

**New Caney Independent School District**  
**Statement of Auditing Standards No. 99**  
*Consideration of Fraud in the Financial Statement Audit*  
*Procedures to Prevent, Deter and Detect Fraud*

**Introduction**

In order to comply with the Statement of Auditing Standards Number 99 (SAS 99), New Caney ISD financial management has examined the risk of fraud within the district. Prior to examining the potential of fraud it is understood strong internal controls and the separation of duties are known to be the most effective methods of fraud prevention. We also understand that fraud can lead to a material misstatement in financial statements of the District. It is our general opinion the risk of fraud is low within the District. However, professional skepticism has been exercised in considering all District locations and some internal control procedures have been changed.

The New Caney ISD **Chief Financial Officer** along with the appropriate staff of the Finance Department is responsible for establishing and enforcing internal controls to protect the assets of the district. Several areas of concern have been reviewed. Our focus has been employee, or insider, fraud. Those concerns include:

- the legitimate creation and proper payment of vendors,
- the legitimate creation and proper payment of employees,
- the proper handling and recording of all cash/check receipts,
- the legitimacy of payments due for cash disbursement,
- and, inventory and equipment shrink.

It is believed the most likely areas of loss due to insider fraudulent behavior is diverting cash receipts (skimming), manipulating and altering bank deposits (lapping), and through misrepresenting a payment due. It is believed the greatest threat is at the campus level. Specifically identified is the position of campus bookkeeper.

**General Information**

Internal control is defined as a process designed by management to provide reasonable assurance regarding the achievement of District objectives in categories relating to daily operations, financial recording and reporting, and compliance with applicable laws and regulations. In simple terms, internal controls are the District policies and procedures designed to prevent and deter errors, irregularities, and insider fraud.

Strong internal controls can be a very effective deterrent to insider fraud, but may not in fact prevent or detect all fraud schemes. It is the goal of the Finance Department to establish a system of internal controls that will provide reasonable assurance that insider fraud is detected. And, that internal control measures are enhanced to prevent *all* outsider fraud.

Focusing on insider fraud we realize that employees who commit fraud do so typically when they have won a high level of trust within the district, and/or they are experiencing personal stress due to marital or family problems, illness, or financial problems. These employees usually are long-term 'model' employees who work long hours, and only take time off when all other employees are off. They are often in situations where the segregation of duties is not practical.

## Descriptions and Characteristics of Fraud

### **Cash Off-Book Schemes**

Cash off-book schemes are fraud involving cash receipts. This scheme creates an under-recording of the cash assets the District is entitled. Cash off-book fraud is usually evidenced as an unjustified decline in average cash receipts in comparison to prior years, or is the lack of cash receipts growth when changes have occurred that should yield increases.

Skimming is the removal of cash *prior* to its entry into the accounting system. Swapping checks for cash is where checks are withheld *prior* to entry in the accounting records. These checks are held until the opportunity arises to swap the check for a similar amount of cash. Off-book schemes would likely be more difficult to detect when a campus is experiencing declines in cash receipts due to the restructuring of attendance zones, or a due to a decline in enrollment within the campus attendance zone.

### **Cash On-Book Schemes**

Cash on-book schemes are fraud usually involving accounts receivable, accounts payable, inventory, purchasing and/or payroll. Larceny is the removal of cash *after* it has been entered into the accounting records.

Employees engaging in on-book schemes may alter District checks or fraudulently use check funds. This check tampering can be done through counterfeit, forgery, check alteration, interception of signed checks and unauthorized checks written by authorized employees.

Billing schemes are on-book schemes that use fraudulent or duplicate invoices, “ghost” or “shell” companies, and false support to make the District pay for goods or services that do not exist.

## Identification of Risks and Appropriate Preventative Measures

Skimming cash or swapping checks could occur at any location that handles cash/check receipts. Proper cash handling and cash transfer documentation, along with frequent deposits, will be necessary to reduce risk.

Fraud centered around the purchasing function is usually a billing scheme that may include the creation of fictitious and phony vendors, and the use of fraudulent invoices. A trusted individual could approve and record a transaction by circumventing internal controls. The authorization of new vendors should be segregated entirely from the accounts payable process by requiring the approval of both the **Senior Purchasing Specialist** and **Chief Financial Officer**.

The District’s payroll could be exploited in the form of a billing scheme. Most likely threats would be in the use of “ghost” employees, false overtime reported for pay purposes, and tax withholding scams, where payroll tax deposits are diverted into the employee’s paycheck. The **Chief Financial Officer** or **Accounting and Purchasing Coordinator** will be reviewing the payroll clerk’s paycheck for accuracy. All new employees should be authorized by the Executive Director of Human Resources.

We believe the easiest fraud to perpetrate would be fraud that involves inventory. Such fraud may involve borrowing District equipment for personal use, or removing supplies to replace supplies used at the individual's home. This removal from the District, and converting supplies into personal use, is often done with the employee justification it was "owed" to them. This would be difficult to detect, and would require significant changes in internal controls and security of the District. A physical inventory is done annually and other preventative measures are under consideration.

### **Identified Red Flags of Possible Fraud**

We will remain observant of District locations using these common 'red flags' of possible fraud.

- Employee not typically closely supervised but 'trusted' to be honest
- Inability to segregate duties for the financial functions
- Missing or altered documentation for cash disbursements
- Weak or sloppy bookkeeping/accounting records
- Out-of-balance, or negative balance, accounts
- Unreasonable – or too many – explanations upon inquiry
- Copies of invoices rather than originals
- Unexplained adjustment to accounting records
- Cash shortages
- Delayed deposits
- Unexplained declines in cash receipts
- Below average or expected results in collection rates of receivables, such as INSF checks
- Unexplained inventory usage and/or shortages

### **Additional Steps to Deter Fraud**

After due consideration we believe that additional steps are necessary to protect the assets of New Caney ISD from fraud. These are:

1. We should recommend the District conduct a thorough background and reference check on all employees that the District hires who will be responsible for financial activities within the District.
2. We should make certain that employees that work overtime are fairly compensated. We should be observant of employee's that feel they are "owed" more in salary, that indicate in a negative manner their perceptions regarding pay equity, or that have expressed an above-normal disappointment regarding any anticipated compensation increases.
3. We believe an audit presence is necessary at all times to reduce the possibility of fraud. The Finance Department will conduct surprise audits within the District to alert employees that the District is keeping a close watch on its assets.
4. We believe that periodically (at least annually) we should review and evaluate the risks of fraud and implement processes, procedures and controls needed to reduce the perceived risks.

5. Have all bank statements mailed to the Central Office where Finance Department staff review cancelled checks and deposit activity monthly. All unusual transactions or timing questions should be carefully reviewed.
6. Segregate responsibilities in the Finance Department so that no one individual controls all facets of a financial function.
7. Limit access to check stock and keep it locked up.
8. Use of locked bank deposit bags for all deposits, and requiring daily deposits for cash collections exceeding \$100.
9. A written code of ethics for all financial employees that will create a culture of honesty and high ethics. We communicate to employees the expectation of honesty is with a zero tolerance for theft and fraud. If theft by fraud is detected, the perpetrator will be prosecuted to the fullest extent of the law.
10. A locked box has been installed at the main entrance of the Administration Building for employees to anonymously report suspicions of fraud.
11. Campus and Student activity fund accounts payable processing is centralized at the New Caney ISD Business Office, with the exception of Athletics.
12. We have implemented the use of Positive Pay, a system that allows for the verification with the bank before payment.

### **Immediate Changes Needed in Internal Controls**

We believe all preventative measures have been implemented; however, we will continue to monitor internal controls for possible changes.