

One Bad Apple Can Ruin Your School District's Finances and Reputation

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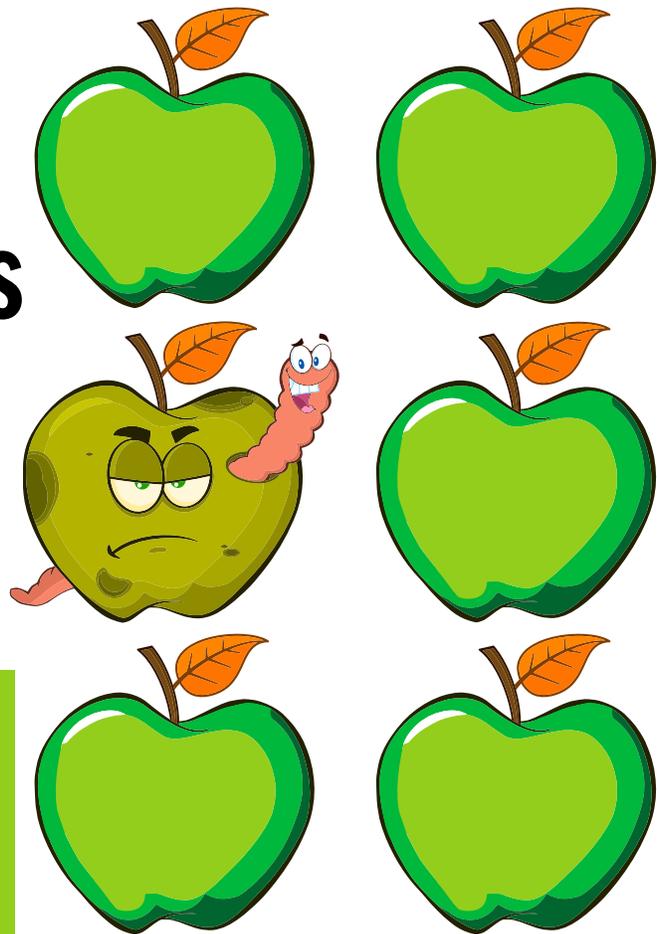
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A former chief financial officer pleaded guilty to 20 federal counts of embezzlement, wire fraud, and money laundering over a 16-year period after stealing \$1.2 million from his former employer. This CFO oversaw all of the employer's finances, including a nearly \$260 million general fund, and misspent \$46 million of the fund balance.

This news item is not about a corrupt corporate CFO – it is about the once-trusted CFO for the Berkeley County School District, who pulled off what is believed to be the largest public embezzlement scheme in the history of South Carolina.¹

What happened in South Carolina is a stark example of how a school district can fall victim not only to financial fraud, but even unintentional financial mistakes, by not establishing the right

¹ “Berkeley schools CFO who embezzled \$1.2 million sentenced to 63 months in federal prison,” The Post and Courier, February 19, 2019, available at https://www.postandcourier.com/news/berkeley-schools-cfo-who-embezzled-million-sentenced-to-months-in-article_c6ab085e-347b-11e9-a3c4-fb69aba546dc.html



internal procedures. This article aims to highlight important policies and processes for school districts to implement in order to minimize the risk of fraudulent activity and financial mishandling.

The Landscape of Financial Fraud

The sad reality is that financial fraud is far from uncommon. The Association of Certified Fraud Examiners (ACFE) publishes an annual study on occupational fraud – defined as the use of one's occupation for personal enrichment through the deliberate misuse of an employer's resources or assets. According to ACFE's 2018 report, the 2,690 studied cases of occupational fraud are believed to be only a small fraction of the actual number of occupational fraud incidents that occurred globally,² strongly suggesting

² For comprehensive information on ACFE's current findings on occupational fraud, refer to “Report to the Nations: 2018 Global Study on Occupational fraud

that fraud is more rampant than the schemes that are detected, investigated and reported.

The ACFE study data reveal striking trends: 89% of fraud involved asset misappropriation (schemes involving billing, check and payment tampering, and theft of non-cash assets), and 80% of all fraudsters either created fraudulent evidence or altered existing evidence to conceal the fraud.³ Moreover, occupational fraud is hardly confined to public and private corporations, or large organizations. Of the organizations victimized by fraud, 16% are governmental entities. Among governmental entities, local government units accounted for 31% of the cases, while state and provincial government units were victims in 26% of the cases. In looking at overall organization size, 28% of the cases in the study involved small organizations (100 or fewer employees).⁴ With regard to small organizations, 42% of fraud involved a lack of internal controls, and the median loss was \$200,000 – compared to a median loss across all sizes of organizations of \$130,000.⁵

These figures, along with other well-publicized financial shenanigans that have taken place in recent years in schools, should hit home to school leaders. Public schools are rich targets for internal fraud schemes based on the amount of operating funds in their control. It is important to remember that many school districts are relatively small-sized organizations without significant administrative staff. Based on the ACFE fraud study data, these smaller school districts could be more vulnerable to costly financial fraud or errors than larger districts.

and Abuse,” Association of Certified Fraud Examiners, available at <https://www.acfe.com/report-to-the-nations/2018/>.

3 See “Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse,” p. 12, 15, available at <https://www.acfe.com/report-to-the-nations/2018/>.

4 See “Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse,” p. 20-1, available at <https://www.acfe.com/report-to-the-nations/2018/>.

5 See “Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse,” pp. 9, 22-3, available at <https://www.acfe.com/report-to-the-nations/2018/>.

Establish Strong Internal Controls

Internal controls are an organization’s processes and structures designed to prevent fraud, and are the cornerstone for maintaining any organization’s financial integrity. A strong internal control system includes the following:

- Segregation of duties
- Restriction of physical and electronic access to assets, records, and IT systems
- Regular data monitoring/analysis (e.g. reconciliation of bank statements and accounts)
- Regular examination of supporting financial documentation
- Regular internal and external audits
- Surprise audits
- Mandatory vacation time for employees with financial authority

The segregation of duties is the most crucial internal control for school districts. Financial errors or impropriety can easily occur when one person controls or can influence all aspects of a school district’s financial transactions. Although a school district’s treasurer has ultimate responsibility for all of a school district’s assets, the treasurer should not control all phases of any school transaction. For this reason, a “Rule of Three” is an effective segregation of duties approach: (1) the treasurer maintains oversight, ultimate responsibility and the power to disburse funds; (2) the business manager (or equivalent role) processes invoices or bills and authorizes the payment of funds; and (3) a third official is responsible for reconciling the school’s bank accounts with the internal school ledger of deposits and disbursements.

In smaller school districts, segregation of duties can pose a challenge due to fewer employees on staff. Accordingly, smaller school districts should consider having a school district official or other trusted party outside the business office review the bank statements or other financial reports for unusual activity or the possibility of error.

Top-down Integrity

For fraud prevention and detection to become part of a school district’s culture, leadership needs

to set the tone about responsible stewardship of public resources. From the superintendent, to business officials, to individual school principals, school district leadership should model and support ethical practices and behavior, open communication about mistakes and potential problems, willingness to correct mistakes, and investigating potential fraudulent activity with appropriate speed and seriousness. The open communication piece is extremely important; otherwise, employees might be reluctant to come forward with allegations of misconduct.

Exercise Diligence in Hiring & Observing Employees

According to the ACFE study, there is no “typical” person who commits fraud – and many fraudsters appear to be honest people on the surface. However, the following hiring process activities can root out the potential for fraud, where allowed by state law:

- Criminal and civil background checks
- Credit checks
- Past employment & education verification
- Reference checks
- Drug screening

After hiring, supervisors and management should stay vigilant not only about quality of employee work product, but in observing employee behavior. Although no foolproof fraudster profile exists, “red flag” employee behaviors include living beyond means, financial difficulties, unusually close association with a vendor/customer, controlling behaviors/ unwillingness to allow access to work product or sharing of duties, divorce/family problems, irritability, suspiciousness or defensiveness.

Establish Fraud Policy & Procedures

Like any employer, school districts should adopt a policy against fraud, waste and abuse. The policy should include the following: examples of inappropriate or suspicious financial dealings; a requirement for employees to report suspected fraud, waste or abuse to a specific school district official; and an anti-retaliation policy for

reporting suspected financial impropriety. Some large organizations have internal fraud hotlines that employees can call to report fraud, which is particularly important in the event that the suspected fraud involves high ranking people in the organization. For smaller organizations, this can be impractical or impossible, so having a third party vendor hotline is one solution to this issue.

The policy should also state the actions that the school district will take to investigate allegations, and a statement of zero tolerance for fraud, waste and abuse, up to and including referral to law enforcement and termination of employees found to have engaged in the conduct.

Train Employees

Employees need to know how to spot problems in order to identify, report and avoid financial irregularities. Therefore, school districts must raise awareness by training their employees to understand what constitutes fraud, the organizational costs of fraud, and how employees can seek advice when faced with ethical dilemmas, such as being asked to override established internal controls. Fraud instruction should also include specific examples of types of fraud, as well as warning signs or “red flags” indicative of possible fraud. Training should highlight the key points of the applicable policy regarding fraud, including the fraud zero-tolerance policy. Importantly, the training should emphasize that employees can report suspicious activity without fear of reprisal or retaliation.

Investigate Promptly & Take Action

Sweeping employees’ reports of errors or suspicious activity under the rug will undermine efforts to root out fraud or other problems. When employees come forward with potential fraudulent conduct, school districts need to respond to the allegations with an investigation according to written policy. In the event that an investigation does uncover inappropriate activity, school districts must take appropriate action – including termination of the employees involved, and criminal referrals to law enforcement if warranted – according to the written policy.

Potential Recovery

In the event of a loss due to financial fraud or mistakes, a school district can possibly recoup losses sustained by turning to various vehicles such as a surety bond or insurance coverage. In some states, school districts are required to purchase surety bonds to help protect the school district from failure of the treasurer to faithfully perform his or her duties. If a financial fraud or mistake involves a school district's treasurer, a claim under a surety bond might be presented. Insurance coverages, such as crime/fidelity, directors' and officers' liability, errors and omissions, and cyber liability, could also apply. The viability of any claim will be highly dependent upon the specific facts of the loss, the parties involved, the type of coverages purchased, and the specific language of the coverages. School districts would be well-advised to consult their attorney and their agent concerning coverages that could apply to a loss.

Protect Your School District

Without the implementation of the policies and processes discussed above, school districts may be vulnerable to financial duplicity or human errors, potentially costing significant resources. By implementing the practical steps described above, school districts can go a long way to help control the risks of financial impropriety.



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