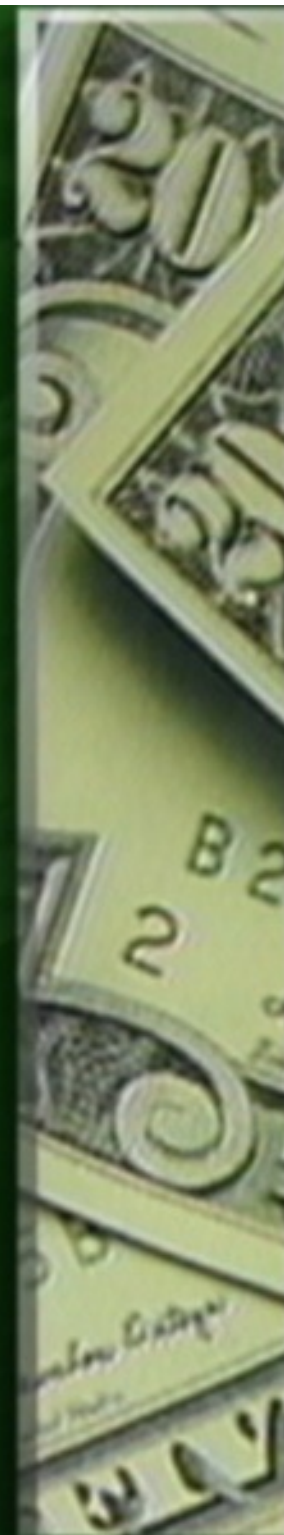
Categories of Occupational Fraud

- Asset misappropriation
- Corruption
- Financial statement fraud

Characteristics

Trustworthy	
Never arrested Educated Married Not likely divorced Religious Position of Responsibility	
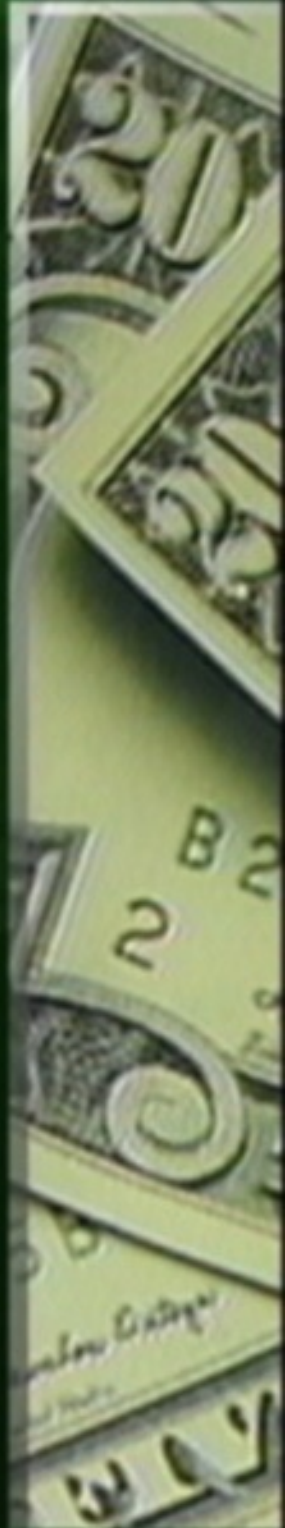
Characteristics

Trustworthy	Fraudster
Never arrested Educated Married Not likely divorced Religious Position of Responsibility	Never arrested Educated Married Not likely divorced Practices religious worship Position of Responsibility
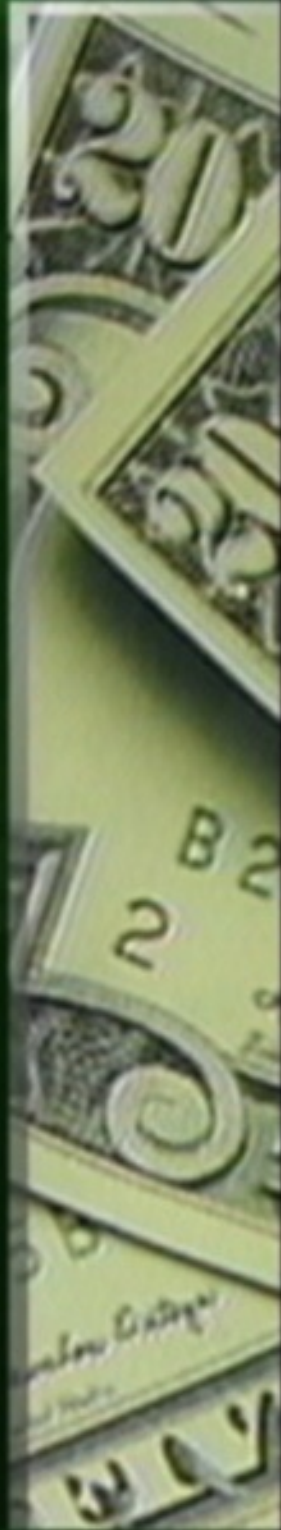
Characteristics

- **Position of trust usually necessary to obtain access to something of value**
- **Fewer restrictions are placed on those who appear trustworthy**
- **Only takes the capability of deceiving another**

Won't happen here!

- Regular failure to follow procedures
- Relying on trust rather than controls
- Key documents missing
- No separation of duties
- Photocopied or incomplete documentation
- Unusual behavior

Myths and Truths

Myth	Truth
Most people are honest and won't commit fraud	Anyone will commit fraud if fraud triangle is present: pressure, opportunity, rationalization
Fraud is usually well concealed	Red Flags of Fraud are usually visible: personal financial pressure, vices (gambling, substance abuse), extravagant purchases, missing files or data, no vacations, too good to be true performance

Myths and Truths

Myth	Truth
Auditors find fraud	According to Association of Certified Fraud examiners most fraud is discovered from tips and complaints.
Trusted employees won't commit fraud	These are the employees that know the system the best

Types of Asset Misappropriation

- Theft of Cash on hand
- Skimming: Taking of cash before the receipt of cash is recorded in the accounting system (theft of cash receipts)
- Cash larceny: Taking cash that has already been recorded (theft of cash receipts)
- Billing scheme: District unknowingly issues fraudulent payments for goods and services not received (Fraudulent disbursements)
- Payroll schemes: False documents produced for time not worked (ghost employees, falsified hours) (Fraudulent disbursements)
- Expense reimbursement schemes (Fraudulent disbursements)
- Check and payment tampering (Fraudulent disbursements)
- Misuse of inventory and other assets
- False purchasing and receiving (Larceny)
- Unconcealed Larceny (Larceny)

Concealment

- 40% created fraudulent physical documents
- 36% altered physical documents
- 27% altered electronic documents or files
- 26% created fraudulent electronic documents or files

Asset Misappropriation Inventory and Other assets

- ## Vendor Fraud

  - ### Sham vendors where employees funnel money to themselves, family or friends

Asset Misappropriation Inventory and Other assets

- ## Prevention of Vendor Fraud

  - Physical address instead of PO boxes
  - Contact info that overlaps employee info
  - Payments just under approval limits
  - Payments outside the normal procedures
  - Different delivery and payment addresses
  - Duplicate payments on same day or within the same payment cycle
  - Vendors outside your typical geographic region

Asset Misappropriation Inventory and Other assets

- Purchasing Scheme
  - Shell company created by employee submits invoices for payment
  - Employee overpays an invoice and then arranges to have overpayment returned to employee
  - Employee submits personal invoices for payment or uses a district credit card for personal purchases

Asset Misappropriation Inventory and Other assets

Prevention of Purchasing Scheme

- Purchase orders required specific descriptions of items, quantities and prices
- Receiving function is separate from purchasing and receiving report is required for all procurement purchases (quantities are counted and compared to invoice and purchase order)
- Mandatory vacations
- Dual approval required for new vendor setup especially if electronic payments are remitted
- Approval of any adjustments to vendor accounts
- Increased scrutiny and approval for invoices for services rendered
- Original support required for all credit card transactions
- Clear explanation of District purpose for all credit card charges

Asset Misappropriation
Inventory and Other assets

- Theft of inventory and equipment
  - Employee uses purchasing authority to purchase and misappropriate merchandise
  - Employee misappropriates assets purchased as they are received
  - Employee "borrows" assets for personal use
  - Employee takes assets from premises

Asset Misappropriation Inventory and Other assets

- ## Prevention of Theft of inventory and equipment
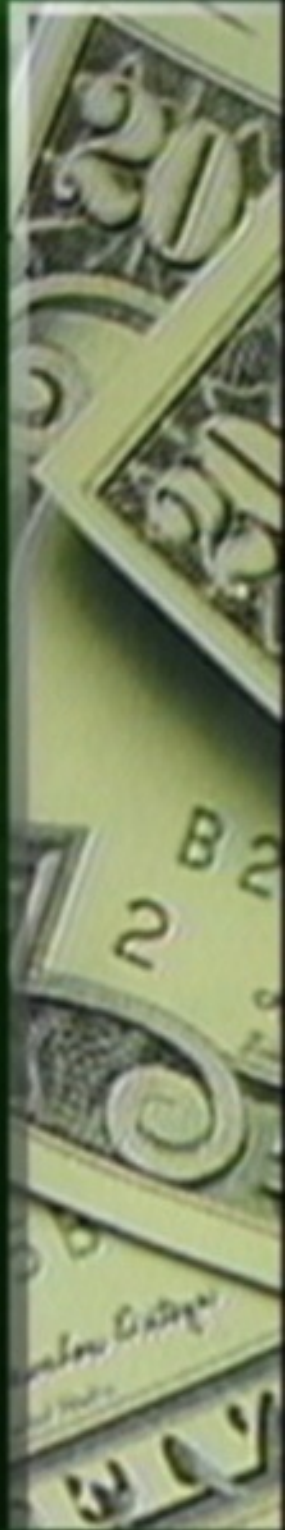   - Recent inventory of equipment listing serial numbers and descriptions
    - Purchase orders required specific descriptions of items, quantities and prices
    - Receiving function is separate from purchasing and receiving report is required for all procurement purchases (quantities are counted and compared to invoice and purchase order)
    - Mandatory vacations

Asset Misappropriation Fraudulent Disbursements

- ## Expense Scheme
  - Employee requests reimbursement for a personal expense characterizing it as business related
  - Employee overstates actual expenses and seeks reimbursement
  - Employee creates a fictitious expense and seeks reimbursement
  - Employee submits single expense for reimbursement multiple times
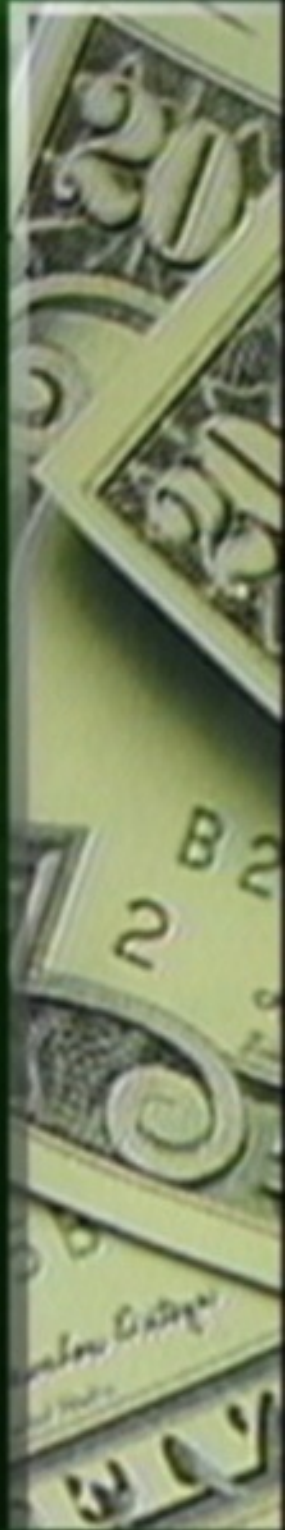
Asset Misappropriation Fraudulent Disbursements

- Prevention of Expense Scheme
  - Detail independent review before payment
  - Receipts required for all expenses reimbursed
  - Examination of receipts and expenses to determine same expense is not submitted twice

Asset Misappropriation Fraudulent Disbursements

- Payroll Scheme
  - Person not employed is on the payroll
  - Employee is paid based on falsified hours and/or rates

Asset Misappropriation Fraudulent Disbursements

□ **Prevention of Payroll Scheme**

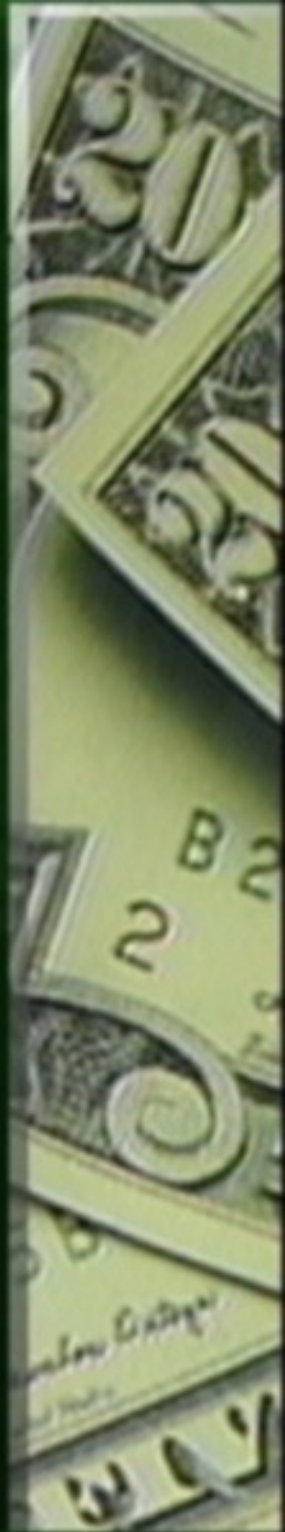 □ Personnel set-up and records are maintained independently of payroll and timekeeping

  □ Require appropriate signed documents for payroll setup and deductions

  □ Review of direct deposit payroll information for duplicate entries

  □ Payroll distribution independent of the department authorizing payroll or entering payroll

  □ Changes to employee payroll files are reviewed and approved by someone independent of employee processing the change.

  □ Mandatory vacations

  □ Employees are required to provide identification

Asset Misappropriation Fraudulent Disbursements

- Expense Scheme
- Payroll Scheme
- Check Tampering Scheme
  - Forged authorized signature
  - Forged endorsement
  - Altered payee
  - Fraudulent checks for personal benefit

Asset Misappropriation Fraudulent Disbursements

□ **Prevention of Check Tampering**
   - □ **Unused checks stored in secure location with limited access**
   - □ **Use of electronic payments where possible to limit paper checks**
   - □ **Positive pay controls with bank**
   - □ **Preparation segregated from authorized signer**
   - □ **Comparison of payees on checks clearing bank to cash disbursement records**
   - □ **Segregation of duties between printing, posting , signing, mailing checks and reconciling the bank statement**

Asset Misappropriation Fraudulent Disbursements

- Expense Scheme

- Payroll Scheme

- Check Tampering Scheme

- Billing Scheme
  - Invoice from fictitious entity for goods and services typically purchased
  - Invoices for false purchased from valid vendor
  - Legitimate vendor invoices that have been tampered with
  - Personal purchased billed to District or paid by District credit card

Asset Misappropriation Fraudulent Disbursements

- Prevention of Billing Schemes
  - Invoices , purchase orders and receiving documents matched before payment
  - Purchasing department independent of : receiving , shipping,, accounting
  - Maintain an approved vendor list
  - Limit the use of blanket purchase orders

Federal Aid

- **May only be used for allowable, allocable costs within each federal program**
  - **Failure to comply can result in having to repay some or all of funds**
- **In some cases, a district or person may be guilty of a violation of the False Claims Act (FCA) .**
  - **The district and/or individual may have to repay substantially more than what was received.**

Federal Aid

- Be familiar with restrictions, conditions and other requirements of accepting federal funds
    - Pay attention to Uniform Guidance requirements
- Ensure effective processes are in place to ensure proper use of federal funds.
    - Adequate procurement
    - Monitoring

Federal Aid Fraud

□ **Fraud Indicators**

  □ No separation of duties

  □ Missing school funds or property

  □ Inventory and financial records not reconciled

  □ Unauthorized or related-party transactions

  □ Altered, inadequate or missing documentation

  □ Grant award money runs out too quickly

  □ Unreasonable costs

  □ Delayed or no reporting

Federal Aid Fraud

- ## Public Corruption
  - Irregularities or undue influence by people in decision-making positions
  - Suspicious bidding trends or patterns
  - Overriding internal controls
  - Billing and payment requests for services that may not been provided
  - Duplicate claim for the same services
  - Transactions lacking a business purpose
  - Unusually large amounts of cash payments
  - Nepotism and favoritism

- ## Computer Crime
  - Accessing without authorization any IT system that is used to administer ED funding

Where in the World is the Fraudster?

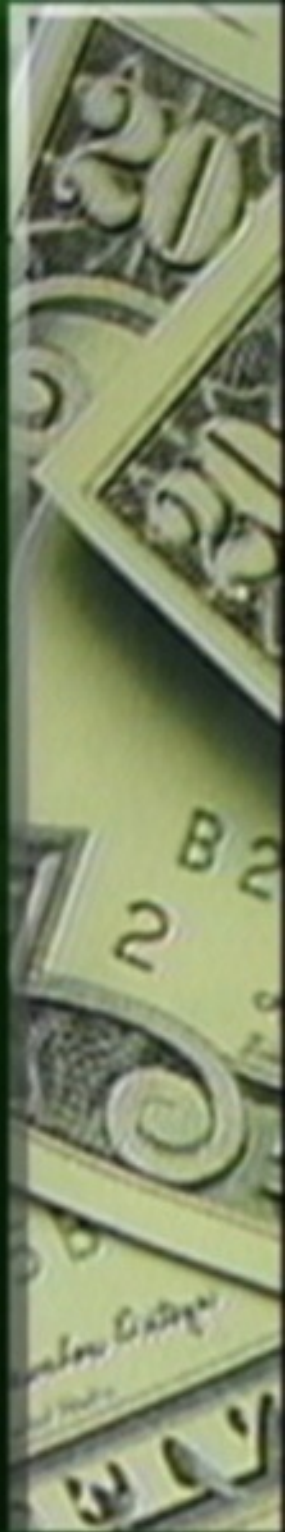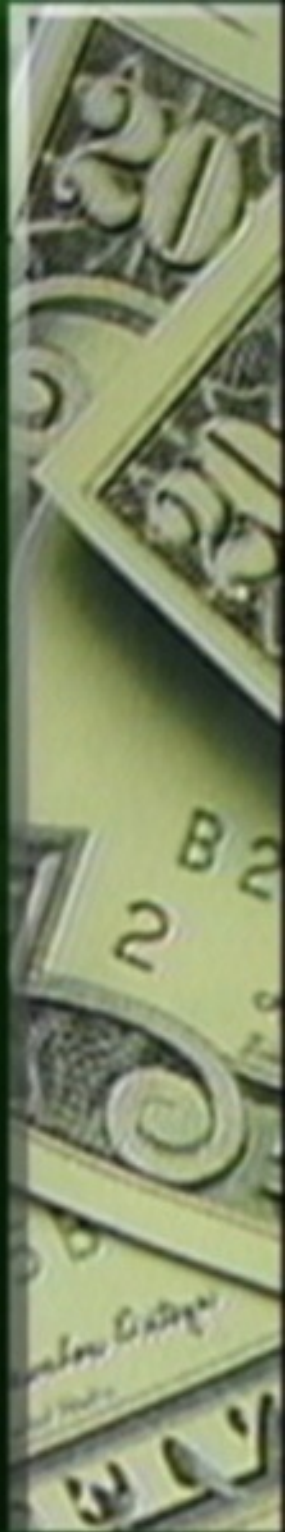- School principal purchases of pre-paid debit cards using the school district's store credit cards at area businesses.
  - Said he needed the funds to purchase "apps" for students' computers
  - He provided receipts for the purchase of the pre-paid debit cards certifying use was for legitimate school district purchase.
- He then transferred the balances of the pre-paid debit cards to another account on PayPal that he controlled. He had opened the account in the school district's name , without their consent.
- A new superintendent was hired who started looking at principal's spending practices.
- Fraudster provided spreadsheets purporting to show apps he had purchased. He had actually made hundred of purchases of food, travel , show tickets, electronics.
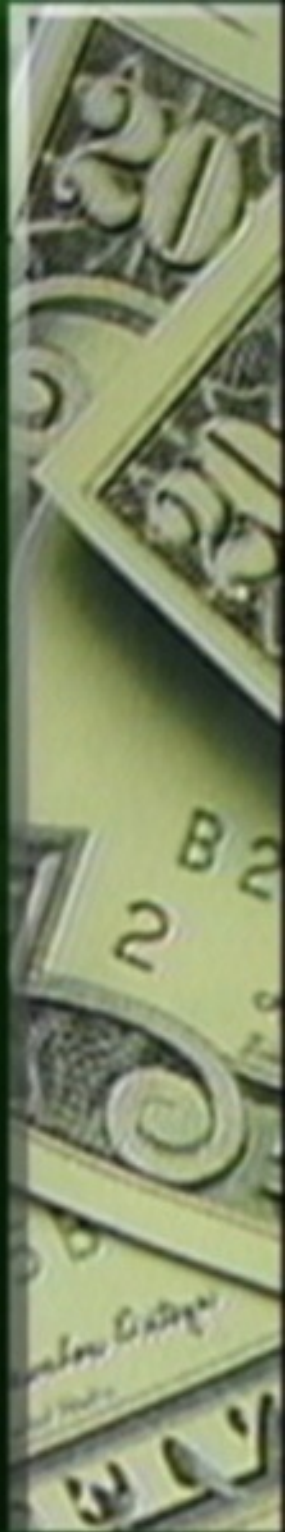
Where in the World is the Fraudster?

- Director of Early Childhood education has worked for district for 8 years.
- She was issued 2 credit cards that were funded with state and federal grants.
  - The cards were to be used to make purchases for the program
  - Documentation of purchases was required
- Director was providing fabricated receipts and transaction logs.
- District was able to obtain original receipts from credit card purchases.
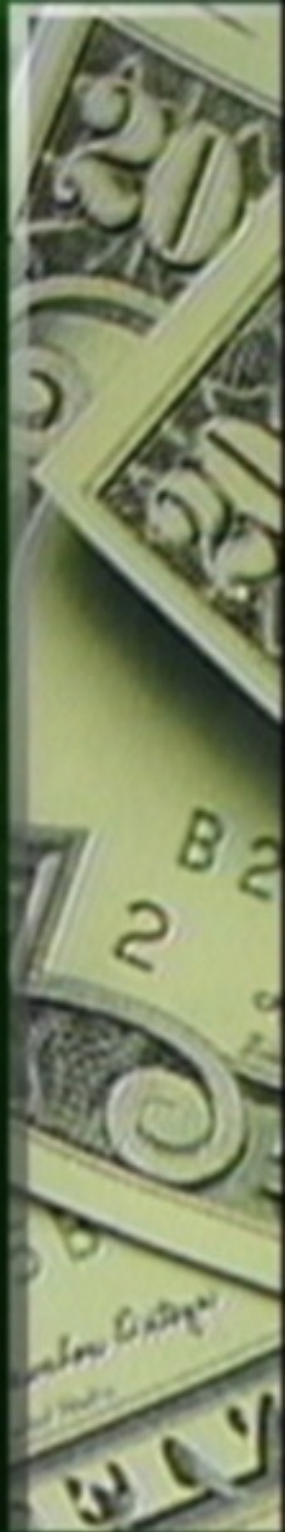 - Director was using cards to shop online.

Where in the World is the Fraudster?

- Purchasing clerk prepares purchase order for school supplies.
- Sales associate at school supply vendor falsified vendor invoices to make it appear that legitimate school supplies had been delivered.
  - In fact , money was diverted to purchase Ipads, Iphones and gift cards for personal use.
- At the same district, a principal was charged with scheme to have employees file for overtime they didn't work and kick back $200,000 to her.
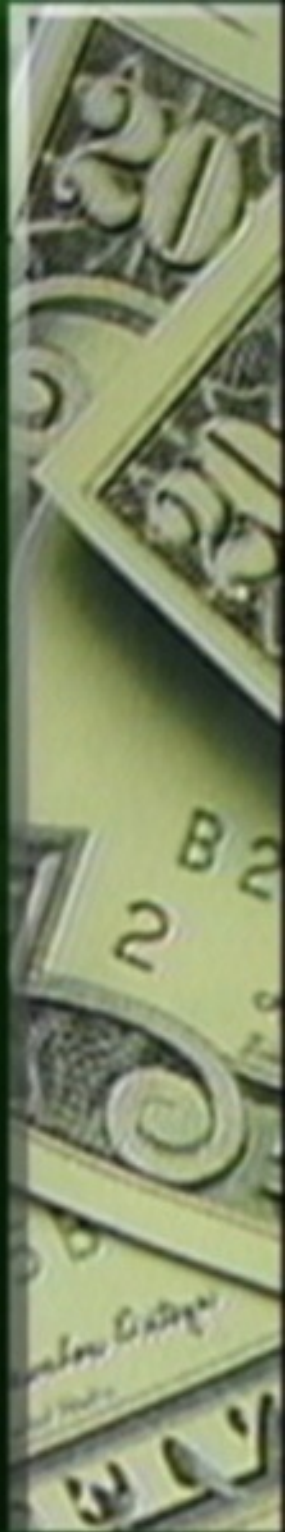
Where in the World is the Fraudster?

- Chief financial officer overpaid vendors with school district accounts then cash the refunds when the vendors issued a refund. He has been accused of stealing over $450,000. Federal indictments charged him with one count fraud and embezzlement , nine counts of money laundering and 10 counts of wire fraud. He was given a 63 month sentence at the age of 62 and restitution of $1.2 million
  - While out on bond, awaiting trial, he stole $35,000 from a local business that hired him as a bookkeeper
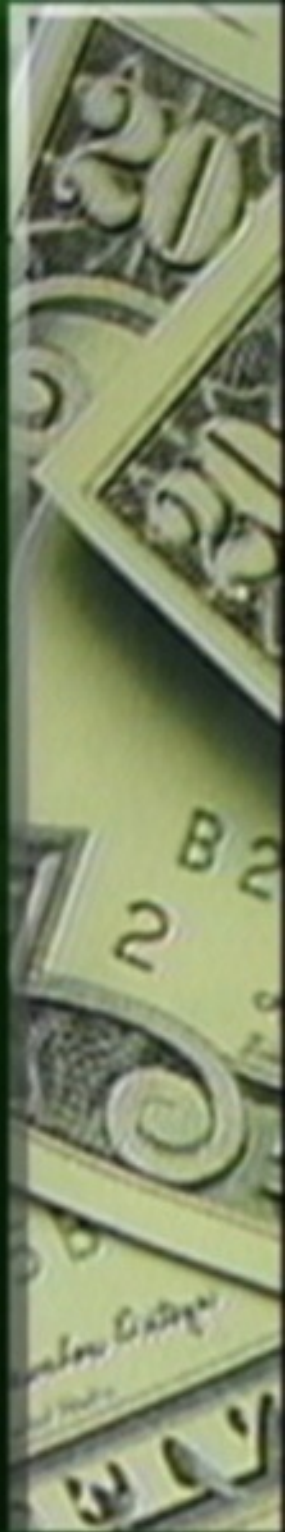
- .

Where in the World is the Fraudster?

- Director of food services placed hundreds of unauthorized orders for food using school district account
- Bulk of orders were chicken wings from the district's main vendor
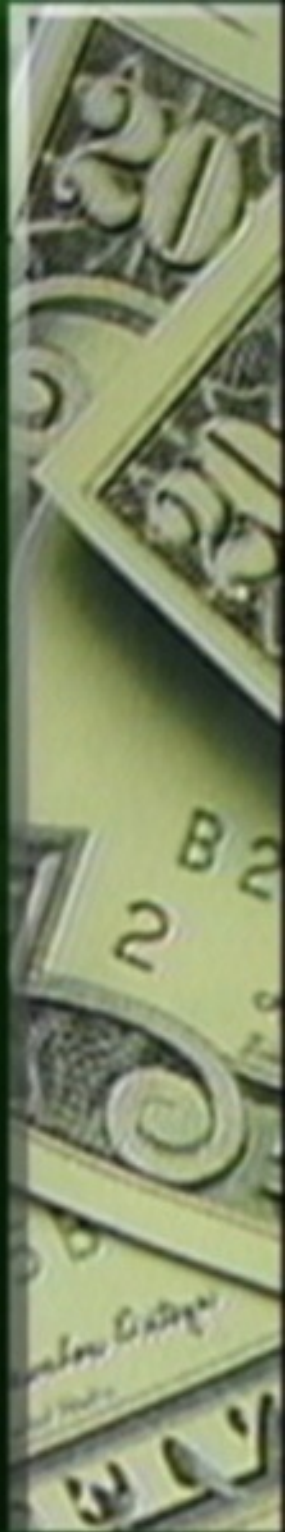- Resulted in $1.5 million in alleged embezzlement over 2 years.

Federal Financial Aid Misuse

- Former deputy superintendent and former district security coordinator and 18 others , including police officers, sheriff deputies and a teacher, were charged in ghost employee scam.
  - Scam: Schedule the individual to work as security guards for school events
    - In some cases, defendants are accused of setting fires or vandalism to justify adding a security officer.
    - Also bloated number of personnel needed for overseeing athletic events
- The deputy superintendent would pick up the check for the ghost employee, cash it and in exchange for using their name, give them 50%. The rest was split between deputy superintendent and the security coordinator.
- Security coordinator also negotiated with a women to use her deployed husband's name as a ghost employee.
  - She subsequently filed a sexual harassment complaint against the security coordinator.

Prevention and Detection

- Know what is acceptable and isn't acceptable "I didn't know that!"
- Inadequate segregation of duties: " We trust 'A'" Remember only people we trust can steal from us. We normally watch the others.
- Control override: " I know that's the policy, but we do it this way."
- Never be intimidated by explanations that are not understandable.
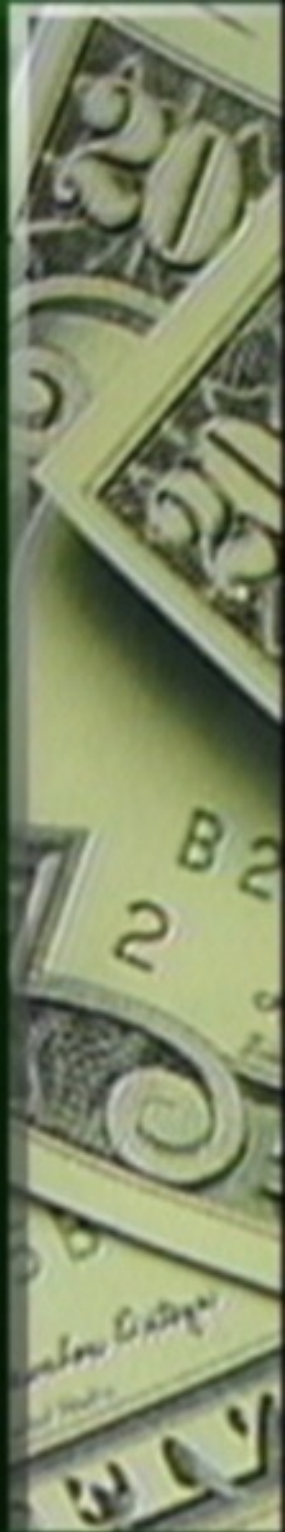- People are people and mistakes happen. You can't foresee or eliminate all risk.

Final Thoughts

- "Trust everyone but always cut the cards"

Mark Twain

- "If you want to make enemies, try to change something."

Woodrow Wilson

Closing

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