

The insidious impact of fraud

How to retro-fit district structure for prevention and detection

By Abigail Stokes Palma, Communications Specialist, VLS Fraud Solutions

Let's set the record straight. Fraud is occurring in special districts. Are you burying your head in the sand, assuming that your district is safe?

VLS Fraud Solutions (a fraud prevention, detection and investigation unit under the umbrella of 56-year-old accounting firm Vicenti, Lloyd & Stutzman in Glendora, CA) has found that fraud is indiscriminate. It occurs in small businesses, school districts, government agencies and non-profits. And since fraud is a white-collar crime, it is often committed by long-time, trusted employees with job titles as varied as mail room clerk to CFO. The Association of Certified Fraud Examiners (ACFE) reported in 2008 that the average loss due to fraud is \$175,000 for all organizations and \$200,000 for small businesses. In 25 percent of the fraud cases reported, losses totaled over \$1 million. Fraud typically goes undetected for at least two years.

Case after case ends with the same moral: an ounce of prevention is worth a pound of cure. Without doubt, fraud occurs when an organization lacks adequate checks and balances among employees who handle money. While there is no fool-proof prevention of fraud, there are established practices that significantly reduce the risks.

In a recent case investigated by VLS, a financial manager (FM) was responsible for receiving cash and other assets and making investments, including the purchase of Certificate of Deposits (CDs). The FM received monies from donors, recorded the donations, made the deposits, purchased CDs, reconciled the bank statements, and prepared reports for the board to review. (If that last sentence did not set off red flags for potential fraud, please keep reading!) With all this power and little to no oversight, the FM was able to manipulate the books in such a way that some CDs were closed out, but not removed from the general ledger. Board members saw a continually increasing balance sheet, but never verified that the various CDs were actually in existence.

Meanwhile, using legitimate credentials and the district's tax ID number, the FM opened a "ghost account" in the name of the district's foundation. He made himself the only signer, and told the bank to hold the statements for pick-up. With the perfect money laundering account in place, the FM renewed certain CDs (that were reported on the general ledger as closed out) and credited the interest earned to this account. Since he was the only signer required, the FM wrote fat checks to himself out of this ghost ac-



count. No one at the district knew what the FM was doing with these funds. Like tectonic plates shifting noiselessly below, this trusted, long-time FM embezzled nearly \$100,000 over the course of ten years. The game was up when the bank accidentally mailed a statement to the district. Earthquake.

The aftermath of the discovery, the impact of the deception and theft at this district has been devastating. The natural flow of work has been disrupted for over four years as the case has been investigated by forensic accountants, civil attorneys, the insurance company and eventually the District Attorney. The story has been splashed all over the district's local newspapers, causing the district to suffer losses in terms of reputation and morale that they won't fully recover. Though there was only one fraudster, the organization in-total is reeling with the impact of what they overlooked.





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How could they, and how can you prevent a scheme like this from happening to your district?

The biggest key is establishing tight internal controls. "Trust, but verify," says Ernie Cooper, CPA, Certified Fraud Examiner, retired FBI Special Agent and VLS Director. Healthy workplaces must extend and require trust among employees and overseers. Nevertheless, accounting practices must be verified in order to protect the organization's assets and reputation. In the case described above, at a minimum, one individual should have been responsible for receiving the cash and other assets, another for purchasing the CDs and maintaining the CD sub-ledger, and another for reconciling the CD sub-ledger with the bank statements. A segregation of duties among multiple employees provides valuable accountability that must extend to every employee's financial duties – even your boss'.

VLS Fraud Solutions offers the following seven steps your district can take to prevent and/or detect fraud.

1. Know some of the common red flags of fraud.

- Long-time trusted employee holds many financial duties
- Small accounting staff lacks segregation of duties
- Change occurs in an employee's lifestyle (divorce, extra-marital affair, lavish style)
- Bank reconciliations are not prepared or are incomplete
- Employees who take no vacations and are very seldom out sick
- Adjusting entries are unusual or confusing
- Original records are not maintained, are disorganized or missing
- Purchases are governed by an informal process, not a set policy
- No policy exists for use of a company credit card

2. Ensure "Tone at the Top" and conduct Fraud and Ethics Training for all employees.

- "The tone of ethical standards must be set from the top," Cooper says. If the values of honesty and ethics are not clearly communicated by the top decision maker, your organization is at a greater risk for fraud.
- Chief executives can circumvent the losses associated with fraud by conducting employee training. "Educate your people about integrity and ethics, the company's code of conduct and fraud policy at least once a year," Cooper continues. "Employees need to know what fraud is, who commits fraud and how to prevent it."

3. Establish proactive relationships with your bank.

At least once a year, two or more officials from your district should sit down with bank representatives and review your accounts. This will bring to light any ghost accounts, but it will also give your district the opportunity to compare in-house reports to bank statements. Your bank should have some very good proactive fraud tips and tools, such as "Positive Pay" for you.

4. Establish a mechanism for a 24-hour anonymous, confidential reporting hotline.

"A fraud hotline is a must for every organization's prevention and detection plan," says Cooper. "In today's environment and with the low-cost of hotlines, there is absolutely no reason not to have a hotline." The ACFE's 2006 Report to the Nation says,

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“The most common means of detecting fraud is through tips. Having a hotline in place is proven to decrease the time to detect fraud, and those entities that had hotlines in active use experienced much lower dollar losses associated with fraud.” In 2008, the ACFE reported that 46 percent of fraud cases were detected because of a tip.

5. Perform proactive personnel measures.

- Prevention begins with conducting background checks and exit interviews.
- Ensure that cash-handling employees take vacations – this is a built-in way to “accidentally” find inconsistencies in reports and ledgers.
- Maintain performance and compensation programs as a key counter-balance to the prevention and detection plans; genuine interest and appreciation for employees creates an environment with good morale and sense of company loyalty. (An ounce of prevention...)
- Implement crisis care during the current recession: “Organizations that proactively support staff members in this time of need – through measures such as employee counseling services, open-door policies, and employee assistance programs – may be able to mitigate the pressures and deter employees from turning to criminal activities” (from the ACFE’s May 2009 report, “Occupational Fraud – A Study of the Impact of an Economic Recession”).

6. Conduct surprise checks and fraud audits.

As a regular part of your district’s review procedures, conduct surprise checks and internal audits of petty cash, cash receipts, bank reconciliations, check registers and other high risk areas. Volunteers and interns can provide an affordable additional source to complete these tasks.

7. Develop a relationship with a fraud expert/forensic accountant.

If you suspect fraud in your organization, the situation should be investigated immediately. “Every entity should have a relationship with a fraud expert with a plan in place to reduce the risks,” says Cooper. In spite of tightened purse strings during this recession, the ACFE recommends that companies increase spending on anti-fraud measures. Cooper concludes, “The

money you’ll spend protecting yourself against fraud is nothing compared to what you stand to lose if you don’t.”

Abigail Stokes Palsma is a communications specialist for VLS Fraud Solutions, a well-developed forensic accounting unit within CPA firm Vicenti, Lloyd & Stutzman. VLS Fraud Solutions investigates fraud and provides consultations to entities looking to develop anti-fraud measures. Contact VLS Fraud Solutions at 626-857-7300 or visit their website at www.vlslp.com. ■



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