

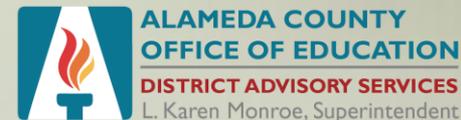
Identifying and Investigating Financial Fraud & Mismanagement

CARSNet Conference
September 24-25, 2019

Presented By:

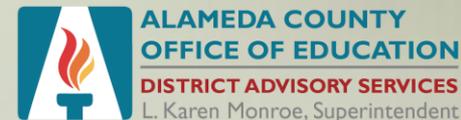
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Overview

- Types of Fraud
- Nationwide Fraud Statistics
- Internal Controls
- External Audit
- Red Flags
- Evidence Collection
- Liability Considerations
- Case Study



Investigations of Charters Schools and Charter Officials

New Mexico Charter School CEO Steals Public Money For 15 Years. How's That For Oversight?

12/25/2017 10:11 pm ET | Updated Dec 26, 2017

HUFFPOST

THE UNITED STATES ATTORNEY'S OFFICE

FOR IMMEDIATE RELEASE

Wednesday, November 2, 2016

Charter School Administrator Pleads Guilty to Federal Program Theft

Charter leaders fired, they spent thousands on cars, spas, concerts

[Matthew Albright](#), The News Journal | Published 12:35 p.m. ET Jan. 13, 2015 | Updated 4:05 p.m. ET Jan. 15, 2015

Investigations of Charters Schools and Charter Officials

A3 Charter Fraud Scheme:

Prosecutors: Two men stole \$50 million in online charter school scheme, 11 face charges

LA Charter School Indicted In Massive Fraud Case

The DA alleges 11 people conspired to steal over \$50 million in public funds to open 19 CA charter schools, & use them to defraud the state.

By Ashley Ludwig, Patch Staff
May 29, 2019 6:39 pm ET

Schools Tied to A3 Charter School Scandal Will All Close

An online charter school empire whose leaders have been charged with enrolling fake students and misappropriating \$80 million in public funds will be forced to close all of its schools across California.

Investigations of Charters Schools and Charter Officials

KTLA: Exclusive -- School Operator Accused of Taking \$3 Million -- Chip Yost Reports

(02:26) 10/09/2009 at 05:27am



Types of Fraud

➤ Occupational Fraud

- Asset misappropriation, corruption, and/or manipulation of financial statements.
- Cash skimming, falsifying expense reports and/or forging company checks.

Types of Fraud

➤ Conflicts of Interest

“Corruption schemes involving an employee using his / her influence in business transactions to obtain a personal benefit that violates that employee’s duty to the employer or the organization.”

Conflict of Interest (COI)

- **What is, and is not, a conflict of interest**

Conflict of interest – the motive involves the subject's own hidden interest

Bribery – the motive is to influence

- **Characteristics**

- ✓ Generally at higher levels within the organization
- ✓ Difficult to investigate and prosecute
- ✓ Can be a subject supported by management and others
- ✓ Takes considerable time and expense to investigate

Typical COI Situations

Most COIs involve undisclosed financial interests:

- Undisclosed financial interest with a vendor, supplier or contractor
- Fictitious vendor or contractor
- Involvement with a vendor or contractor having a separate business in competition with entity
- Employee acceptance of gifts, travel, kickbacks

Fraud On The Rise

Number of U.S. Complaint Reports by Type			
Year	Fraud	Identity Theft	Other
2001	137,336	86,250	101,963
2002	241,783	161,977	146,862
2003	331,336	215,240	167,051
2004	410,298	246,909	203,176
2005	487,585	255,687	216,042
2006	423,672	246,214	236,243
2007	505,563	259,314	305,570
2008	620,832	314,587	325,705
2009	708,781	278,360	441,836
2010	820,072	251,074	399,160
2011	1,041,517	279,191	577,835
2012	1,112,693	369,958	632,428
2013	1,159,115	290,098	685,352
2014	1,526,365	332,545	762,021
2015	1,165,625	490,112	1,427,784
2016	1,226,402	398,952	1,423,823
2017	1,290,636	371,034	1,215,464
2018	1,427,563	444,602	1,125,354



Source: Federal Trade Commission

Fraud On The Rise

Complaints in 2018

Theft Type	Theft subtype	Rank	No. of reports	Change from previous year
Credit card fraud	New accounts	1	130,928	+24%
	Existing accounts	5	32,329	-6%
Employment or tax-related fraud	Tax fraud	3	38,967	-38%
	Employment or wage-related	6	30,592	+44%
Phone or utilities fraud	Mobile telephone - new accounts	4	33,466	+28%
	Utilities- new accounts	8	21,994	+0%
	Landline telephone - new accounts	17	7,838	+28%
	Mobile telephone - existing accounts	23	4,983	+6%
	Landline telephone - existing accounts	27	1,423	+25%
	Utilities - existing accounts	28	1,322	+20%
Bank fraud	Debit cards, electronic transfer/ACH	7	23,219	+0%
	New accounts	10	19,639	+12%
	Existing accounts	14	12,990	+2%
Loan or lease fraud	Business/personal loan	9	20,328	+82%
	Auto loan/lease	11	18,815	+89%
	Non-federal student loan	18	6,327	+78%
	Apartment or house rented	20	5,439	+50%
	Real estate loan	21	5,178	+17%
	Federal student loan	22	5,082	+119%



Source: Federal Trade Commission

Fraud On The Rise

Complaints in 2018 (con't)

Theft Type	Theft subtype	Rank	No. of reports	Change from previous year
Government documents or benefits fraud	Government benefits applied for/received	12	16,021	-10%
	Other government documents issued	19	5,645	+5%
	Driver's license issued/forged	24	4,493	+19%
	Passport issued/forged	29	703	+35%
Other identity theft	Other	2	87,675	+121%
	Medical Services	13	13,833	+103%
	Online shopping or payment account	15	10,294	+18%
	Email or social media	16	9,439	+23%
	Evading the law	24	4,439	+7%
	Insurance	25	3,675	+24%
	Securities accounts	26	1,837	+15%



Note: The data in this table does not total the identity theft complaints for 2018 because, according to the FTC, consumers can report multiple types of identity theft.

Source: Federal Trade Commission

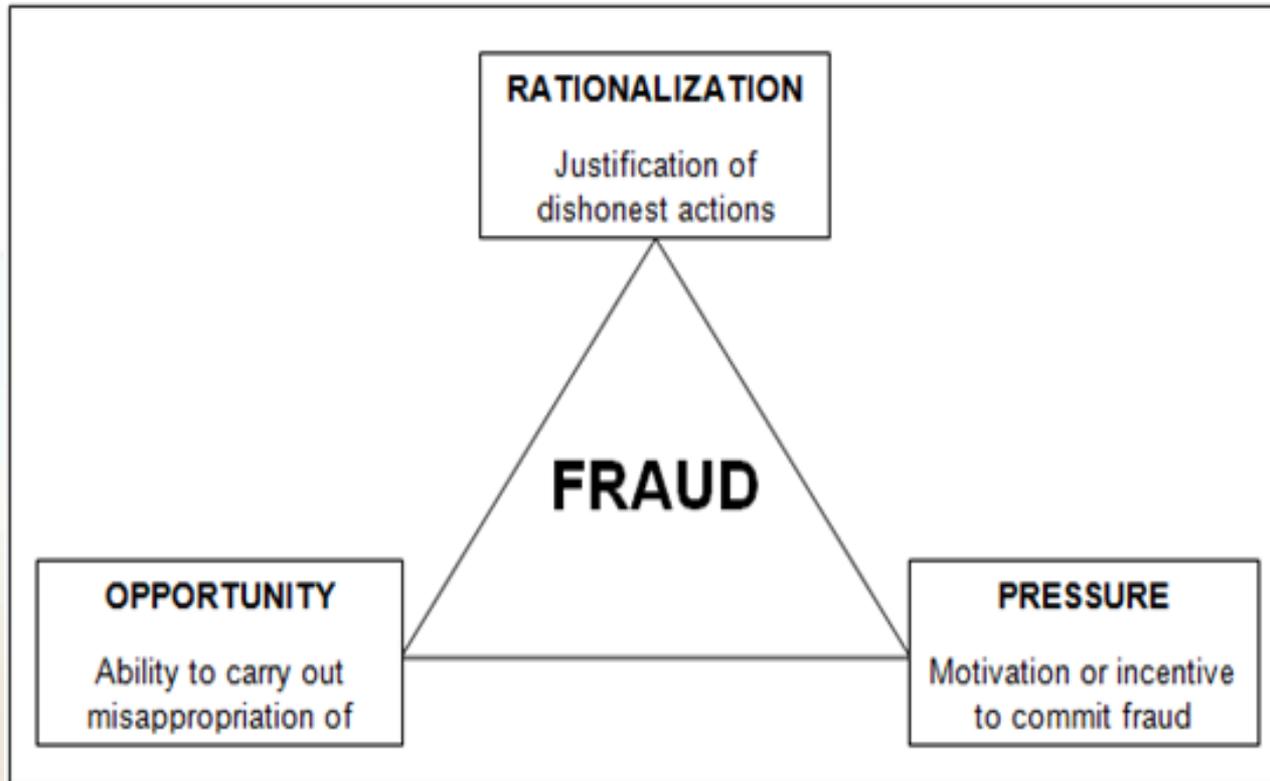
Fraud On The Rise

Age group	No. of complaint reports
19 and under	14,251
20-29	76,760
30-39	107,367
40-49	84,165
50-59	63,229
60-69	42,704
70-79	16,462
80 and higher	5,989



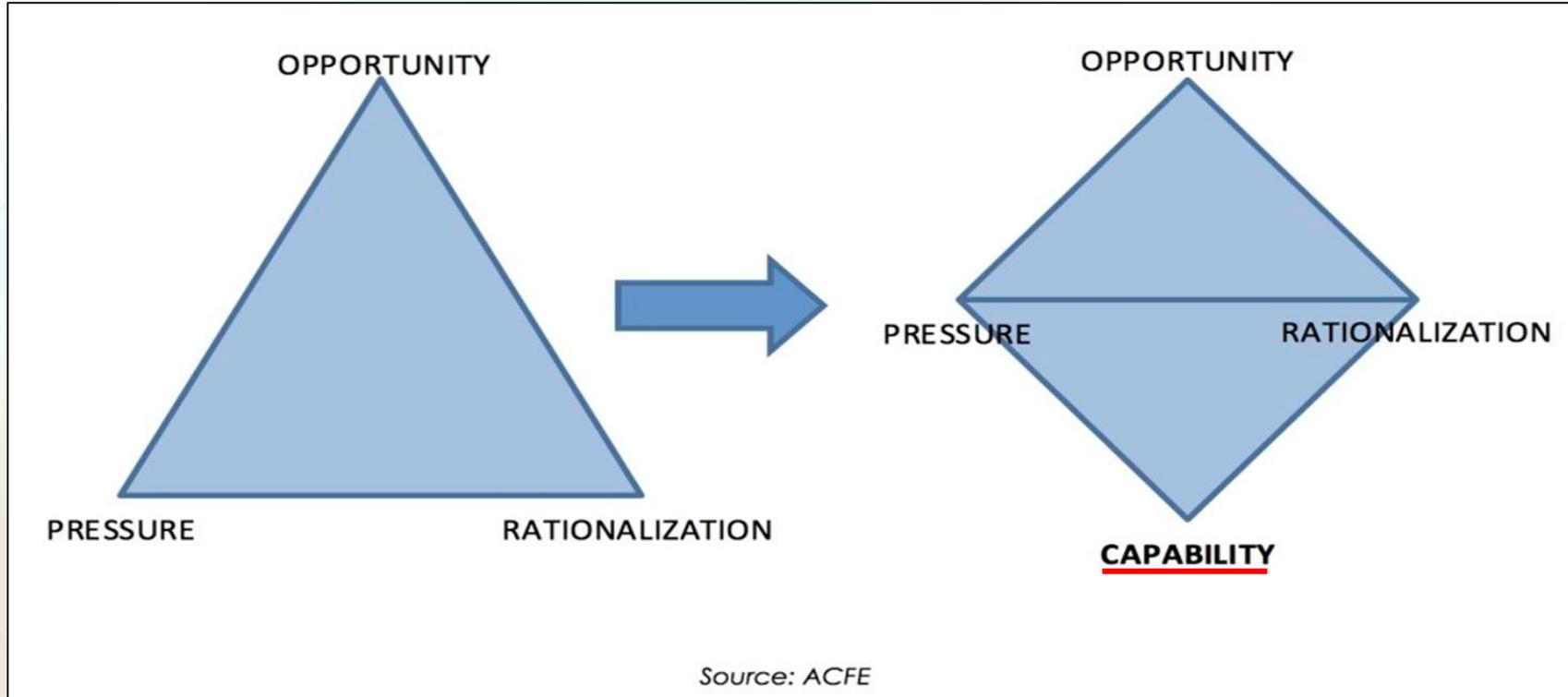
Source: Federal Trade Commission

The Fraud Triangle



The Fraud Triangle (Cressey, 1953), includes three factors: Incentive/Pressure/Motivation, Opportunity, and Rationalization/attitude.

The Fraud Diamond



Source: Wolfe and Hermanson (2004)

All Organizations are Vulnerable

- Organizations are vulnerable to those who succumb to the four elements of the fraud diamond.
- Vulnerability can be reduced by establishing mechanisms to effectively prevent or detect fraudulent activities (internal controls).
- People who commit fraud generally follow a pattern, starting small and growing in magnitude.



Internal Controls

- What are they?
- How can they help to detect & prevent fraud?

Internal Controls

Policies & Procedures

- They help safeguard an agency with checks & balances.
- Provide accurate & timely financial information that complies with laws and regulations.

Internal Controls help limit the “opportunity”

Systems of Internal Controls

- Separation of duties
- Rotation of duties
- Limiting access to assets
- Management review and approval
- Timely reconciliations
- Maintaining and updating established policies, procedures and standards of conduct
- Performance evaluations
- Training programs
- Efficient and effective accounting and business practices, policies and procedures

Examples of Internal Controls

- Use a system of checks & balances to ensure no one person has control over all parts of a financial transaction
- Reconcile agency bank accounts every month and compare actuals vs. budget
- Restrict use of agency credit cards/accounts & verify all charges made to ensure they are business related
- Prepare all fiscal policies and procedures in writing and obtain approval from governing board

External Audit

- Net Position → How does this compare with reports sent to your office?
- Payables → Are they making progress?
- Loans → What are the terms?
- ADA/UPP → Do these match the certified amounts?
- Audit Adjustments → Were these addressed? Were there any conflicts with the auditor?

Review the Audit!



Red Flags - What to Look For

- Unexplained or unusual favoritism with a vendor/contractor
- Organizational culture
- Living beyond their means
- Failure to file or complete Form 700
- Expenditures for noneducational purposes
- Fictitious employees



Red Flags - What to Look For

- Displaying unusual interest in a vendor or supplier
- Employee conducting business on the side
- Addresses of a vendor or contractor are the same as an employee, employee's relative and/or an associate
- Failure or resistance of an employee to take vacation or allow others to handle duties

Uncovering Fraud

Information can sometimes be obtained through unlikely channels

- Teacher conflicts
- Site visits / interviews
- Board meetings / minutes
- Whistleblowers

Uncovering Fraud

Fraud detection & oversight is more about awareness and observation than a checklist

- People – who had the authority and access
- Policies - what policies are in place
- Schemes – identify various fraud scheme(s) that may be present or likely

Uncovering Fraud

Decisions required when fraud is uncovered:

- Who should be informed, and when? Charter authorizer? County office?
- Involve legal counsel?
- Preserve relevant documents / electronic files?
- Do you need external expertise?

What to Do if Fraud is Suspected

- Limit communication of suspected fraud
- Safeguard any potential evidence
 - Prevent removal of computers and documents, including applicable external storage media and devices
- Restrict access of all suspected parties to assets, data and relevant systems
 - Immediate termination not recommended to prevent evidence destruction
- Avoid accusations of fraud or guilt
- Act immediately – especially if suspected fraud is ongoing
- Contact FCMAT
 - COE may request AB 139 Extraordinary Audit under E.C. 1241.5(b)

County Superintendent Responsibilities under AB 139

California Education Code Section 1241.5 states that:

. . . the county superintendent may review or audit the expenditures and internal controls of any school district / charter school in his or her county if he or she has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination. The review or audit conducted by the county superintendent shall be focused on the alleged fraud, misappropriation of funds, or other illegal fiscal practices and shall be conducted in a timely and efficient manner.

► ***Only the County Office can initiate an AB 139 Extraordinary Audit***

The AB 139 Process

- The authority to call for an investigation resides with the county superintendent of schools.
- District typically initiates request to county office.
- The review determines if sufficient documentation and evidence exists to further investigate the findings, and/or if there is evidence of potential criminal activity that should be reported to the local district attorney's office for further investigation.
- If a report is provided to the district attorney's office, it will determine whether to prosecute the alleged perpetrator(s).

What Happens During an AB 139 Review

- FCMAT (or other fraud examiner*) will conduct investigation
 - Experienced fraud investigators
 - Independent review ensures objectivity and thoroughness
 - Internal staff may be participants in scheme
- Determination if fraud *may have* occurred
 - Fraud vs. mismanagement
- Identify next steps
 - COE to report findings to district governing board
 - If necessary, contact district attorney, relevant agencies, affected parties, insurance provider, etc.
 - District to decide if employee discipline / termination is necessary
 - Improvement of internal controls to prevent recurrence
 - “Notice of Violation” & “Notice of Intent to Revoke and Notice of Facts” (E.C. 47604.5 & 47607)

* If an outside consultant / fraud examiner conducts the investigation, FCMAT must approve the scope and cost prior to their work, if reimbursement will be requested by the COE.

Investigations of Charters Schools and Charter Officials

FCMAT Recent AB 139 Extraordinary Audits

<u>Year</u>	<u>Completed</u>	<u>Started/Discontinued</u>	<u>Total</u>
2014-15	9	1	10
2015-16	4	2	6
2016-17	3	4	7
2017-18	9	8	17
2018-19	6	5	11

Ongoing in 2019-20 = 9

Evidence Collection

Internal Sources

- ✓ Hotline reports
- ✓ COI disclosure forms (Form 700)
- ✓ Ethics and compliance certifications or questionnaires
- ✓ Information from security investigations
- ✓ Prior internal audit reports
- ✓ Legal files
- ✓ HR files

Evidence Collection

External Sources

- ✓ Training records
- ✓ Contracts
- ✓ Travel & entertainment expense reports
- ✓ AP & AR
- ✓ Purchase orders / invoices
- ✓ Inventory data / control sheets
- ✓ Master vendor / employee files
- ✓ Financial and audit reports

Evidence Collection

External Sources

Background check(s)

- Financial issues (bankruptcy, divorce, child support, etc.)
- Other debt (credit cards, additional mortgages, etc.)
- Outside business contracts and associates
- Property records
- Convictions

Evidence Collection

External Sources

Public records

- Court records
- Real property tax records
- Business and commercial filings
- Internet searches
- Social networking sites
- Construction permits

Evidence Collection

External Sources

Nonpublic records – *requires consent*

- Business / tax schedules (C & D)
- Address and contact lists / phone records
- Business / personal calendar
- Certain expense records for travel and entertainment
- Business credit card statements / records
- Credit reports
- Loan records

Oversight Tips – Things to Look For

- Transfer of funds to entity not identified in the charter petition that is involved with the operation of the charter school
- Creation of governance structures outside the local charter board
- Agreement that allows day-to-day management by another entity
- Transfer of funds between schools rather than spending the revenue on the students that generated the revenue (including LCAP impact)
- “Leasing” of employees and services between entities

Consider These Items in the Charter Petition

- Clear statement of board composition, where and when it will meet, and how seats will be filled
- Review corporate bylaws
- Require submission of any CMO / EMO agreements
- Require the charter to notify the district if it opens other charter schools under a different authorizer
- Identify all locations operating under the district's authorization
- Include all notifications to school districts and county superintendents for any charters operating outside the authorizer's boundary

Memorandum of Understanding

- Include 10-day advance notification to authorizer when non-voter approved debt is occurring .
- Confirm unlimited access to financial information from all entities involved in operation of the school(s) you authorize – including back office service providers, CMOs, EMOs, and/or franchisers.
- Confirm that amendments to corporate bylaws are material revisions to the charter requiring approval by the authorizer.
- Include language in MOU to cover STRS obligations and final payroll balances, and any outstanding vendor payments, in the event of closure.

Liability Considerations

- Under the California Charter Act, the authorizing agency is not responsible for the debts or obligations of a nonprofit charter, provided that the authorizer has fulfilled its oversight functions.

❖ Ed Code 47604(c):

An authority that grants a charter...to be operated by, or as, a nonprofit public benefit corporation is not liable for the debts or obligations of the charter school, or for claims arising from the performance of acts, errors, or omissions by the charter school, if the authority has complied with all oversight responsibilities required by law, including, but not limited to, those required by Section 47604.32 and subdivision (m) of Section 47605.

Liability Considerations

- ! • *One Notable Exception...*
- CalSTRS expects all applicable service credit to be fully paid!
 - May hold authorizer or COE liable for unpaid employee & employer withholdings
 - *Already has* held one county office – even as a nonauthorizer! – responsible for all remaining pension obligations
 - ✓ The county office is the “direct reporting agency” for STRS obligations
 - Includes penalties and interest, and even any outstanding audit findings
 - There may not be any remaining or residual funds to pay the obligations

Liability Considerations

- ! • *One Notable Exception (continued)...*
- CalSTRS uses Ed Code 23007 to support their position:
- *If any county superintendent, district superintendent, ...or other employing agency that reports directly to the system fails to make payment of any assessment by the board, the (State) Controller shall, upon order of the board, withhold subsequent payments from the State School Fund to the county for deposit in the county school service fund or, upon the request of a county superintendent of schools to the county auditor, he or she shall withhold payments to a school district for deposit in the district general fund until the contributions and report are received in acceptable form in the office of the system and the board directs the Controller to make those payments, less the amount of the assessments to the county that would have been paid had no payments been withheld. The Controller shall then pay to the system the amount of the assessments withheld for deposit in the State Treasury to the Teachers' Retirement Fund.*

Liability Considerations

- ! • *One Notable Exception (continued)...*
 - Will occur even if nonprofit charter files for bankruptcy
 - CalSTRS will withhold state apportionments to cover unpaid costs
 - Residual funds, such as state apportionments received after charter closure, *may be* allowable for unpaid pension obligations
 - ✓ Not yet adjudicated
 - Withholding from a *district*, as authorizing agency, has not yet occurred
 - Not necessarily applicable to CalPERS, as charters don't typically participate in CalPERS
 - Legislative fix planned to prevent this

A Recent Case Study – A3 Charter Schools

The Charter:

- Opened 19 charters throughout California
- Enrolled roughly 40,000 students using false records
- Some students took actual classes, others did not (fake students)
- Targeted small districts to authorize charters in return for oversight revenue

The Charge:

- Conspiracy to steal over \$50 million in public funds
- Includes misappropriation of public funds, paying for student information and conflict of interest
- CEO and president of A3 Education each face 40+ years in prison
- Investigation ongoing and trial pending

A Recent Case Study – A3 Charter Schools

The Loopholes:

- Online charters qualify for 100% funding – no reduction versus traditional charter schools
 - ❖ Must pass two tests to qualify:
 1. 40% of its funding must go to teacher salaries
 2. 80% of its funding must go to educational services
 - ❖ A3 falsified documentation to qualify. Not flagged as suspicious by state-approved auditor.
 - ❖ No plans to update auditing process at this time

A Recent Case Study – A3 Charter Schools

The Loopholes:

- Unenrolling and re-enrolling students during summer school can boost revenue
 - ❖ One student should represent one unit of funding for an entire school year
 - ❖ Unenrolling a student from traditional public school, enrolling them in summer school, and re-enrolling the student in traditional public school can add 20% to revenue
 - ❖ State does not track this movement and cannot expose this scheme

A Recent Case Study – A3 Charter Schools

The Loopholes:

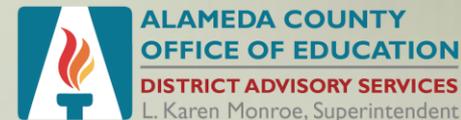
- Moving students midyear between schools can also boost revenue
 - ❖ A3 had many schools and could increase funding by 20% by operating this scheme

- Seeking charter authorization from small school districts is permissible
 - ❖ Small districts lack the resources, knowledge and internal controls to conduct effective and thorough charter oversight

Resources Available

❖ FCMAT.org

- FCMAT's Fiscal Indicators
- Charter School Annual Oversight Checklist
- Charter School Accounting & Best Practices Manual



Questions?

