AB 139 FRAUD AUDITS
A BRIEF INTRODUCTION FOR AB 1200 PRACTITIONERS
CCSESA BASC FALL CONFERENCE 2018

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INTRODUCTION
• Fraud has many names:
  • Misappropriation
  • Embezzlement
  • Theft
  • Collusion
• But all fraud often contains common factors:
  • The offenders are people – employees, related parties, vendors, third parties, etc.
  • The offenders are “capable”:
    • Able and willing to commit unethical behavior
    • Have an understanding of the applicable internal controls
    • Have the ability to exploit internal control weaknesses to plan and implement fraud
FRAUD INDICATORS FOR A COUNTY OFFICE

- District staff bring evidence or suspicion to attention of county office
- An audit or other report provides indication of possible fraud
- Whistleblower reports or tips are received

And don’t forget the fraud triangle/diamond indicating the necessary components that cultivate fraud…

ALL ORGANIZATIONS ARE VULNERABLE

- Organizations are vulnerable to those who succumb to the three elements of the fraud triangle – and have "capability".
- 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.
MAIN RISK FACTORS

• Operating environment
• Management’s leadership and commitment towards openness, honesty, integrity, and ethical behavior – “Tone at the Top”
• Effectiveness of internal controls
  • No system of internal controls can fully eliminate the risk of fraud.
  • Be aware of, and realistic about, weaknesses.
  • A well designed system can deter fraud by:
    ✓ Reducing opportunity, thus reducing vulnerability
    ✓ Increasing perception of detection

TYPES OF INTERNAL CONTROLS

PREVENTIVE CONTROLS
• Stop fraud before it occurs
• May be manual or automated processes

DETECTIVE CONTROLS
• Identify fraud after it occurs
• May be manual or automated processes

• Timing and Effectiveness Analysis
  • Preventive is preferred
  • Detective for when preventive fails
  • Good internal control systems should employ both

A FALSE SENSE OF SECURITY

• Internal controls need regular review and evaluation to ensure effectiveness
  • Questions to ask:
    ✓ Are the current internal controls working?
    ✓ Have there been any weaknesses identified, and if so, remedied?
  • Don’t over-rely on independent auditors to identify all deficiencies in internal control
  • Remember, not every transaction is reviewed. They are only sampled.
  • The annual audit is NOT a fraud audit, and is not primarily focused on internal controls.
  • The annual audit is a compliance audit to verify financials and confirm adherence to various statutory and accounting requirements.
SYSTEMS OF INTERNAL CONTROL

• 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

WHAT TO DO IF FRAUD IS SUSPECTED

• Limit internal 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
• Call FCMAT!
  ➤ COE may request AB 139 extraordinary audit under E.C. 1241.5(b)

COUNTY SUPERINTENDENT RESPONSIBILITIES UNDER AB 139

CALIFORNIA EDUCATION CODE SECTION 1241.3 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.
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, 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, they 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, current 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

* 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.

AB 139 AUDIT REIMBURSEMENT PROCESS

- State Budget Act names FCMAT as the entity to administer reimbursements after approved by DOF and SPI
  - $687,000 currently available annually for this purpose
  - Reimbursed on a first come, first served basis
  - E.C. 1241.3 (b) and (c)
- Instructions for reimbursement can be found at:
RECENT FCMAT FRAUD AUDITS

- Since 2015-16, FCMAT has conducted 19 AB 139 Extraordinary Audits at the request of county offices.
  - 11 school districts/COEs
  - 8 charter schools
  - 13 studies resulted in a finding that fraud may have occurred.

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<tr>
<th>District</th>
<th>Charter</th>
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<tr>
<td>Alum Rock Union ESD</td>
<td>San Ysidro USD</td>
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<tr>
<td>Coachella Valley USD</td>
<td>Salinas USD</td>
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<td>Wattsburg USD</td>
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<td>Montebello USD</td>
<td>Hope Academy Charter</td>
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<td>Parlier USD</td>
<td>Tri-Valley Learning Corp.</td>
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<td>Raisin City ESD</td>
<td>Oxford Prep Academy</td>
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<td>Raisin City ESD</td>
<td>Yuba City USD</td>
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<td>Bakersfield ESD</td>
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Most common findings:
- Misuse of funds/improper reimbursements (travel, credit cards, etc.)
- Conflict of interest or related-party transactions

Most common reason fraud occurred:
- Inadequate internal controls

Other findings include:
- Poor payroll and human resource controls
- Governance/board policy violations
- Accounts payable and purchasing/bid requirement deficiencies
- Improper use of associated student body funds/accounts
- Diversion of assets

FOR MORE INFORMATION

- About FCMAT
  - http://fcmat.org/
- Request an AB 139 Extraordinary Audit
  - https://admin.fcmat.org/wizard_job_type.asp?Create=1
- FCMAT AB 139 Audit Reports
  - http://fcmat.org/extraordinary-audits/
- Association of Certified Fraud Examiners
  - https://www.acfe.com/
QUESTIONS?

Thank you!