

INTRODUCTION

BETWEEN JUNE 2001 AND APRIL 2003, THE TOPEKA SCHOOL DISTRICT EXPERIENCED FRAUDULENT CHECK LOSSES OF MORE THAN \$500,000.

19 FRAUDULENT CHECKS WERE PAID OUT OF THE DISTRICT'S ACCOUNT.

<SHOW LIST OF FRAUDULENT CHECKS>

- 17 CHECKS LOOKED PRETTY MUCH LIKE USD 501 CHECKS (RIGHT BANK, BANK NUMBER, AND ACCOUNT NUMBER INFORMATION) – ABOUT \$550,000 IN TOTAL.
- 2 LOOKED LIKE PERSONAL CHECKS (STILL HAD RIGHT BANK, BANK NUMBER, AND ACCOUNT NUMBER INFORMATION) – ABOUT \$300 IN TOTAL.

WITH ONE EXCEPTION, FRAUDULENT CHECKS WEREN'T DISCOVERED UNTIL LATE OCTOBER 2003 (AT THAT TIME, BECAUSE THE DISTRICT'S BOOK BALANCE SHOWED ABOUT \$500,000 MORE THAN IT ACTUALLY HAD IN ITS BANK ACCOUNT, THE DISTRICT EXPERIENCE 230 OVERDRAFT CHARGES IN TWO DAYS TOTALING ABOUT \$7,000).

ANYONE WITH A CHECKING ACCOUNT CAN BE THE VICTIM OF A CHECK FRAUD ATTEMPT. WHAT'S IMPORTANT TO A GOVERNMENT ORGANIZATION WITH A CHECKING ACCOUNT IS THAT CHECK FRAUD BE PREVENTED OR DETECTED AND DEALT WITH ON A TIMELY BASIS. IF THAT'S DONE, NO LOSSES RESULT FROM CHECK FRAUD ATTEMPTS.

WHAT WE'LL DO IN THIS SESSION IS:

- DISCUSS WHAT BANKS DO TO PREVENT OR DETECT CHECK FRAUD IN CUSTOMER ACCOUNTS
- DISCUSS WHAT ORGANIZATIONS WITH CHECKING ACCOUNTS CAN DO TO PREVENT OR DETECT CHECK FRAUD
- DISCUSS WHAT PROCEDURES THE TOPEKA SCHOOL DISTRICT HAD IN PLACE TO PREVENT OR DETECT CHECK FRAUD, WHY IN SPITE OF THOSE PROCEDURES THE FRAUDULENT CHECKS WEREN'T DISCOVERED FOR SO LONG, AND WHAT LESSONS MIGHT BE LEARNED FROM THAT EXPERIENCE

INTRODUCE KIMBERLY (HER COMMENTS)

WHAT ORGANIZATIONS CAN DO TO PREVENT/DETECT CHECK FRAUD

(IN DEVELOPING THESE LISTS, WE CONSULTED ACCOUNTING AND AUDITING TEXTBOOKS AND THE LIST OF BEST PRACTICES DEVELOPED BY THE GOVERNMENT FINANCE OFFICERS ASSOCIATION)

CONCERN ABOUT BOTH INTERNAL FRAUD (FRAUDULENT CHECK WRITTEN BY AN EMPLOYEE) AND EXTERNAL FRAUD (FRAUDULENT CHECK WRITTEN BY SOMEONE OUTSIDE THE ORGANIZATION)

FINANCIAL PRACTICES

RECOMMENDED PRACTICE	DESIGNED TO
USE SECURITY FEATURES IN PRINTING THE CHECKS	MAKE IT MORE DIFFICULT TO COUNTERFEIT A CHECK
KEEP UNUSED CHECKS SECURE	PREVENT UNAUTHORIZED ACCESS TO BLANK CHECKS
KEEP SIGNATURE PLATES OR OTHER SIGNATURE APPARATUS SECURE	PREVENT UNAUTHORIZED ISSUANCE OF APPARENTLY LEGITIMATE CHECKS
RECONCILE BANK ACCOUNT EACH MONTH ON A TIMELY BASIS, AND INVESTIGATE DIFFERENCES	DETECT CHECK FRAUD AFTER THE FACT BUT IN TIME TO HAVE IT CORRECTED
HAVE BANK RECONCILIATIONS DONE BY EMPLOYEES WHO DON'T HANDLE CASH, WRITE CHECKS, INITIATE THE CHECK-WRITING PROCESS, OR RECORD CASH TRANSACTIONS IN THE ACCOUNTING RECORDS	PREVENT THE POSSIBILITY OF ONE PERSON WRITING A FRAUDULENT CHECK AND COVERING IT UP BY FALSIFYING BANK RECONCILIATIONS AND ACCOUNTING RECORDS
USE THE BANK'S POSITIVE PAY SERVICE IF AVAILABLE AND COST-EFFECTIVE	DETECT A FRAUDULENT CHECK BEFORE THE BANK PAYS IT
KEEP SIGNATURE CARDS CURRENT	DEMONSTRATE THAT AN UNAUTHORIZED PERSON HAS SIGNED A CHECK

MANAGEMENT PRACTICES

RECOMMENDED PRACTICE	DESIGNED TO
HIRE AND ASSIGN QUALIFIED STAFF	INCREASE THE LIKELIHOOD THAT FINANCIAL PRACTICES ARE FOLLOWED AND ARE EFFECTIVE IN PREVENTING AND DETECTING CHECK FRAUD
HAVE ENOUGH STAFF TO ACCOMPLISH THE ASSIGNED RESPONSIBILITIES	
PROVIDE ADEQUATE GUIDANCE	
HAVE MANAGEMENT STAFF PERIODICALLY REVIEW BANK RECONCILIATIONS AND INVESTIGATE UNUSUAL RECONCILING ITEMS	
CONDUCT PERIODIC INDEPENDENT AUDITS OR REVIEWS OF PROCEDURES	

THE TOPEKA SCHOOL DISTRICT EXPERIENCE

THE KANSAS LEGISLATIVE DIVISION OF POST AUDIT WAS DIRECTED TO REVIEW THE TOPEKA SCHOOL DISTRICT CHECK FRAUD SITUATION AND DETERMINE WHY IT TOOK SO LONG TO DISCOVER THE FRAUDULENT CHECKS.

DISCLOSURES AND DISCLAIMERS:

- OUR AUDIT DIDN'T ATTEMPT TO DETERMINE HOW THE CHECK FRAUD ITSELF OPERATED
- OUR AUDIT DIDN'T ATTEMPT TO IDENTIFY ANY LIABILITY ON THE PART OF THE BANK, THE SCHOOL DISTRICT'S EMPLOYEES, OR THE SCHOOL DISTRICT'S AUDITORS
- THE DISTRICT'S FORMER ACCOUNTANT DECLINED TO TALK WITH US DURING THE AUDIT, SO ACTIONS ATTRIBUTED TO HIM ARE BASED ON THE DOCUMENTS WE REVIEWED
- THE SCHOOL DISTRICT FILED A LAWSUIT AGAINST THE BANK, AND AS FAR AS I KNOW THAT LAWSUIT IS STILL PENDING

WHETHER I SAY THEM OR NOT, PLEASE PRESUME THE WORDS "ALLEGEDLY", "AS FAR AS WE KNOW", AND "TO THE BEST OF OUR KNOWLEDGE" WHEREVER IT'S APPLICABLE.

FIRST, THE DISTRICT'S BANK RECONCILIATIONS WEREN'T DONE PROPERLY.

DURING THE TIME PERIOD WHEN FRAUDULENT CHECKS WERE BEING PAID FROM ITS BANK ACCOUNT, THE TOPEKA SCHOOL DISTRICT HAD FINANCIAL PROCEDURES IN PLACE THAT (IF PROPERLY FOLLOWED) SHOULD HAVE DETECTED ALL OF THE FRAUDULENT CHECKS IN TIME TO HAVE ANY RELATED LOSSES RESTORED TO ITS ACCOUNT BY THE BANK. THE KEY PROCEDURE WAS A MONTHLY BANK RECONCILIATION. HERE'S HOW THAT SHOULD HAVE WORKED:

- THE ACCOUNTANT RECONCILES THE BANK ACCOUNT
- BY COMPARING CHECKS PAID BY THE BANK TO CHECKS WRITTEN BY THE DISTRICT, THE ACCOUNTANT DISCOVERS A CHECK PAID BY THE BANK THAT WASN'T WRITTEN BY THE DISTRICT
- THE DISTRICT NOTIFIES THE BANK (GENERALLY THERE'S A 30-DAY WINDOW OF OPPORTUNITY FOR THIS)
- MONEYS PAID OUT BY THE BANK FOR THE FRAUDULENT CHECK ARE RESTORED TO THE DISTRICT'S ACCOUNT

THE BASIC PROBLEM FOR THE TOPEKA SCHOOL DISTRICT WAS THAT STARTING IN JUNE 2001 THE ACCOUNTANT DIDN'T REALLY RECONCILE THE BANK ACCOUNT. THE DISTRICT'S PROCEDURES CALLED FOR THE ACCOUNTANT TO GET THE OUTSTANDING CHECKS FIGURE FOR EACH MONTH'S RECONCILIATION FROM A DISTRICT REPORT THAT WAS PRODUCED BY COMPARING DISTRICT INFORMATION ABOUT CHECKS IT HAD WRITTEN AND BANK INFORMATION ABOUT CHECKS THE BANK HAD PAID. CHECKS WRITTEN BY THE DISTRICT BUT NOT PAID BY THE BANK (THE OUTSTANDING CHECKS) WERE LISTED AND TOTALED. THE ACCOUNTANT, WHO STARTED WITH THE DISTRICT IN JUNE 2001, APPARENTLY USED THAT REPORT FOR THE APRIL AND MAY 2001 BANK RECONCILIATIONS.

STARTING WITH JUNE 2001, HOWEVER, THE ACCOUNTANT STOPPED USING THAT REPORT FOR THE OUTSTANDING CHECKS FIGURE. WE DON'T KNOW WHY BECAUSE THE ACCOUNTANT DECLINED TO TALK WITH US. ACCORDING TO DISTRICT OFFICIALS, THE ACCOUNTANT ARRIVED AT THE MONTHLY OUTSTANDING CHECKS FIGURE BY USING DISTRICT INFORMATION ABOUT CHECKS IT HAD WRITTEN AND BANK INFORMATION ABOUT CHECKS THE BANK HAD PAID BUT WITHOUT COMPARING THE TWO SETS OF INFORMATION. BECAUSE IT DOESN'T MAKE THAT COMPARISON, THE PROCESS ASSUMES THAT ALL CHECKS PAID BY THE BANK ARE ACCURATE AND LEGITIMATE (WHICH WASN'T THE CASE), AND ANY RESULTING RECONCILIATION DOESN'T REALLY RECONCILE THE ACCOUNT. THE RECONCILIATIONS AS DONE WOULDN'T AND DIDN'T FIND ANY OF THE FRAUDULENT CHECKS.

<SHOW GRAPHIC OF THE APJ600 PROCESS>

THE ACCOUNTANT HAS SAID THAT THE INFORMATION IN THE MONTHLY REPORT OF OUTSTANDING CHECKS WAS FLAWED. FIRST, LATER ANALYSIS SHOWED ABOUT 20 ITEMS IN ERROR WITH A TOTAL IMPACT OF LESS THAN \$15,000. SECOND, REGARDLESS THE ACCOUNT STILL DIDN'T RECONCILE, BUT THE MONTHLY REPORTS MADE IT LOOK LIKE IT DID. THE SCHOOL DISTRICT HAD EVERYTHING IT NEEDED TO RECONCILE THE ACCOUNT EACH MONTH – NOT ONLY THE ELECTRONIC LIST OF ITEMS PAID BY THE BANK, BUT ALSO A TRADITIONAL BANK STATEMENT AND A CD THAT CONTAINED A COPY OF EVERY ITEM PAID BY THE BANK, INCLUDING THE FRAUDULENT CHECKS.

WE NOTICED TWO OTHER THINGS ABOUT THE RECONCILIATIONS WE REVIEWED:

- THE DIFFERENCES BETWEEN THE OUTSTANDING CHECKS AMOUNTS USED BY THE ACCOUNTANT ON THE RECONCILIATIONS AND THE AMOUNTS FROM THE DISTRICT'S MONTHLY REPORT GRADUALLY GREW TO MORE THAN \$500,000 AND THE GROWTH OF THIS DIFFERENCE GENERALLY PARALLELED THE ACCUMULATING LOSSES FROM FRAUDULENT CHECKS.

<SHOW TABLE OF ACCUMULATING LOSSES>

- MANY OF THE RECONCILIATIONS APPARENTLY WEREN'T DONE ON A TIMELY BASIS. (RECONCILIATIONS WERE DONE AS MUCH AS EIGHT MONTHS LATE.) NORMALLY THAT'S A PROBLEM BECAUSE YOU NEED TO BRING QUESTIONABLE TRANSACTIONS TO THE BANK'S ATTENTION ON A TIMELY BASIS TO ENSURE THEY GET CORRECTED WITHOUT A LOSS TO YOU. HOWEVER, BECAUSE THE RECONCILIATIONS AS ACTUALLY DONE DIDN'T IDENTIFY ANY FRAUDULENT CHECKS, THE LACK OF TIMELINESS DIDN'T MAKE ANY DIFFERENCE IN THIS CASE.

SECOND, MANAGEMENT REVIEWS OF THE RECONCILIATIONS DIDN'T SEEM TO BE IN SUFFICIENT DEPTH.

IN GENERAL, THE DISTRICT HAD APPROPRIATE MANAGEMENT PROCEDURES TO ENSURE THAT ITS BASIC FINANCIAL PROCEDURES WERE CARRIED OUT PROPERLY

HOWEVER, ONE PROCEDURE WASN'T ALWAYS CARRIED OUT WELL—REVIEW OF THE BANK RECONCILIATION REPORT WAS AT A HIGH LEVEL, FOCUSING ONLY ON THE SUMMARY PAGE.

HOWEVER, EVEN A MORE IN-DEPTH MANAGEMENT REVIEW OF THE BANK RECONCILIATIONS WOULDN'T NECESSARILY HAVE GUARANTEED THAT DISTRICT MANAGEMENT WOULD KNOW THE RECONCILIATIONS WEREN'T DONE PROPERLY. FOR MOST MONTHS DURING THE TIME PERIOD OF CONCERN THERE WEREN'T ANY INDICATIONS THAT THE RECONCILIATIONS WEREN'T DONE PROPERLY. HOWEVER, FOR SOME MONTHS THERE WERE INDICATIONS. IF THOSE INDICATIONS HAD BEEN SEEN AND INVESTIGATED, THE FRAUDULENT CHECKS LIKELY WOULD HAVE BEEN DISCOVERED AT THAT TIME.

FOR EACH MONTH'S RECONCILIATION, THE ACCOUNTANT PREPARED A RECONCILIATION REPORT FOR MANAGEMENT REVIEW. REMEMBER THAT THE RECONCILIATIONS AS DONE DIDN'T IDENTIFY ANY FRAUDULENT CHECKS, THE QUESTION IS WOULD THERE HAVE BEEN SOMETHING ABOUT THE RECONCILIATION REPORT TO INDICATE TO MANAGEMENT THAT THE RECONCILIATION WASN'T DONE PROPERLY. WE FOUND THAT EACH MONTH'S RECONCILIATION REPORT GENERALLY LOOKED LIKE A PROPERLY DONE RECONCILIATION. WE'LL LOOK AT AN EXAMPLE – FOR DECEMBER 2002. BY THIS TIME, ALL BUT ONE OF THE 19 FRAUDULENT CHECKS HAD BEEN PAID OUT OF THE DISTRICT'S ACCOUNT, AND CHECK LOSSES HAD ACCUMULATED TO MORE THAN \$500,000.

<SHOW EXAMPLE RECONCILIATION REPORT>

THE SUMMARY PAGE INDICATES THAT THE BALANCES RECONCILE. THE APPLICABLE LINES ARE THE FIRST TWO. THE LINE LABELED "BANK" HAS THE BANK STATEMENT FIGURES, AND THE LINE LABELED "GENERAL LEDGER" HAS THE CHECKBOOK FIGURES. THE FIGURES IN THE "ADJUSTEMENTS" COLUMN ARE THE TOTALS OF THE DIFFERENT RECONCILING ITEMS.

THE NEXT FOUR PAGES PROVIDE THE DETAIL OF THE RECONCILING ITEMS. THE ONLY REASON THAT THERE ARE FOUR PAGES OF THESE IS THAT, IN DECEMBER 2002, THE DISTRICT'S CHECKBOOK BALANCE APPARAENTLY HADN'T BEEN ADJUSTED FOR RECONCILING ITEMS ALL THE WAY BACK TO APRIL 2001. ONLY THE LAST 17 LINES IN THE MIDDLE COLUMN ON THE FOURTH PAGE OF DETAIL ITEMS ARE RECONCILING ITEMS RELATED TO THE MONTH OF DECEMBER 2002. SO, IF RECONCILIATION ADJUSTMENT WERE KEPT CURRENT, THERE WOULD NORMALLY BE ONE PAGE OF SUPPORTING DETAIL. THE RECONCILIATION PACKAGE ALSO INCLUDED MANY PAGES OF LISTS OF ITEMS, BUT THE TOP FIVE PAGES ARE THE KEY ONES FOR MANAGEMENT REVIEW.

IN DOING ITS REVIEW OF MONTHLY RECONCILIATIONS, DISTRICT MANAGEMENT FOCUSED ON THE SUMMARY PAGE, AND NOT THE RECONCILING ITEMS ON THE FOLLOWING FEW PAGES. BECAUSE OF THAT, MANAGEMENT MISSED OPPORTUNITIES TO SEE INDICATIONS THAT THE RECONCILIATIONS WEREN'T BEING DONE PROPERLY. DURING THE TIME FRAUDULENT CHECKS WERE BEING PAID FROM THE DISTRICT'S BANK ACCOUNT, THERE WERE SEVERAL OF THESE.

FIRST, FOR FIVE DIFFERENT MONTHS, THE RECONCILIATION REPORT ADDED THE OUTSTANDING CHECKS FIGURE TO THE BANK BALANCE. NORMALLY, IN DOING A BANK RECONCILIATION, OUTSTANDING CHECKS ARE SUBTRACTED FROM THE BANK BALANCE. THE DECEMBER 2002 RECONCILIATION ITEMS DETAIL INCLUDES AN OUTSTANDING CHECKS FIGURE BUT IT'S ADDED TO THE BANK BALANCE. THE FACT THAT THE OUTSTANDING CHECKS FIGURE IS ADDED ISN'T NECESSARILY OBVIOUS, BUT IT WAS THERE TO BE SEEN FOR FIVE DIFFERENT MONTHS.

THE FIRST TIME WAS IN LATE AUGUST 2002, WHEN THE RECONCILIATION OF JULY 2002 WAS COMPLETED. AT THAT TIME, THE CUMULATIVE FRAUDULENT CHECK LOSS WAS ONLY ABOUT \$180,000.

SECOND, THE ONE FRAUDULENT CHECK IDENTIFIED BY THE BANKING SYSTEM WASN'T SHOWN AS A RECONCILING ITEM. THAT CHECK WAS PAID OUT OF THE DISTRICT'S ACCOUNT IN MID-OCTOBER 2002, CONFIRMED AS FRAUDULENT EARLY IN NOVEMBER 2002, AND REIMBURSED TO THE DISTRICT'S ACCOUNT IN EARLY MARCH 2003. DISTRICT MANAGEMENT WASN'T AWARE OF THAT SITUATION UNTIL THE REIMBURSEMENT IN MARCH.

IF IT HAD BEEN REVIEWING RECONCILING ITEMS, MANAGEMENT MAY HAVE REMEMBERED THAT THIS CHECK HADN'T BEEN SHOWN AS A RECONCILING ITEM ON EARLIER BANK RECONCILIATIONS. IF THE RECONCILIATIONS HAD BEEN DONE PROPERLY, THE CHECK IN QUESTION WOULD HAVE BEEN SHOWN AS A RECONCILING ITEM—A CHECK PAID OUT BY THE BANK BUT NOT WRITTEN BY THE DISTRICT—FROM THE TIME OF ITS DISCOVERY UNTIL THE REIMBURSEMENT.

IN DEALING WITH THIS SITUATION, OFFICIALS TOLD US THE DISTRICT DID THE FOLLOWING:

- HIRED TEMPORARY ACCOUNTANTS TO REVIEW AND CORRECT THE PREVIOUS BANK RECONCILIATIONS. THAT'S WHEN THE DISTRICT BECAME AWARE OF THE 18 FRAUDULENT CHECKS NOT ALREADY FOUND BY THE BANKING SYSTEM.

- FILED REPORTS WITH THE TOPEKA POLICE DEPARTMENT AND FEDERAL BUREAU OF INVESTIGATION.
- NOTIFIED ITS SCHOOL BOARD.
- FILED A CLAIM WITH ITS BANK TO RECOVER MONEYS FOR THE FRAUDULENT CHECKS. (THAT CLAIM WAS DENIED AS NOT BEING TIMELY.) THE DISTRICT HAS FILED A LAWSUIT AGAINST THE BANK. THAT LAWSUIT IS STILL PENDING.

LESSONS TO BE LEARNED

THE EXPERIENCE OF THE TOPEKA SCHOOL DISTRICT SHOULD MAKE IT CLEAR THAT CHECK FRAUD CAN HAPPEN, THAT IF NOT PROMPTLY DETECTED THE RELATED LOSSES CAN BE SIGNIFICANT, AND THAT STAFF MAY NOT ALWAYS PROPERLY CARRY OUT KEY PROCEDURES. GOOD BASIC FINANCIAL MANAGEMENT PRACTICES SHOULD ADDRESS MOST OF THE RISK IN THIS AREA, BUT SPECIFIC CONSIDERATION SHOULD BE GIVEN TO:

- USE OF POSITIVE PAY SERVICES – PROVIDE A LIST OF CHECKS WRITTEN TO THE BANK, AND THE BANK DOESN'T PAY ANY CHECKS NOT ON THAT LIST. FOR ANY GIVEN ORGANIZATION, SUCH SERVICES MAY NOT BE AVAILABLE, OR MAY NOT BE WORTH THE COST.
- ADDITIONAL OVERSIGHT OF THE RECONCILIATION PROCESS— HAVE MANAGEMENT OCCASIONALLY TEST A BANK RECONCILIATION BY TRACING KEY AMOUNTS TO THE ACTUAL ACCOUNTING RECORDS, OR FROM TIME TO TIME HAVE ANY EMPLOYEE WHO DOESN'T NORMALLY DO THE BANK RECONCILIATION DO THAT MONTH'S.