FOLLOW THE MONEY!

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

ten things every charter school board should know when it comes to protecting the 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 ORIGINAL MONOGRAPH BY BRIAN L CARPENTER

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

"We didn't trust 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, hot tubs, or give plum jobs to their unqualified kids, they all exclaim the same thing: "We just can't believe this happened. We trusted him!"

As a certified fraud examiner, every time I read a sentiment like this in an article, book, or report, I shake my head and think to myself, "If only they had known the maxim, '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 myself. Here's what happened.

Years ago, 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 coordinating refugee relief work as a volunteer for the agency in the midst of a genocidal catastrophe. When I returned, I began speaking to civic clubs to raise money for the agency's continuing relief efforts.

Brian Carpenter of [redacted] holds one of the precious lives he touched as an aid volunteer in [redacted] refugee camps in [redacted] Even after the ravages of war, [redacted]

This was going well until one day when an employee tipped off another board member about a questionable financial transaction initiated by our Executive Director. 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*.

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. If you think fraud doesn't happen in charter schools, or wouldn't in your school, think again.

Having been in the charter school sector nationally on a full-time basis since 2005, I'm not exactly a charter OG, but I can attest that after nearly two decades, it appears to me that charters are just as susceptible to being victims of fraud, waste, abuse, and financial exploitation, perhaps more so in some ways, as other public schools and other sectors, especially those with volunteer boards (e.g., local and national non-profits, civic groups, and churches).

What makes me think this? As a school consultant who is also a certified fraud examiner (CFE), I have been using Google alerts to track financial shenanigans in charters across the US for years. Although I rarely do investigations (most of my work with clients is focused on deterrence and detection controls), I follow such stories with intense curiosity to see what can be learned from them. Sometimes I even use the Freedom of Information Act to obtain source documents such as revocation notices from authorizers, IG investigative reports, and school documents themselves. It's been an informative journey, though sometimes disheartening.

What I most wish for charter school board members to understand from all I've observed is this: if you think fraud doesn't happen in charter schools, or wouldn't in your school, think again. That we know, although it doesn't happen in most schools, it does occur. For each of the fraud perpetrators below, I have at least one real world charter school case in my files:

- founders
- school leaders (even ones leading academically successful schools)
- C-Suite execs over multi-campus schools (CEO/CFO/COO)
- PTO/Booster club officers
- EMO/CMO bad actors (these cases tend to represent the highest dollar losses to taxpayers)
- back office service provider bad actors (e.g., payroll companies, though rare)
- athletic coaches
- board presidents, treasurers, and other board members
- business managers/accountants/bookkeepers
- office staff such as receptionists
- IT Coordinators
- lunchroom workers (although the biggest case with which I'm acquainted occurred in a conventional district school)

Presumably, the boards of all 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.

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3. THE PRIMARY RESPONSIBILITY FOR DETERRING + DETECTING FRAUD, WASTE, AND ABUSE IN YOUR SCHOOL BELONGS TO YOUR BOARD AND MANAGEMENT—NOT YOUR AUDITOR.

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 its 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 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).

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 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 more comfortable, as well as *cheaper,* to talk about fraud deterrence and detection than it is fraud remediation. 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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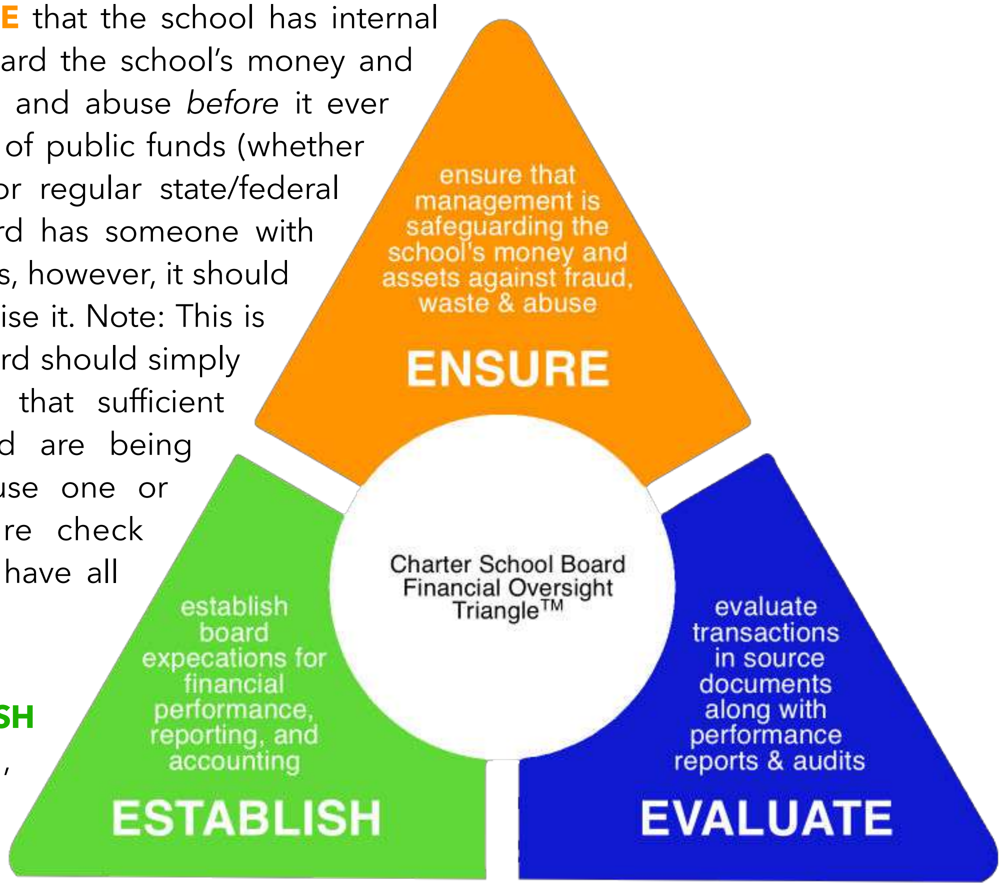
4. FINANCIAL OVERSIGHT CONSISTS OF THREE DISTINCT BOARD FUNCTIONS THAT CANNOT BE DELEGATED TO MANAGEMENT. FAILURE BY YOUR BOARD TO PRACTICE ALL THREE, RESULTS IN WEAK FINANCIAL OVERSIGHT WHICH INCREASES YOUR RISK.



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 very 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 performance, reporting, 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 because individual transactions are all but invisible in an income statement or a balance sheet. 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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5. The premise behind the financial oversight triangle: Your board's role is to provide oversight OF school financial management, not to be a participant IN it.

Everyone has heard that boards are supposed to "stay in their lane," but most have no idea where the lane lines even are.[1] This has led to big problems for countless charter schools over the past few decades, 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 authorities don't know where the lanes are, and thus actually *mandate* that charter school boards:

- participate in budget development (then subsequently approve the budget!);
- require the board treasurer to *manage* the school's finances (often in the bylaws);
- operate a "finance committee" instead of a financial oversight committee (names matter);
- adopt various financial policies, *without ever explaining that the board has to continuously see to it that its policies are being followed*; and
- approve routine payables (good luck spotting bogus invoices)
- include members as checks signer (which is of modest oversight value at best)

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 if is participating in financial management. (Board independence is also a strong argument against allowing charter school board members to be related to key employees or service providers, but some 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 aspects of each on the next page. (That I know, I'm the first to do so, so I don't think you will find these in any other literature, but if you do, please contact me.)

[1] My "I HOPE Lane Lines Model™" depicts what I propose to be the five key distinctions between charter school governance and management. You can download it free of charge on my website.

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6. In order for your board to provide oversight of financial management vs. being a participant in it, it has to understand where the lane lines are.

	Aspect	Management's Lane	The Board's Lane
1	**Fraud risk management**	Follow best practices	Ensure best practices are being followed
2	**Annual fraud risk assessment**	Execute (i.e., do it)	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
9	**Employee dishonesty insurance**	Obtain quotes and acquire	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 against
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	Verify accuracy
19	**Routine transactions**	Approve/execute/report	Evalute 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. If your board isn't routinely inspecting source documents in addition to financial reports, it's a sitting duck for someone who knows how to cook the books (which doesn't take much skill).

I know of a lot of instances of charter school fraud, waste, and abuse that could have been easily detected if the board hadn't limited its financial oversight to taking management's word for it—which is exactly what a board is doing when all it looks at are an income statement and balance sheet. In contrast, source documents such as bank and credit card statements—if directly obtained from the bank—will reveal actual 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 will tell you who is actually being paid, and how much.)

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8. RED FLAGS (I.E., POTENTIAL WARNINGS) ARE OFTEN (BUT NOT ALWAYS) OBSERVABLE BEFORE FRAUD, WASTE, ABUSE AND EXPLOITATION ARE DISCOVERED. IF YOU OBSERVE ANY OF THESE, KEEP ASKING QUESTIONS UNTIL YOU GET SATISFACTORY RESOLUTION.

1. “Don’t you trust me?” (As a rule, I find that the more indignant this protest when someone asks a question about a financial matter, the more likely it is that someone is doing something wrong. In contrast, honest people invite full transparency.)
2. The school uses debit cards instead of credit cards. (Don’t.)
3. The person who maintains the general ledger is the same person who reconciles it.
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 which that trusts personalities above policies. Example: Not directing the school leader to adhere to controls because he or she is the founder, *is* trusting a personality.
9. A set of financial statements that are so detailed and granular, they are hard for non-financial professionals to understand (e.g., a 30-page income statement).
10. A board 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 transactions are never looked at by the board.
14. Any situation in which potential conflicts of interest among director 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. A board member that routinely bills mileage to the school without prior travel approval.

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9. Every charter school leader should conduct an annual fraud risk assessment as part of overall enterprise risk management.

Don't let unfamiliarity with the highfalutin terms "fraud risk assessment" or "enterprise risk management" send you fleeing for cover from technical bafflegab. Granted, unless you're in a risk management related profession, neither term is common, but both are essential to financial oversight.

Translated into ordinary words, fraud risk assessment just means looking at where your school might be vulnerable to being ripped off (e.g., no one on the board ever looks at senior management's school credit card statements). Enterprise risk management amounts to being proactive in thinking globally about ways the organization may be exposed to fraud, as well as various other harms, then working to reduce that exposure. For example, routinely inspecting playground equipment for signs of damage is an example of enterprise risk management.

Frankly, the two biggest impediments to putting both into practice in charters are that (1) most charter school leaders have never been trained on how to conduct them (or are even aware that they should), and (2) most charter school leaders are spread so thin with simply managing through ordinary chaos that they don't have the time do them, even when they know how. (The smaller the school, the more 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 you're committed to reducing the overall risk exposure of any school you lead, an annual fraud risk assessment is an indispensable strategy because it enables you to focus your attention on school financial management practices long enough to identify potential problem areas. Your auditor, association, or insurance company may be able to assist you with learning how to conduct one.

The same thing is true of practicing enterprise risk management in a manner that is consistent with the literature. And, every board should review and discuss both these every year.

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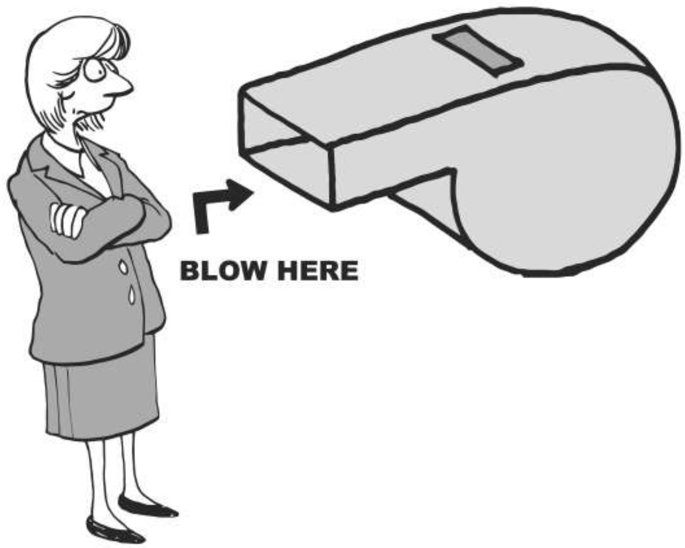
10. About half of all organizational frauds are first uncovered by a tip, so make it easy for people to anonymously tip off your board.

Because of employee proximity to the daily workload in a school, when fraud, waste, and abuse occur within a school, it is often the case that employees suspect something is wrong before board members. 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. 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 reporting hotline, then require the financial oversight committee to monitor and report allegations to the board. (A whistleblower protections policy is also a best practice.)

One word of caution: No matter how much you emphasize that the purpose of the fraud tip line is only for fraud allegations, some stakeholders will use it to file all kinds of complaints and suggestions that have nothing to do with fraud. This will require the committee to stay on point, that is, to not 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 eventually became a school leader over 30 years ago, earned a PhD in Education, and later a graduate certificate in forensic accounting and fraud examination, and became certified.

For the past 19 years, it's been my privilege to help advance the charter school sector 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, it will tank—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 email me at Brian@BrianLCarpenter.com.

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