

# At Issue

A RISK MANAGEMENT NEWSLETTER FOR AMERICA'S PRIVATE SCHOOLS



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## Employee Dishonesty and Fraud: Trends and Solutions



by Robert Bambino, CPCU  
Vice President, Risk Management

*At Issue:* Over the past few years, the public has been inundated with news stories involving employee fraud and embezzlement. Although most incidents occurred in the corporate arena, educational institutions were not exempt. There have been several large-scale losses that gained national attention involving public school districts. These cases have put school administrators under a

*microscope. Some educational risk managers and school administrators are concerned that state legislatures may begin to enact laws requiring the establishment of audit committees, mandatory external audits and other risk control techniques to prevent fraud in private educational institutions – especially if auditors or whistleblowers unveil similar improprieties.*

*This edition of At Issue will address methods headmasters and school*

*administrators can use to assess the risk associated with employee fraud.*

### Fraud in Private Schools

Data concerning employee fraud in private schools is difficult to find. However, the Association of Certified Fraud Examiners (ACFE) indicates that because of a lack of management action, overall occupational fraud has increased over the last five years with losses totaling hundreds of billions of dollars. Within the education sector, the most common type of fraud was a result of improper billing. The average fraud lasted 18 months before detection, and detection was typically a result of a tip from an employee, client/customer, vendor, or from an anonymous source. A typical billing scheme involves payment to fictitious vendors that are funneled to a bank account controlled by the perpetrator. How large are losses within the not-for-profit sector? According to the

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ACFE, the median fraud loss for not-for-profit organizations is \$40,000.<sup>1</sup>

### Fraud Perpetrator Profile

Employees with characteristics indicated in the fraud perpetrator profile are not necessarily involved in fraud, but may lead management to investigate the work environment and check financial records. In general, perpetrators usually are:

- Male
- Older (losses perpetrated by employees over 60 years old are 27 times higher than losses committed by employees 25 and younger)
- First-time offenders
- Targeters, typically, of smaller organizations rather than larger ones
- Appear to be hardworking employees with longevity
- Married, most usually
- Under stress (involved with an extra-marital affair, have a gambling, credit or substance abuse problem)

Losses caused by managers and administrators are usually substantial. The median loss committed by an employee is \$60,000 as compared to \$250,000 when committed by managers.

### Red Flags

Red flags are signals or signs that something is out of the ordinary, and may need to be investigated



further. Red flags do not indicate guilt or innocence, but just provide a warning that fraud is possible. The signals are different for administrators/supervisors and employees. If there is a problem, red flags can help prevent a situation from worsening and they can lead to change within the organization.<sup>2</sup>

### Red Flags for Employees

- Lifestyle changes
- Credit problems – calls from creditors, or debt collectors appearing at work
- Refusal to stay home when sick or take vacation
- Borrowing money from co-workers
- Excessive drinking

### Red Flags for Administrators/Supervisors

- Reluctance to provide information to auditors
- Refusal to take sick or vacation time
- Excessive number of year-end

transactions

- Frequent requests to override internal controls
- Excessive number of checking accounts and/or credit cards

### Other Red Flags

#### Organizational

- Small organizations (< 100 employees)
- Management ignores irregularities
- High turnover/low morale
- No staff training
- Decentralized structure with inadequate monitoring
- Insufficient internal controls—for example, no separation of duties

#### Non-Profit Issues

- Unsupervised financial work being done at home or off-site; pro bono work without internal controls
- Personal purchases on procurement cards

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- Inappropriate charges to travel vouchers; excessive travel
- Misappropriation of cash
- Fictitious accounts/vendors/employees
- Unexplained write-offs of inventory or cash shortages

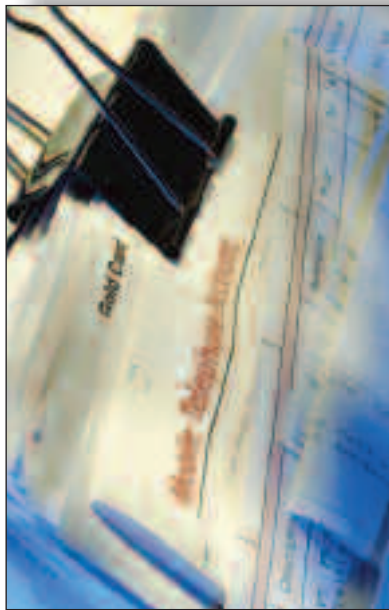
### A Word About Expense Accounts

Many employees who commit fraud start small – for example with expense accounts, where the amounts at risk are usually not that large. It's an easy way to test the system. If caught, fraud initially can be explained as errors or mistakes.

In education, where large expense account reimbursements are not the norm, administrators should be on the lookout for the following three schemes:

- Altered (overstated) Receipts: changing receipts to reflect higher amounts.
- Fictitious Expenses: submitting fake documentation for reimbursement.
- Mischaracterized Expenses: submitting expenses for unapproved or non-business expenditures.

Expense account fraud can be prevented by periodic audits requiring original receipts, issuing school credit cards (where the billing goes directly to the school) and routine verification of expenses (by spot-



checking with hotels, stores, or travel agents).

### Risk Assessments

Risk assessments for employee dishonesty exposure are not unlike those for property or liability exposures – it's an identification of hazards or conditions that increase the likelihood of fraud or employee theft. A well-done risk assessment will also help form a basis for determining how hazards will be addressed.

Characteristics that increase risk inherent to organizations are:

- Opportunity: cash, supplies and equipment are fungible and can easily be spent or sold. The more cash that's on hand, the greater the opportunity for fraud and employee theft.
- New Activities: new processes, procedures and mandates are frequently implemented to fulfill

a need or requirement. Internal controls often come after the process is established and implemented.

- Complexity: the more complex an operation or function is, the greater the possibility of errors.
- Changes in operating environments and personnel: new and untested technology and inexperienced staff decrease the efficiency of internal controls.

A detailed risk assessment examines an organization's workflow and procedures involving cash and other assets. The assessment will identify critical points in a school's procedures and workflow to ensure that internal controls are in place. There are two areas to check; one is personnel-related and the other involves segregation of key duties among staff, so no one person has unsupervised access to cash or other assets.

Administrators should also review their most recent audit to be sure that the recommendations that were made have been implemented and are being followed.

### Hiring Process/Personnel

The following key questions should be asked when reviewing your hiring processes and personnel policies:

- Is there a code of ethics? Is it distributed to all employees?

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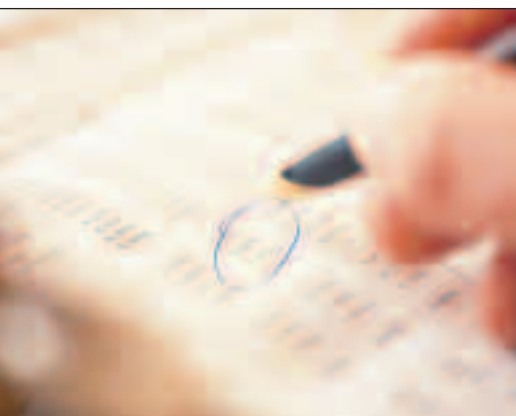
## Employee Dishonesty and Fraud

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- To the extent permitted under law and collective bargaining agreements, are references checked and background investigations conducted?
- Is there a procedure for recording, reviewing and paying approved expenses?
- Do time cards justify payroll?
- Are employees with access to cash and assets listed on your crime policy?
- Are records kept when there are unexplained irregularities or other types of red flags?
- Are employees properly supervised?
- Are attendance and overtime records maintained?

### Segregation of Duties

A review should be made to ensure that there is a segregation of duties for the following key functions:



## Insurance Requirements for External Auditors

As with other vendors and consultants, external auditing firms should provide evidence of financial responsibility. Auditors should provide proof of the following types of insurance:

- Commercial General Liability: \$1,000,000 each occurrence and \$2,000,000 in the aggregate. \$1,000,000 Personal

and Advertising Injury Liability. The school as well as its Board of Directors should be additional insureds.

- Accounts Errors and Omissions Insurance: \$1,000,000 each occurrence and \$2,000,000 in the aggregate. Coverage should include auditing services.
- Workers' Compensation: State statutory limits and coverages.

- Maintenance of accounting records, physical custody of assets and subsidiary records
- Computer programs and computerized accounting functions
- Check writing, signing, recording, distributing and bank reconciliation
- Cash collection, recording, verifying receipts and reconciling bank accounts
- Purchasing goods and services, authorizations and receiving
- Approving payroll records, preparing payrolls and signing checks
- Handling of monies from student activities funds, trips, sales, scholarships and other fundraising events

absence of fraud. School administrators must be cautious and knowledgeable about red flags and other warnings that may arise from time-to-time. A proactive approach to identifying fraud and weaknesses in procedures or systems will help reduce risk while increasing administration's confidence that systems, procedures, and control are working optimally.

The ACFE indicates that the median loss in companies that had either internal or external audits was 35% lower than companies that did not have an audit function.

<sup>1</sup>Wells, Joseph T. *Occupational Fraud: The Audit as Deterrent*. The Association of Certified Fraud Examiners. April 2002.

<sup>2</sup> Part of the material for this bulletin was taken from: Local Government Management Guide: Internal Controls, Office of the New York State Controller, Division of Local Government Services and Economic Development.

# Protecting School Buildings and Grounds

by Joann Robertson, CSP, ARM  
Coordinator of  
Risk Management

Maintaining security and safety is a twelve month a year job that requires private schools to remain vigilant over holidays and beyond the closing day of school. With spring break just a few weeks away, it's a good time for headmasters, buildings and grounds staff and other administrators to review the school's existing security plans.

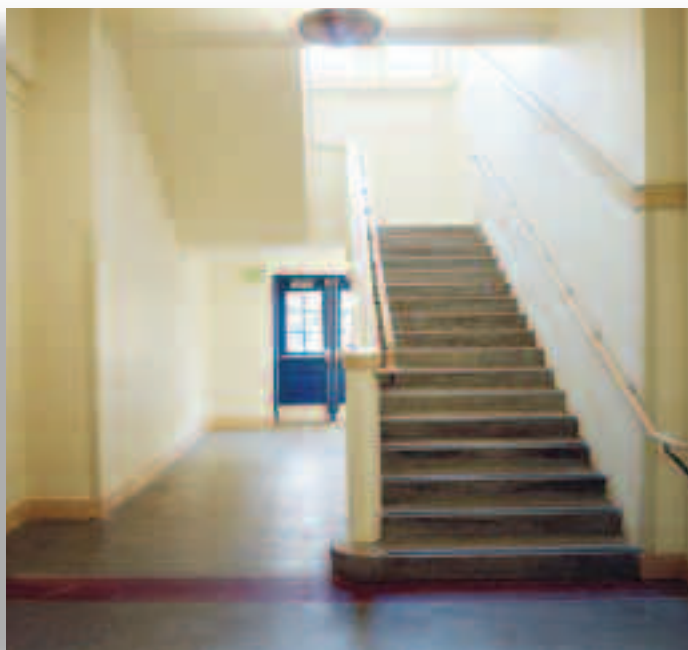
Several potential problems relate to empty schools, but there are solutions.

## The Problem:

Unauthorized access to school buildings; vandalism, theft and loitering

## The Solutions:

- Keep skeleton staffs working in the building.
- Make certain all non-essential doors are locked from the outside.
- Secure property and equip-



ment that is at risk for theft.

- Lock all storage facilities.
- Collect all keys from staff members who do not need to gain access to the building over holidays or in the summer.
- Limit alarm codes to vital personnel.
- Consider security cameras at problem areas.

## The Problem:

Use of facilities by outside groups

## The Solutions:

- Carefully screen groups who are authorized to use the building.

- Lock rooms that are not being used while ensuring that egress is maintained for facility users.
- Assign a staff member to check the buildings and fields periodically and lock up at the end of the day.
- Make certain the groups' certificates of insurance are in proper order and that the school is named as an additional insured.

## The Problem:

School playgrounds

## The Solutions:

- Conduct regular inspections of playground equipment and the surrounding area to make certain all are in good condition and free of trash, broken glass and tripping hazards.
- Post signs listing playground rules.
- Regularly measure and replenish playground surfacing materials to the proper depths.

WRIGHT RISK MANAGEMENT

333 EARLE OVINGTON BLVD., SUITE 505 • UNIONDALE, NY 11553-3624

PHONE: 516.750.9395 • FAX: 516.227.2352 • WWW.WRIGHTRISK.COM

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