FOLLOW THE MONEY!

IT'S NOT FINANCIAL OVERSIGHT IF THE BOARD ISN'T LOOKING

a certified fraud examiner's lowdown on protecting your charter school's money and assets from fraud, waste, abuse, and financial exploitation, ***even if*** your board trusts the school leader/founder/treasurer/PTO/business manager/fill-in-the-blank

ANOTHER BRIAN L CARPENTER ORIGINAL

4TH EDITION

IT'S NOT FINANCIAL OVERSIGHT IF THE BOARD ISN'T LOOKING

I've been tracking charter schools using Google alerts for about as long as I have been consulting in this sector, which is to say, for nearly 21 years now. When it comes to fraud, here's something I've learned: ***with a few exceptions, when fraud has occurred in charter schools, the board wasn't looking, or to be more precise, looking at the right things.***

How do I know?

Most fraud cases in US charter schools that I'm familiar with are what you might call "garden variety," frauds, meaning that no sophisticated techniques were used. (There have been a few sophisticated cases, such that the boards could not have been reasonably expected to have caught them.)

Garden variety frauds usually come down to this: people that the board trusts (see the next page) use school funds to purchase such things as family vacations, expensive jewelry, nice houses and hot tubs, not to mention straight up cash grabs, either by writing school checks to themselves or using a school debit card to make ATM withdrawals.

Here's the thing: ALL OF THESE TRANSACTIONS HAVE ONE THING IN COMMON: THEY ARE EASILY SPOTTED IN BANK STATEMENTS, but can easily be made invisible in financial reports. **In other words, all a board has to do to spot them is *look***. (see topic #7)

So why aren't more boards looking? Most of them haven't been trained on how to do so. This is why I wrote this little publication which covers the following topics:

1. Trust is not a control.
2. Assuming that fraud would never occur in your school actually creates the opportunity for it.
3. The board's role is to provide oversight of school financial management, not to be a participant in it.
4. Fraud deterrence and detection: they're not your auditor's job—they're yours.
5. The Charter School Board Financial Oversight Triangle, i.e., the three "legs" of financial oversight.
6. Lane lines, i.e., distinctions between charter school financial management vs. oversight.
7. A simple technique to avoid being fooled by a set of cooked books.
8. Red flags
9. A fraud risk management plan.
10. Operate a tip line.

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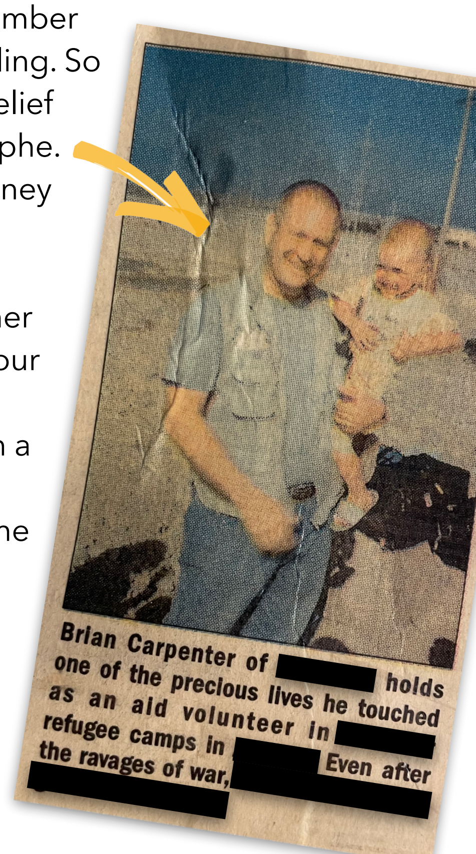
1. Trust is not a control. Take my word for it, your board does not want to learn this the hard way.

"We never trusted that dude for a minute," said no charter school board member ever, after discovering that their school got ripped off by its leader/founder/treasurer/PTO/business manager/fill-in-the blank. Rather, upon learning that said person used school funds to buy cruises, luxury cars, & vacations, or give plum jobs to their unqualified kids, they all exclaim the same astonishment: "We just can't believe this happened. We trusted him!"

As a certified fraud examiner (CFE), every time I read a sentiment like this in an article, book, or report, I shake my head and think to myself, "'Trust is not a control.'"

But look, I don't blame anyone for not understanding that board financial oversight has nothing to do with trust. I've been duped as a board member myself. Here's what happened.

About two decades **before** I earned my CFE in 2017, I was a board member of an international relief agency whose mission I found deeply compelling. So much so, in fact, I spent six weeks in a war zone coordinating refugee relief work as a volunteer for this agency in the midst of a genocidal catastrophe. When I returned, I even began speaking to local civic clubs to raise money for the agency's continuing relief efforts.



This was going great until one day when an employee tipped off another board member about a questionable financial transaction initiated by our Executive Director, **whom we trusted**. When the board looked into it, what we found shocked us: a Swiss bank account in the ED's name with a ton of the organization's money being wired to it from our account–including a $2,000 contribution from yours truly. Eventually–it took some time–the ED was convicted and went to prison, and the organization slowly recovered. But here's my point: *His massive fraud could have been detected early–and possibly deterred altogether–if our board had understood that trust is not a control*. ***If only I had***.

Please take my word for it, your board does not want to learn this lesson the hard way. Burn this phrase into your brain by saying it out loud three times: Trust is not a control. Trust is not a control. Trust is not a control.

Again.

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2. Assuming that fraud would never occur in your school actually creates the opportunity for it.

Similar to mistaking trust as a control as discussed on the previous page, sometimes charter school board members believe that fraud would never happen in *their* school. This false sense of security actually creates the opportunity for fraud, for at least three reasons:

1. The board probably won't be vigilant when it comes to internal controls (topic #5);
2. Red flags (see topic #8) will go unnoticed as such, and
3. The fraud will be committed by someone who the board never thought about as having the opportunity to do so. (Fraud in charter schools isn't always committed by school leaders).

To illustrate this point, I have at least one case of charter school fraud in my files which was committed by one of the following:

- founders
- board presidents, treasurers, and other board members
- PTO/Booster club officers/members
- management companies, both for-profit and not-for-profit (these cases represent the highest dollar losses to taxpayers because of scale)
- back office service providers (e.g., bookkeeping/payroll companies, etc., though rare)
- coaches
- business managers/CFOs/COOs
- office staff such as receptionists
- IT coordinators
- lunchroom workers (although the biggest case with which I'm acquainted occurred in a conventional district school)

Here's the take-away. Presumably, the boards overseeing these schools didn't think fraud would occur in their schools either. Until it did. For a few schools, unfortunately, *inaction from that assumption created the opportunity for fraud that resulted in their financial collapse or charter revocation*.

The best mindset is to assume that your school can become just as vulnerable as any other, especially when the board doesn't look.

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3. The board's role is to provide oversight <u>of</u> school financial management, not to be a participant <u>in</u> it. (John Carver)

Everyone has heard that the board is supposed to "stay in its lane," but most have no idea where the lane lines even are.[1] This has led to big problems for countless charter schools since the first one opened its doors in 1992, including boards being involved (or even entangled) in financial management, which they generally mistake as financial oversight.

Of course, it doesn't help that some regulatory entities themselves don't know where the lanes are, and thus **actually *mandate* that charter school boards cross the line by requiring them to**:

- participate in budget development (then subsequently approve the budget!);
- elect a board treasurer to *manage* the school's finances (rather than assist the board in the **oversight** of financial management, as noted by famed governance author John Carver);
- operate a "finance committee" instead of a financial oversight committee (names matter);
- adopt various financial policies, *without ever explaining that the board's real duty is to see that the school has sound internal controls and that they are being followed*;
- approve routine payables (good luck spotting bogus invoices!); and,
- have board members sign all checks (which is of moderate oversight value at best and misleading at worst because it tends to lull the board into a false sense of security).

So much for lane lines between financial oversight and financial management. "But why all the fuss?" you ask.

The answer comes down to this: The main premise for the existence of charter school boards in the first place is that taxpayers need someone to provide ***independent* oversight** of management. By definition, a board cannot be regarded as providing independent financial oversight <u>of</u> financial management if it is participating <u>in</u> it. (Board independence is also a strong argument against allowing charter school board members to be related to key employees or service providers, but some state legislatures still allow it. That doesn't mean your board has to.)

"Okay," you say. "I follow the logic of board independence, but where exactly are the lane lines between oversight of financial management vs. participation in it?"

Glad you asked. I've listed 25 of them in topic #6. (As far as I know, I'm the first to define these, so I don't think you will find them in any other literature, but if you do, please contact me.)

[1] My "Board CHAMPS Model™" depicts what I propose to be the six key distinctions between charter school governance and management, [available on Amazon for $2.99](#).

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4. Fraud Deterrence and Detection: They're Not Your Auditor's Job—They're Yours.

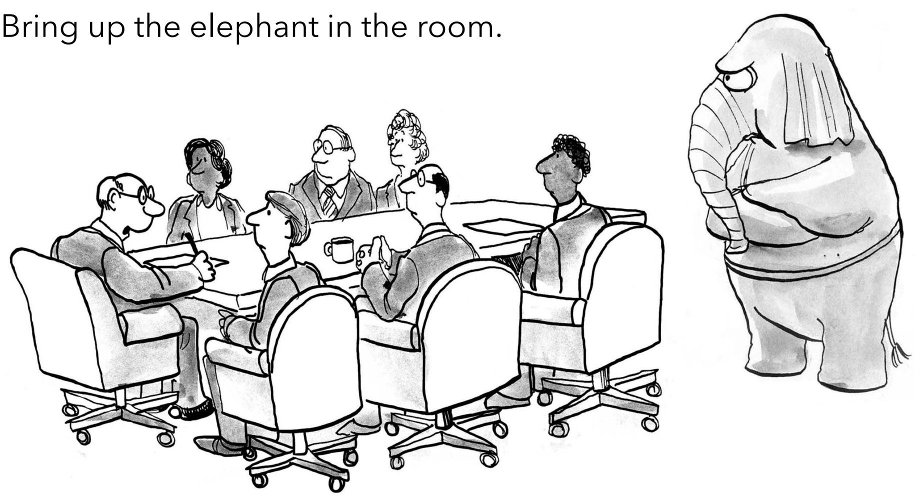
I know this may seem counterintuitive, but risk management literature is all but universal in stating that the primary responsibility for deterring and detecting fraud, waste, and abuse in an organization belongs to the board and management—NOT the organization's auditor.

In fact, the extent to which an auditor is even looking for signs of fraud in an annual audit is limited. This is not because auditors are lazy or ignorant. It's basically because the purpose of an audit is essentially to confirm that your financial statements materially represent the school's actual financial position and performance, and that the school is following proper accounting standards (of which there are many). The random sampling methods used by auditors to accomplish this purpose can easily result in fraud going undetected.

In other words, if your charter school becomes a victim of fraud, waste, and/or abuse, it probably won't do you any good to blame your auditor for not catching it. That job belongs primarily to the board (for fraud committed by other board members and senior employees) and to senior employees (for fraud committed by employees subordinate to them).

But how can a volunteer board deter or detect fraud? Start by making copies of this monograph and discussing it with your fellow board members and school leader. Afraid the subject will make people uncomfortable? It might, but any fraud examiner will tell you that it's *cheaper,* to talk about fraud deterrence and detection than it is to remediate fraud.

So, go ahead. Bring up the elephant in the room.



"I suppose I'll be the one to mention the elephant in the room."

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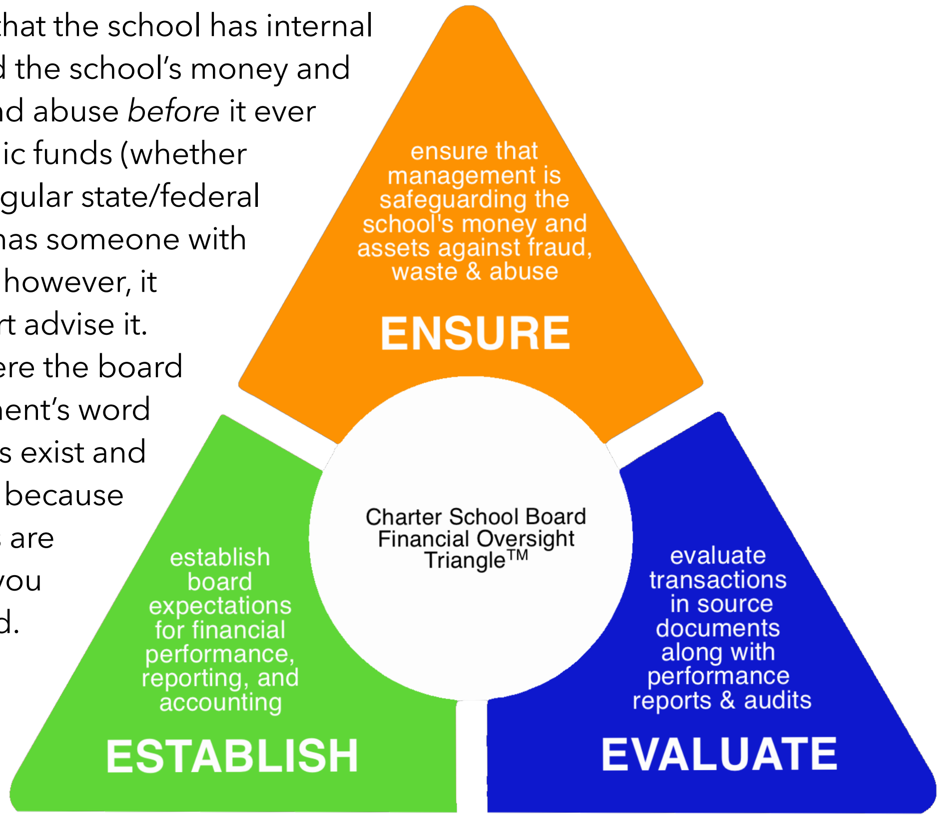
5. TA-DA! INTRODUCING THE CHARTER SCHOOL BOARD FINANCIAL OVERSIGHT TRIANGLE.

I call this little doodle the Charter School Board Financial Oversight Triangle. Notice that the three legs represent a board's duties as three "Es", ENSURE, ESTABLISH, and EVALUATE. If your board isn't systematically practicing all three, it is increasing the school's risk exposure to fraud. (Note: These cannot be "delegated" to management.) Here's a short description of each.



Your board should **ENSURE** that the school has internal controls in place to safeguard the school's money and assets against fraud, waste and abuse *before* it ever receives its first dollar of public funds (whether through a start-up grant or regular state/federal funding). Unless your board has someone with expertise in internal controls, however, it should have an outside expert advise it. Note: This is not a matter where the board should simply take management's word that sufficient internal controls exist and are being followed. Also, just because one or more board members are check signers doesn't mean you have all the controls you need.

Your board should **ESTABLISH** written expectations (i.e., board policies) for financial and accounting standards. You might not have thought about the risks that can occur by failing to do so, but I've witnessed many schools flounder, and some go under because their boards didn't establish any such expectations.

Your board should periodically **EVALUATE** individual transactions in source documents in addition to financial reports because individual transactions <u>are all but invisible in an income statement or a balance sheet</u> (see topic #7). How important is this? In most cases of charter school fraud with whose details I am familiar, the board could have detected fraud very early if it had practiced ***just this one leg*** of the Financial Oversight Triangle. Some of those schools are now toast, too.

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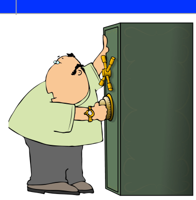
6. BEHOLD, THE LANE LINES.

GIVE YOURSELF 1,000 BONUS POINTS IF YOU NOTICED THAT THE COLORS MATCH THE OVERSIGHT TRIANGLE!

	Aspect	Management's Lane	The Board's Lane
1	**Fraud risk management**	Own it	Take time to learn about it
2	**Annual fraud risk assessment**	Conduct one	Ensure completion through review
3	**Internal controls**	Design, implement, and follow	Ensure they exist and are being followed
4	**Criminal background checks**	Submit the paperwork	Ensure completion by all officers & directors
5	**Check stock**	Maintain/safeguard	Verify safeguards are being followed
6	**Assets**	Safeguard via tags and inventory	Ensure annual asset inventory occurs
7	**New vendors**	Approve per policy	Verify policy being followed
8	**Investigate fraud allegations**	Against subordinates	Against senior management/board members
9	**Employee dishonesty insurance**	Purchase	Establish coverage amount/verify policy renewal
10	**Budget/budget revisions**	Develop and manage	Submit for board approval
11	**Financial performance & position**	Manage within key metrics	Establish key metrics/monitor performance thusly
12	**General ledger/accounting standards**	Maintain within standards	Audit for standards compliance
13	**Personal reimbursements**	Approve for faculty and staff	Approve for senior leader and board members
14	**School indebtedness**	Recommend as needed	Determine whether to approve
15	**Financial reports**	Prepare, submit, explain	Require monthly balance sheet and income stmt
16	**School credit cards**	Control and monitor use	Monitor senior management card activity
17	**Spend from reserves**	Only upon board authority	Approve/decline management recommendations
18	**Payroll/benefits/tax deposits**	Execute/monitor for accuracy	Periodically review
19	**Routine transactions**	Approve/execute/report	Evaluate appropriateness
20	**Contracts for services**	Approve within limits of authority	Approve/decline beyond admin limits of authority
21	**Procurement**	Gather quotes; select vendors	Establish limit of authority/evaluate compliance
22	**Financial oversight committee**	Subordinate to (not a member of)	Evaluate transactions in source documents
23	**External auditor**	Cooperate and consult with	Recommend and select
24	**Source documents**	Implement a retention policy	Verify appropriate retention
25	**Monthly reconciliation report**	Generate and analyze	Receive and review



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7. A simple technique to avoid being fooled by a set of cooked books.

As previously stated, most instances of charter school fraud, waste, and abuse could have been easily detected if the board hadn't limited its financial oversight to taking management's word that the books aren't being cooked—which is exactly what a board is doing when it only looks at a budget to actual report. In contrast, source documents such as bank and credit card statements—if directly obtained from the bank—will reveal individual transactions such as ATM withdrawals, checks written to "cash," and the purchase of luxury items such as jewelry, all of which can be hidden in a set of cooked books for years. The same fact is true of payroll reports. They tell you who is actually being paid, and how much.

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8. RED FLAGS: DON'T ACCUSE ANYONE, BUT GET ANSWERS IF YOU SEE ANY OF THESE.

1. "Don't you trust me?" (As a rule, I find that the more indignant this protest is when someone asks a question about financial oversight, the more likely it is that someone is doing something wrong. In contrast, honest people gladly invite full transparency.)
2. The school uses debit cards that have the capability of ATM withdrawals. (Don't!)
3. The person who maintains the general ledger is the same person who reconciles it. (Don't!)
4. The board doesn't receive an income statement AND a balance sheet, *every* month. Even more of a red flag when the board doesn't require management to provide both.
5. Large-dollar contracts no one vetted beforehand with an independent attorney.
6. A management service provider contract that amounts to the company keeping every dollar after it has paid all the school's liabilities. (Such a school will never have a meaningful fund balance, which means it can never really terminate the provider's contract.)
7. A board that allows its chair (or any board member) to walk into the school and demand that staff give him/her a blank check.
8. A board that trusts personalities above policies. Example: Not requiring the school leader to demonstrate compliance with controls because he/she is the founder, *is* trusting a personality.
9. Transfers/checks to an account called "Friends of [your charter school's name]."
10. A school that doesn't require the school's PTO/Booster Club to submit its bank statements/ credit card statements to the school on a monthly basis.
11. A school that doesn't carry a robust amount of employee dishonesty insurance and/or doesn't bond board members who are check signers.
12. A board whose membership includes the spouse/sibling/child of a key person in management (or in the management company).
13. School credit cards whose leader's transactions are never looked at by the board.
14. Any situation in which potential conflicts of interest among directors and officers (a term that includes board and senior leaders) hasn't been disclosed in writing.
15. A board that abdicates external auditor selection to management.
16. Language in vendor contracts that stipulates auto-renewal of their contract unless they are notified within a window, e.g., 90-150 days, instead of a simple x-number of days notice.
17. A board that has never evaluated how well any particular internal control is being followed.
18. A board that doesn't require management to get approval before acquiring school indebtedness (such as a line of credit for the school).
19. Checks written to "cash" (other than for replenishing petty cash)
20. Directors and officers (board and employees) who refuse to submit to a criminal background check.
21. School-held accounts which are not reported out monthly, and/or of which, the board does not know they exist.

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9. Something every school needs that you might never have even heard of: a fraud risk management plan

Don't let unfamiliarity with the term "fraud risk management plan" send you fleeing for cover from technical jargon. Granted, unless you're in a risk management profession, the term is uncommon, but it is considered essential to organizational financial oversight.

At the risk of oversimplifying things, a fraud risk management plan just means that management has evaluated where your school might be vulnerable to being ripped off, then puts remedies into place such as financial controls to **deter** and **detect** fraud if it should happen. (Notice that financial controls can serve one or both purposes. Cool, huh?)

Frankly, the two biggest impediments to putting a fraud risk management plan in place in charter schools are that (1) most charter school leaders have never been trained on how to create one (or are even aware that they should), and (2) most charter school leaders are spread so thin simply managing through ordinary chaos that they don't have the time to do one, even if they know how. (The smaller the school, the more significant of a problem this is.)

As a recovering school leader who still occasionally provides leadership to charter schools as an interim, I get it. But here's the thing: If your school leader is committed to reducing the overall risk exposure of the school, an annual fraud risk management plan is an indispensable strategy because it enables them to focus their attention on school financial management practices long enough to identify potential problem areas. Your auditor, association, or insurance company may be able to assist the leader with learning how to conduct one.

Although it is not the board's responsibility to create a fraud risk management plan, it should require the school leader to do one at least once a year. The board or one of its committees should review this plan, and document in its minutes having done so. (If it ain't writ, it's just spit.) It's also a good practice to convey to all stakeholders that the board and management do this work because when others know that your school actively works to detect and deter fraud, this can be its own deterrent. (Also pretty cool.)

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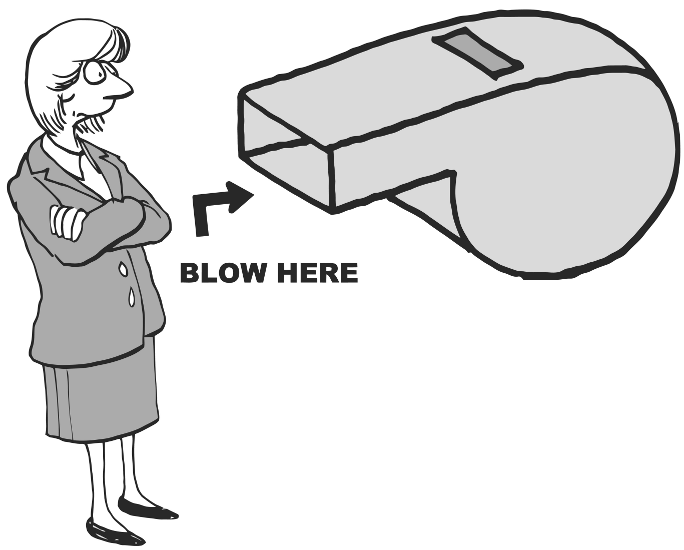
10. A FINAL VALUABLE TIP(LINE)

Because of employee proximity to the daily activities in a school, when fraud, waste, and abuse occur within a school, it is often the case that they suspect something is wrong before board members do. However, if they don't have a way to anonymously tip off the board, they may be afraid to say something out of fear of losing their job. I've seen this happen. This is not a dilemma you want to exist in your school.



The Dilemma of a Whistle Blower

The board can remedy this quite easily. All it needs to do is establish a fraud/ethical misconduct reporting hotline, then require the financial oversight committee to monitor and report allegations to the board. (In addition, having a whistleblower protections policy is also a best practice.)

One word of caution: No matter how much you emphasize to stakeholders that the purpose of the fraud tip line is only for fraud allegations or reporting ethical misconduct, some will use it to register every imaginable complaint and suggestion that have nothing to do with fraud or ethical misconduct. This will require the committee to stay on point, that is, not to allow itself to be dragged into investigating complaints that have nothing to do with fraud.

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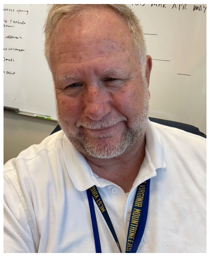
ABOUT THE AUTHOR



When I dropped out of high school in 1977 and joined the Marine Corps, neither I nor any of my friends and family could have imagined that my life's trajectory would ultimately take a 180. In retrospect, it does indeed seem an unlikely path that I became a school leader (over 35 years ago), earned a PhD in Education, and later became a Certified Fraud Examiner (CFE). (I give the glory to Christ the Lord.)

For nearly 21 years, it's been my privilege to help advance parental choices in education across the US by promoting and explaining the keys to effective charter school governance, finance & operations, enterprise risk management (including fraud risk management), and strategic thinking. While these topics understandably cause the eyes of many a reasonable person to glaze over, I geek out on them because when they're done poorly in a school, the school usually tanks, regardless of its academic performance. No one wants this, least of all the children who get displaced when boards and leaders fail them.

I've authored a few books (which you can find on Amazon by typing Brian L. Carpenter into the search bar), served as CEO of the National Charter Schools Institute at Central Michigan University (2005-2009), and been honored to be an invited speaker at countless conferences.

To schedule a confidential conversation with me to discuss how I might be able to assist you, please schedule a no-obligation Zoom call using my website.

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