Fraud In Single Audits

FSA4/26/V1

SURGENT ACCOUNTING & FINANCIAL EDUCATION

Contents for Today's Course

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Section 1

Chief Fraud Officer

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A Little Background on the Course

- Benjamin Franklin knew the cost of not proactively studying and therefore simply learning by firsthand consequences when he wrote "Experience keeps a dear school, but fools will learn in no other."
- To ignore the severe pain and post affects of fraud experienced by auditees and auditors runs the risk of our having to learn of them firsthand. Instead, we should try to learn from the experiences of others to recognize the warning signs of fraud



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A Little Background on the Course

The frauds we will discuss in this course actually occurred. We have changed the names of the individuals and entities involved, as certain cases discussed are still in resolution/adjudication. To provide you with a feel for the materiality of the frauds discussed, only minor changes were made to the dollar amounts involved. Keep in mind that the goal of this course is not to point fingers at what others may potentially have missed, but rather **with the incredible gift of hindsight** learn how fraud is occurring and the warning signs of fraud

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Section 1 – Learning Objective

In this section, we will discuss how the long-term chief financial officer (CFO) of a not-for-profit (NFP) managed to steal more than $40,000,000

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Chief Fraud Officer

- Our first fraud to discuss involves NFP A and its former CFO (Alex), who stole more than $40,000,000 in a little over a decade
  - It is unclear in terms of how the fraud was initially detected by officials of NFP A in its final year
- NFP A is a conservancy organization in a large metropolitan area with the mission of developing access to a riverfront (e.g., a riverwalk, plazas, pavilions, and green spaces)
- NFP A is funded by both private donors and grants
  - In several of the latter years of the fraud, NFP A had single audits due to pass-through funding it received from a state's department of transportation under the 20.205 Highway Planning and Construction program

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Profile of the Fraudster

- As mentioned on the prior slide, the fraud at NFP A occurred in a little over a decade, not coincidently, this timeframe aligned to Alex being employed as NFP A's CFO
  - It appears Alex began his fraud towards the end of his first year at NFP A
- Alex was in his early-40s to early-50s during the time of the fraud
- Alex's compensation in the final years of employment at NFP A averaged well over $200,000
- Alex appears to have lived somewhat large (e.g., he owned properties in multiple states and Mexico, a nightclub, and a yacht)

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Profile of the Fraudster

- Alex had substantial power in overseeing and managing NFP A's financial affairs with little oversight. For example,
  - Alex opened a $5,000,000 line of credit on behalf of NFP A by forging documents with a bank claiming to have the authority to do so from NFP A's Board. **Note.** Alex used the $5,000,000 to infuse monies into NFP A's bank accounts to help cover up his substantial embezzlement from those accounts
  - Alex was able to limit online access to NFP A's bank information to himself and only provided paper copies of the bank statements (which Alex had altered) to NFP A's bookkeeper approximately four times a year
- Alex appears to have had multiple side businesses

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Exercise 1

When NFP boards consider the skillsets of potential new board members they tend to focus on significant donors and individuals highly supportive of the mission. Unfortunately, this can potentially lead to a board which is overly trusting of management and focused on furthering the mission and lacking in oversight of management. **If an NFP's board asked you to describe the types of individuals that should make up a board, what would you suggest?**

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Solution to Exercise 1

- It takes a proper **composition** of board members with **different skillsets** to properly oversee management and the direction of the NFP. The course author believes boards should look for board members that **collectively**…
  - Have some experience in running a business (e.g., they understand the importance of management roles, controls, policies, and budgeting);
  - Have some financial acumen and curiosity (e.g., they'll ask questions during the monthly budget for actual review at board meetings);
  - Are willing to exercise a healthy level of skepticism in overseeing management (i.e., they can discern the difference between being supportive and overly trusting of management);
  - Have legal knowledge or access to it;
  - Are knowledgeable and supportive of the mission; and
  - Are plugged in to the NFP's donor base

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Exercise 2

How many board members do you think that NFP A had and **does the number of board members make any difference?**

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Solution to Exercise 2

- At the time the fraud came to light, NFP A had over 40 active board members listed on its website
- There is no magic number of board members, and it really is a Goldilocks and The Three Bears type issue NFPs should consider
  - **Too many board members can potentially result in a complicated structure and potentially water down oversight of management as individual members may assume their role is relatively small and it's not their job**
  - Too few board members can potentially stretch board members too thin, and oversight of management can fall by the wayside
- **The course author's thoughts**: If Apple and Amazon can be overseen by 8-12 board members, perhaps the typical NFP can be as well

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Exercise 3

The board of directors should oversee management and part of that includes overseeing the NFP's **financial performance, controls and reporting**. If an NFP board asked you to **name ten specific things they should be doing in overseeing management in terms of financial matters, what would you recommend?**

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Solution to Exercise 3

- The course author would suggest:
  - At monthly board meetings, reviewing the monthly/YTD budget-to-actual statement of activities and key balance sheet accounts (e.g., cash, investments, receivables, payables)
  - Ensuring annual financial statements and the Form 990 are prepared, reviewed, and submitted when due (and yes, the benefits of an audit outweigh the cost even when it is not required)
  - Ensuring that payrolls are reviewed by someone other than the payroll person, payroll taxes are being paid, and Forms 941 are being filed*****
  - Ensuring that monthly bank reconciliations are being performed*****
  - Ensuring that controls exist over credit card usage and monthly reconciliations are being performed*****

*****This can be done by inquiring of management and perhaps board member verification on a spot basis particularly where segregation of duties issues exist

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Solution to Exercise 3

- The course author would suggest: (continued)
  - Inquiring of management about compliance with grant and donor stipulations
  - Ensuring fraud reporting mechanisms exist and are conveyed to employees (e.g., an email account monitored by the board treasurer)
  - Ensuring a monthly online review of bank account activity is occurring (particularly looking at transfers in and out)*
  - Where applicable, ensuring that receivables, write-offs, discounts are being reviewed on a monthly basis*
  - Inquiring about all of the resource inflows (contributed cash and noncash items) of the NFP and the controls that exist over those flows

*****This can be done by inquiring of management and perhaps board member verification on a spot basis particularly where segregation of duties issues exist

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The Steps Alex Followed to Commit Fraud

- Alex diverted NFP A's funds from its bank accounts to a bank account in the name of an entity owned and controlled by Alex. The entity was not an approved vendor for NFP A and provided no goods or services of any kind to NFP A
  - Over the years, Alex transferred over $24,000,000 from NFP A's bank accounts to an account in the name of the entity Alex controlled
  - **Note.** Alex routinely transferred NFP A funds through elaborate chains of intermediate entities, all with the intent of concealing the source and nature of those funds

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The Steps Alex Followed to Commit Fraud

- Alex maintained a credit card account in the name of another of the many entities he owned and controlled (i.e., this was a different entity from the one discussed on the prior slide)
- Over the years, Alex used approximately $15,000,000 in NFP A's funds to pay off purchases made on this account
  - None of these expenditures were authorized by NFP A, which maintained other credit card accounts for NFP A's purchases
  - Alex used the credit card account to purchase furniture, designer clothing, handbags, lawn care services, airline tickets, and other consumer goods and services for himself and his family

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The Steps Alex Followed to Commit Fraud

- Alex used NFP A's funds to purchase cashier's checks from various financial institutions
  - The cashier check purchases were unauthorized, and Alex used the cashier's checks for his own purposes without the knowledge or approval of NFP A's Board of Directors
- As mentioned earlier, Alex limited online access to NFP A's bank information to himself and only provided paper copies of the bank statements to NFP A's bookkeeper on an intermittent basis
  - In some instances, Alex falsified bank statements that he provided to NFP A's bookkeeper, altering or deleting unauthorized transfers on the statements in order to keep them off of NFP A's books
  - The improper $5,000,000 line of credit (mentioned earlier) was also used to cover up missing amounts

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Opportunities to Commit Fraud That Alex Observed at NFP A

- Alex appears to have taken advantage of an overly trusting board and management team (of which he was a part) to perpetrate and conceal a long-time fraud
  - For example, Alex had the ability to limit online access to bank accounts to himself, and no one questioned the lack of segregation of duties with no compensatory control
- It appears that those below Alex within the organization were either afraid to raise questions or did not know what to be looking for
  - For example, no one seemed to ask why NFP A's bookkeeper was only given limited access to financial information (and the paper bank statements they did receive contained altered information)
- In sum, this is a classic case of **management override of controls**

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A Few Words About Management Override of Controls and the Audit…

- AU-C section 240.A6 discusses that **management override of controls** can be committed by techniques such as:
  - Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives
  - Inappropriately adjusting assumptions and changing judgments used to estimate account balances
  - Omitting, advancing, or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period
  - Omitting, obscuring, or misstating disclosures required by the applicable financial reporting framework or disclosures that are necessary to achieve fair presentation
  - **Concealing facts** that could affect the amounts recorded in the financial statements
  - **Engaging in complex transactions** that are structured to misrepresent the financial position or financial performance of the entity
  - **Altering records** and terms related to significant and unusual transactions

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A Few Words About Management Override of Controls and the Audit…

- AU-C section 240 discusses that due to the unpredictable way in which **management override of controls** could occur, it is a risk of material misstatement due to fraud and, thus, a **significant risk**
  - AU-C section 240 discusses that the engagement team discussion is required to address the risk of management override of controls
  - AU-C section 240 discusses that while the level of risk of management override of controls will vary from entity to entity, **the risk is**, nevertheless, **present in all entities**

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A Few Words About Management Override of Controls and the Audit…

- Paragraphs .31 to .33 of AU-C section 240 discuss specific audit procedures for risks related to management override of controls including requirements related to:
  - Testing the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements, including entries posted directly to financial statement drafts
  - Reviewing accounting estimates for biases
  - Evaluating significant unusual transactions
- Paragraph .44 of AU-C section 240 requires the auditor to document the results of the audit procedures, **including those designed to address the risk of management override of controls**

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From NFP A's First Form 990 After the Fraud Was Detected

FORM 990, PART VI, SECTION A, LINE 5	ON [redacted] PLACED THE ORGANIZATION'S CHIEF FINANCIAL OFFICER ON ADMINISTRATIVE LEAVE AFTER DISCREPANCIES WITH THEIR FINANCIAL DOCUMENTS WERE IDENTIFIED, AND THEREAFTER, ON [redacted], THE CHIEF FINANCIAL OFFICER EMPLOYMENT WAS TERMINATED FOR CAUSE. SINCE THE DISCOVERY OF FRAUD, LEADERSHIP HAS FOCUSED ON CONTINUOUS IMPROVEMENT AND ADVANCEMENT OF THE ORGANIZATION'S FINANCIAL MANAGEMENT. IN [redacted] ENGAGED [redacted] AS AN OUTSOURCED ACCOUNTING SERVICE PROVIDER TO OVERSEE ITS FINANCIAL INFORMATION. A FORENSIC ACCOUNTING FIRM WAS ENGAGED TO INVESTIGATE AND REPORT ON THE FINANCIAL DISCREPANCIES AND A LAW FIRM HAS BEEN ENGAGED TO ASSIST WITH CIVIL LITIGATION AND ACT AS A LIASON BETWEEN THE [redacted] AND THE FEDERAL PROSECUTOR ASSIGNED TO THE CRIMINAL CASE. THE [redacted] ALSO ENGAGED A NEW INDEPENDENT AUDIT FIRM TO COMPLETE THE FINANCIAL STATEMENT AUDIT FOR YEAR ENDED [redacted]. CONTRACTING WITH THESE NEW PARTNERS IS PART OF A SERIES OF SIGNIFICANT AND STRATEGIC IMPROVEMENTS BEING MADE TO ENHANCE FINANCIAL INTEGRITY, TRANSPARENCY, AND OPERATIONAL EFFICIENCY. IN ADDITION, A NEW CEO, INTERIM-CFO, AND NEW ACCOUNTING DEPARTMENT HAVE BEEN BROUGHT IN TO REINFORCE SEGREGATION OF DUTIES AND STRENGTHEN INTERNAL CONTROLS. THE FINANCIAL STATEMENT AUDIT FOR YEAR ENDED [redacted] IS UNDERWAY BUT WILL NOT BE COMPLETED PRIOR TO FILING OF THE FORM 990. THE [redacted] WITH ASSISTANCE FROM ITS FORENSIC ACCOUNTING FIRM AND AUDIT FIRM, IS WORKING TO DETERMINE THE MAGNITUDE OF THE DISCREPANCIES AND ANTICIPATES THE FINANICAL STATEMENTS ISSUED FOR THE YEAR ENDED [redacted] WILL ACCURATELY REPRESENT THE [redacted] FINANCIAL INFORMATION AND BE FREE FROM MATERIAL MISTATEMENT.

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A Few Additional Thoughts About This Case – The Below Are Excerpts from the Schedule of Findings and Questioned Costs for the Two Most Recent Single Audits Performed Prior to the Fraud Being Detected

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

For the Year Ended [redacted]

SUMMARY OF AUDITOR'S RESULTS

Financial Statement:

Type of auditor's report issued on whether the financial statements audited were prepared in accordance with accounting principles generally accepted in the United State of America: Unmodified

Internal control over financial reporting:

- Material weaknesses identified? ____ Yes __X__ No
- Significant deficiencies identified? ____ Yes __X__ None reported

Noncompliance material to financial statements noted? ____ Yes __X__ No

Federal Award:

Internal control over major programs:

- Material weaknesses identified? ____ Yes __X__ No
- Significant deficiencies identified? ____ Yes __X__ None reported

Type of auditor's report issued on compliance for major federal programs: Unmodified

Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)? ____ Yes __X__ No

Identification of major federal programs:

Assistance Listing Number	Name of Federal Program or Cluster
20.205	Highway Planning and Construction (Federal-Aid Highway Program)

Dollar threshold used to distinguish between Type A and Type B programs: $ 750,000

Auditee qualified as low-risk auditee? ____ Yes __X__ No

FINANCIAL STATEMENT AUDIT FINDINGS

None

MAJOR FEDERAL AWARD PROGRAM AUDIT FINDINGS AND QUESTIONED COSTS

None

SCHEDULE OF FINDINGS AND QUESTIONED COSTS

For the Year Ended [redacted]

SUMMARY OF AUDITOR'S RESULTS

Financial Statement:

Type of auditor's report issued on whether the financial statements audited were prepared in accordance with accounting principles generally accepted in the United State of America: Unmodified

Internal control over financial reporting:

- Material weaknesses identified? ____ Yes __X__ No
- Significant deficiencies identified? ____ Yes __X__ None reported

Noncompliance material to financial statements noted? ____ Yes __X__ No

Federal Award:

Internal control over major programs:

- Material weaknesses identified? ____ Yes __X__ No
- Significant deficiencies identified? ____ Yes __X__ None reported

Type of auditor's report issued on compliance for major federal programs: Unmodified

Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)? ____ Yes __X__ No

Identification of major federal programs:

Assistance Listing Number	Name of Federal Program or Cluster
20.205	Highway Planning and Construction (Federal-Aid Highway Program)

Dollar threshold used to distinguish between Type A and Type B programs: $ 750,000

Auditee qualified as low-risk auditee? ____ Yes __X__ No

FINANCIAL STATEMENT AUDIT FINDINGS

None

MAJOR FEDERAL AWARD PROGRAM AUDIT FINDINGS AND QUESTIONED COSTS

None

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Exercise 4

On the following slide are excerpts from NFP A's comparative statements of financial position for the last audit completed before the discovery of Alex's fraud. The left column represents the most recent period, and the right column is the comparative period. **With the incredible gift of hindsight and the knowledge we now have about what Alex was doing, what areas jump out to you for further analysis?**

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Exercise 4

ASSETS		
Current Assets:		
Cash and cash equivalents	$ 226,212	$ 9,695,880
Pledges receivable – current portion (no allowance considered necessary) (Note D)	5,266,421	2,427,758
Prepaid expenses	667,583	38,559
Total Current Assets	**6,160,216**	**12,162,197**
Other Assets:		
Cash held for fiduciary deposits (Note F)	232,143	69,864
Investments (Note E)	7,612,451	9,030,048
Pledges receivable (net of current portion) (no allowance considered necessary) (Note D)	1,594,080	523,154
Easements and related leases (Note A)	41,138,961	41,138,961
RiverWalk (net of accumulated depreciation of $7,839,135 and $7,129,199 in [redacted] and [redacted] respectively) (Note A)	117,690,771	99,292,120
Right-of-use assets under operating leases (Note G)	735,026	-0-
Furniture and equipment (net of accumulated depreciation of $267,783 and $259,517 in [redacted] and [redacted] respectively) (Note A)	15,567	23,833
Total Other Assets	**169,018,999**	**150,077,980**
Total Assets	**$ 175,179,215**	**$ 162,240,177**

LIABILITIES AND NET ASSETS		
Current Liabilities:		
Accounts payable and accrued expenses	$ 4,786,241	$ 1,481,736
Fiduciary deposits payable (Note F)	232,143	69,864
Operating lease liabilities – current portion (Note G)	155,745	-0-
Total Current Liabilities	**5,174,129**	**1,551,600**
Long-Term Liabilities:		
Operating lease liabilities (net of current portion) (Note G)	582,118	-0-
Total Liabilities	**5,756,247**	**1,551,600**
Net Assets:		
Net assets without donor restrictions	142,351,069	128,454,055
Net assets with donor restrictions (Note B)	27,071,899	32,234,522
Total Net Assets	**169,422,968**	**160,688,577**
Total Liabilities and Net Assets	**$ 175,179,215**	**$ 162,240,177**

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Solution to Exercise 4

Alex's theft was clearly putting a strain on NFP A's cash, and this **may** have been a reason for the large **decrease** in **cash and cash equivalents** (well over $9,000,000) and the **increase** in **accounts payable and accrued expenses** (well over $3,000,000)

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Exercise 5

If you wanted to drill down into the $9,000,000 decrease in cash and cash equivalents, what procedures might you perform?

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Solution to Exercise 5

- A couple of suggestions might include:
  - An online analysis of the bank accounts in comparison to the altered paper copy bank statements may have detected the transfers
  - A more involved procedure could be performing a proof of cash essentially showing how total deposits and disbursements from bank accounts are reconciled to revenues and expenses reported in an NFP's accounting system

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A Few Words About the Auditor…

- In the course materials, we will include a brief description of the audit firm involved in each case. We do this not to pick on the firm but rather to affirm/disaffirm conceptions you might have about audits where fraud occurs. Here are some facts about the audit firm in the case we just discussed
  - The firm appears to be a small regional firm with three offices (including an office in the city NFP A operated in)
  - The firm's website indicates that they do a fair amount work with NFPs and governments
  - The firm appears to have had a fairly long relationship with NFP A
  - The firm was a member of the AICPA Governmental Audit Quality Center
  - The firm received a peer review rating of pass in its most recent peer review

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Section 2

After School Job

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Section 2 – Learning Objective

In this section, we will see how two management employees of an NFP fraudulently obtained at least $1,800,000 by submitting fraudulent expenditure reports and reimbursement requests to a pass-through entity

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After School Job

- Our second fraud to discuss involves NFP B and its former executive director (Bill) and project manager (Cindy), who fraudulently obtained at least $1,800,000 over an estimated five-year period
  - It is unclear how the fraud was initially detected. However, the audit for perhaps the final year of the fraud was issued very late (30 months after the fiscal year end) and it contained the following unusual comment in the Schedule of Findings and Questioned Costs which indicates that the state (i.e., the pass-through entity) may have had suspicions

III. FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

[redacted] State Board of Education initiated the process of conducting a monitoring report in [redacted]. The report pertains to [redacted] and [redacted] during which the [redacted] State of Education indicated certain findings relating to the Organization's Questioned Costs. The Organization has responded to the findings and disagreed with the findings. As of the date of this report no final determination has been made regarding the Questioned Costs

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After School Job

- NFP B is an NFP in a large metropolitan area with the mission of preventing and eradicating juvenile delinquency through the development and support of local community self-help efforts
- NFP B heavily relied on pass-through awards it received from a state's department of education under the 84.287 Twenty-First Century Community Learning Centers program
  - This program is primarily focused on providing students with academic enrichment opportunities during non-school hours or periods when school is not in session (e.g., before school, after school, or during summer recess)

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Profile of the Fraudsters

- As mentioned earlier, the fraud at NFP B occurred over an estimated five-year period
  - Bill was in his mid-50s during the time of the fraud
  - Cindy was in her late-40s during the time of the fraud
- About midway through the five-year period Bill gave up his role as executive director of NFP B and was replaced by Cindy (who moved up from her project manager role)
- Bill and Cindy appear to have had substantial power in overseeing and managing NFP B's financial affairs with little oversight
- Both Bill and Cindy controlled additional NFPs

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The Steps Bill and Cindy Followed to Commit Fraud

- While NFP B did at times provide afterschool programming, in applying for grants, Bill and Cindy inflated NFP B's expenses and also falsely claimed NFP B would receive some programmatic and administrative services from five other entities
  - Two of the entities were NFPs controlled by Bill and Cindy and three other entities were NFPs providing youth development programming in the area
- Bill opened and controlled bank accounts with multiple financial institutions
  - Some of the accounts were in the name of an NFP he controlled
  - Without their authorization, Bill also opened accounts in the names of the three other NFPs providing youth development programming in the area

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The Steps Bill and Cindy Followed to Commit Fraud

- Bill and Cindy prepared and submitted fraudulent periodic expenditure reports and reimbursement requests to the pass-through entity
  - Inflating NFP B's actual expenses
  - Falsely claiming the five other entities (mentioned on the prior slide) had performed program services on NFP B's behalf
- Bill and Cindy prepared and retained false check requests and supporting documents for the amounts included in the expenditure reports

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The Steps Bill and Cindy Followed to Commit Fraud

- After the grant funding was received from the state, Bill and Cindy converted the grant funds to their own purposes via:
  - Issuing checks to an NFP Bill controlled and the three other NFPs mentioned earlier (i.e., the NFPs which Bill had opened bank accounts in the name of). These checks were then deposited into the bank accounts Bill controlled and were:
    - Used to pay Bill's credit cards
    - Withdrawn as cash
    - Used to write checks that were then negotiated at a currency exchange for cash or to purchase money orders
  - Issuing checks to an NFP Cindy controlled which were then negotiated at a currency exchange for cash or to purchase money orders
  - Paying Bill's credit cards directly out of NFP B's account
  - Making cash withdrawals from NFP B's account

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Opportunities to Commit Fraud That Bill and Cindy Observed at NFP B

- The opportunities to commit fraud at NFP B closely parallel those observed in our first case (involving NFP A) as it appears to be a classic case of management override of controls with limited board oversight
- The collusion of two members of management made the fraud easy to perpetrate
- The fact that NFP B operated almost exclusively off pass-through awards (i.e., 84% of total revenue in the believed final year of the fraud) meant that NFP B did not have traditional donors asking about how funds were being spent or expecting to see results from amounts given

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From A Cover Letter Accompanying NFP B's Financial Statements in the Believed Final Year of the Fraud

I, [redacted] CEO, certify that:

1. I have reviewed these financial statements.
2. Based on my knowledge, the statements do not contain any untrue statement of a material fact, nor do they omit a material fact.
3. Based on my knowledge, the financial statements fairly present in all material respects the financial position, results of operations, changes in net assets, and cash flows of [redacted].
4. Both certifying officers are responsible for establishing and maintaining a system of internal controls and procedures.
5. Both certifying officers have disclosed any significant deficiencies and material weaknesses in the internal controls over financial reporting, have disclosed any fraud that involves management or other employees.

As of [redacted] believes its system of internal controls over financial reporting was effective for providing reliable published financial statements.

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From the Audit Report on the Financial Statements in the Believed Final Year of the Fraud

Basis for Qualified Opinion

The [redacted] management did not have adequate records to support balances reported for Revenue and Receivables. As a result, we are unable to audit the reported balances for Revenue and Receivables. Therefore, management was not able provide records to properly ascertain the amounts reported in the Revenue Group of Accounts. Accounting principles generally accepted in the United States of America require Program Contract and revenues are recognized as Revenue to the extent of the expenditure in the contract period in which services are provided by management.

Qualified Opinion

In our opinion, except for the matter described in the "Basis for Qualified Opinion" in the preceding paragraph above, the financial statements present fairly, in all material respects, the financial position of [redacted], as of [redacted], and the changes in financial position for the year ended in accordance with accounting principles generally accepted in the United States of America.

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From the Single Audit Report in the Believed Final Year of the Fraud

Opinion on Each Major Federal Program

In our opinion, [redacted] has not compiled, in all material respects, with the types of compliance requirements referred to above that could have a direct and material effect on each of its major federal programs for the year ended [redacted]

Author's Note: The above wording appears to be rendering an adverse opinion, however the report did not contain a "Basis for Adverse Opinion" paragraph

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From the Single Audit Report in the Believed Final Year of the Fraud

[redacted]
SCHEDULE OF FINDINGS AND QUESTIONED COSTS
YEAR ENDED DECEMBER 31, 2017

I- SUMMARY OF AUDITOR'S RESULTS

Financial Statements

Type of report the auditor issued on whether the financial statements audited were prepared in accordance with GAAP: Unmodified

Internal control over financial reporting:

- Material weakness(es) identified? ( )Yes (√)No
- Significant deficiency (ies) identified? ( )Yes (√) None reported

Noncompliance material to financial statements noted? ( )Yes (√) No

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? ( )Yes (√) No
- Significant deficiency(ies) identified? ( )Yes (√)None reported

Any audit findings disclosed that are required to be reported in accordance with 2 CFR 200.516(a)? ( )Yes (√)No

Identification of Major Federal Programs

CFDA Numbers	Name of Federal Program Cluster	Type of Auditor's Report Issued on Compliance for Major Federal Programs
84.287	21st Century Community Learning Centers	modified

Dollar threshold used to distinguish between type A and type B program: $750,000

II. FINANCIAL STATEMENT FINDINGS

For the fiscal year ended [redacted], matters required to be reported under Uniform Guidance were found (Finding [redacted]-01 and [redacted]-02)

[redacted]
SCHEDULE OF FINDINGS AND QUESTIONED COSTS (CONTINUED)
YEAR ENDED DECEMBER 31, 2017

III. FEDERAL AWARD FINDINGS AND QUESTIONED COSTS

[redacted] State Board of Education initiated the process of conducting a monitoring report in [redacted]. The report pertains to [redacted] and [redacted] during which the [redacted] State of Education indicated certain findings relating to the Organization's Questioned Costs. The Organization has responded to the findings and disagreed with the findings. As of the date of this report no final determination has been made regarding the Questioned Costs

IV. SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS

For the fiscal year ended [redacted], matters required to be reported under Uniform Guidance were found [redacted]

IV. SECTION 505(d) 1 (ix) REPORTING REQUIREMENT

Auditee qualified as low risk auditee under section 501(a) ( ) Yes (√) No

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Exercise 6

In the Schedule of Findings and Questioned Costs (SFQC) we just reviewed, did you notice anything which appeared incorrect?

Solution to Exercise 6

- A few of the issues with the SFQC include:
  - As we saw earlier, the auditor issued a **qualified opinion** on the financial statements (due to the lack of adequate records to support revenue and receivables). However, the SFQC indicated that the opinion on the financial statements was **unmodified**
  - The auditor did report two current year financial statement level findings (which we will soon see). However, the SFQC did not indicate that they were either significant deficiencies or material weaknesses which would seem unusual in light of the reason the auditor gave for qualifying the report on the financial statements (i.e., the lack of records)
  - As we saw earlier, the auditor appears to have issued an adverse opinion on compliance for its major program. However, the SFQC's Section I did not indicate that any findings existed related to federal awards and Section III just included wording describing that the pass-through entity was looking into certain things

A Few Additional Thoughts About This Case – The Below Is an Excerpt From the Two Current Year Financial Statement Level Findings in the Believed Final Year of the Fraud

II. FINANCIAL STATEMENT FINDINGS

Finding [redacted]-01

Revenue was not recorded in a timely manner

Condition and Criteria

Revenue is earned and recognized upon product delivery or service completion, without regard to the timing of cash flow. As a result of the untimely cash flow, [redacted]'s revenue was not recorded or recognized in a timely manner.

Effect:

The improper recognition of revenue impairs the quality of reported financial statements, potentially misleading Grantors and regulators.

Cause:

[redacted] did not have adequate controls and procedures in place to monitor and record revenue promptly

Recommendation:

Review contracts with Grantors and determine method of implementation and review financial statement and compliance disclosures

Management Response

Note: The Management Response section was left blank in the report

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From the Two Current Year Financial Statement Level Findings in the Believed Final Year of the Fraud

Finding [redacted]-02

Misstated Financial statements

Condition and Criteria

Revenue was misstated by over a million dollars as a result of unrecognized receivables

Effect:

Misstated revenue impairs the quality of reported financial statements, potentially misleading grantors and regulators.

Cause:

Improper accounting procedures and weak internal controls

Recommendation:

Procedures should be developed and implemented to address the above item.

Management Response

Note: The Management Response section was left blank in the report

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A Few Words About the Auditor…

- Here are some facts about the audit firm in the case we just discussed
  - The firm appears to be a small local firm with an office in the city NFP B operated in
  - The firm's website indicates that they do a fair amount of work with NFPs and governments
  - The audit reporting we just discussed was the firm's first year with NFP B as a client
  - The firm was a member of the AICPA Governmental Audit Quality Center
  - The firm received a peer review rating of pass in its most recent peer review

SURGENT ACCOUNTING & FINANCIAL EDUCATION

Exercise 7

As mentioned on the prior slide, the audit reporting we reviewed was the firm's first year with NFP B as a client. So, in the year prior to that, the fraud was also underway, and a different auditor was involved. **How do you believe that audit went?**

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Solution to Exercise 7

Unfortunately, the auditor of the prior year did not appear to have detected anything as evidenced by the below SFQC for that year

SECTION I - SUMMARY OF AUDITOR'S RESULTS	
Financial Statements	
Type of auditor's report issued:	Unmodified
Internal control over financial reporting:	
Any material weaknesses identified?	NO
Any reportable conditions identified that are not considered to be material weaknesses?	NO
Any non-compliance material to financial statements noted?	NO
Federal Awards	
Internal control over major programs:	
Any material weaknesses identified?	NO
Any reportable conditions identified that are not considered to be material weaknesses?	NO
Type of auditor report issued on compliance for major programs:	Unmodified
Any audit findings disclosed that are required to be reported in accordance with section 510(a) of OMB Circular A-133?	NO
Identification of major programs:	
Title IV - 21st Century Community learning Centers	CFDA No. 84.287
Dollar threshold to distinguish between type A and type B programs:	$750,000

SECTION II - FINANCIAL STATEMENT FINDINGS
For the year ended [redacted], there were no reportable conditions, material weaknesses, or instances of non-compliance related to the financial statements that are required to be reported in accordance with the Uniform Guidance
SECTION III - FEDERAL AWARD FINDINGS AND QUESTIONED COSTS
For the year ended [redacted], no matters required to be reported under Uniform Guidance were found.
SECTION IV - SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
For the fiscal year ended [redacted], matters required to be reported Uniform Guidance were found. [redacted]
SECTION V - SECTION 505(d)1(ix) REPORTING REQUIREMENT
Auditee qualified as a low-risk auditee under Section 510(a) NO

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Section 3

PTO – Pay the Officer

SURGENT ACCOUNTING & FINANCIAL EDUCATION

Section 3 – Learning Objective

In our first two cases, we have seen how the presence of management personnel with bad intentions and a weak board can lead to fraud. Our third case will continue this theme. In this case, we will see how the chief executive officer (CEO) of an NFP diverted a significant amount of funds to herself through the payroll process (specifically the use of paid time off)

Another Reminder of the Importance of Those Charged With Governance When it Comes to Fraud Prevention

- AU-C section 240.04 discusses the importance of those charged with governance when it discusses that:
  - The **primary responsibility** for the prevention and detection of fraud rests with **both those charged with governance of the entity** and **management**. It is important that management, **with the oversight of those charged with governance**, places a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior, **which can be reinforced by active oversight by those charged with governance**. **Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of financial statement users regarding the entity's performance and profitability**

PTO – Pay the Officer

- Our third fraud involves NFP C and its former CEO (Debbie) who received more than $7,500,000 in total compensation over a three-year period
  - Included in the $7,500,000 was approximately $3,400,000 in paid time off (PTO)
- It is unclear how the fraud was initially detected. However, court filings indicate that news media reports sparked an investigation by the state
- NFP C's purpose (as described in its audit reports) was to empower women through the elimination of personal and institutional violence and oppression by advocating for social change through non-violence and nondiscriminatory alternatives

SURGENT ACCOUNTING & FINANCIAL EDUCATION

PTO – Pay the Officer

- NFP C was responsible for receiving and distributing federal and state funding to over 40 domestic violence centers across the state
  - For example, it appears NFP C passed-through approximately 80% - 90% of the federal and state awards it received to subrecipients
- NFP C relied heavily on grants from several federal and state programs (e.g., the 93.671 Family Violence Prevention and Services/Domestic Violence Shelter and Supportive Services program)

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Profile of the Fraudsters

- Debbie served as CEO of NFP C for over a decade
- Debbie appears to have had substantial power in overseeing and managing NFP C's financial affairs with little oversight
- Debbie was in her late-40s during the three-year period involving the more than $7,500,000 in compensation
- Debbie enjoyed homes in multiple states
- Debbie also had some assistance from NFP C's CFO (Evelyn) who is believed to have received close to $300,000 in excessive PTO payouts
  - Evelyn was in her early-50s during the three-year period

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The Steps Debbie Followed to Commit Fraud

- To accumulate funds for NFP C to be able to pay the excessive PTO, Debbie and Evelyn submitted false quarterly reports
  - The reports contained expenses for false positions with high salaries and charges for services never provided
- Over a three-year period, Debbie accumulated close to 1,200 days of PTO which could be carried forward indefinitely and cashed out at her discretion (**Note**. Additional days were also given in other years)
- Debbie also awarded Evelyn PTO hours

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The Steps Debbie Followed to Commit Fraud

- NFP C's board of directors awarded much of the PTO to Debbie but appear to have little knowledge of the NFP's financial operations
  - Board members were not aware that most of NFP C's funding came from government sources (**Note**. This is a little jarring as over 95% of NFP C's revenues typically came from government sources)
  - Board members accepted at face value Debbie's assurances that sufficient funding was available for her compensation
  - Board members appear to have been confused if they were awarding hours or days of PTO and thought the awarded PTO was just going to be used if Debbie had a medical issue
- Debbie and Evelyn cashed out the PTO (approximately $3,400,000 to Debbie and $300,000 to Evelyn)

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Opportunities to Commit Fraud That Debbie Observed at NFP C

- The opportunities to commit fraud at NFP C mirror those observed in our last case (involving NFP B) as:
  - It appears to be a classic case of management override of controls with limited board oversight
  - The collusion of two members of management made the fraud easy to perpetrate
  - The fact that NFP C operated almost exclusively off government awards meant that NFP C did not have traditional donors asking about how funds were being spent

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A Few Additional Thoughts About This Case – An Excerpt From NFP C's Notes to the Financial Statements

NFP C's financial statements typically had a note (see below example) which indicates that some of NFP C's board members were also reliant on funding from NFP C. That certainly raises the perception that they were less likely to be questioning of Debbie (for fear of losing funding) and that perhaps Debbie had cultivated a non-questioning board

(9) **Related Party Transactions and Balances:**

Certain board members of the Organization are also Executive Directors of not-for-profit agencies that are service providers of the Organization. An independent oversight board that receives no compensation or funding from the Organization determines the allocation of Organization funds to all service providers. Service provider Executive Directors in no way make any allocation determinations. Expenses incurred and outstanding payables to these service providers for the year ended [redacted] were $7,532,606 and $1,398,929, respectively. Account receivables due from these service providers for the year ended [redacted] were $2,025. These transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.

A Few Additional Thoughts About This Case – The Single Audits Performed Prior to the State's Investigation

- As mentioned earlier, media reports regarding NFP C led to an investigation by the state. In the four single audits performed immediately prior to the state's investigation
  - Clean opinions were issued on the financial statements
  - Clean opinions were issued on compliance for major programs
  - No financial statement or federal award findings were reported
  - The audits were performed by a large regional firm
    - The firm was a member of the AICPA Governmental Audit Quality Center
    - The firm received a peer review rating of pass in its most recent peer review

Exercise 8

Fraud can obviously take a heavy toll on NFPs, but can it actually lead to them being shut down?

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Solution to Exercise 8

Potentially, yes. Approximately 18 months after the state completed its initial investigation, NFP C received a court order to dissolve itself under state law. No vote of the board of directors was required. NFP C was placed under receivership and all liabilities and obligations of the NFP were to be settled in accordance with the court order

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A Few Additional Thoughts About This Case – The First Single Audit After the State Investigation

- We briefly discussed the four single audits immediately preceding the state investigation of NFP C. In the first single audit after the state investigation,
  - A different audit firm performed the single audit, and they had the "advantage" of knowing what they were getting into due to the state investigation
  - A smaller firm was chosen to perform the audit
    - The firm was a member of the AICPA Governmental Audit Quality Center
    - The firm received a peer review rating of pass in its most recent peer review

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A Few Additional Thoughts About This Case – The Below Are Excerpts From the SFQC for the First Single Audit After the State Investigation

Part A - SUMMARY OF AUDIT RESULTS

Financial Statements

Type of audit report issued: *Qualified*

Internal control over financial reporting:

- Material weakness(es) identified? ___ yes X no
- Significant deficiencies identified? ___ yes X none reported

Noncompliance material to financial statements noted? ___ yes X no

Federal Awards

Internal control over major federal programs:

- Material weakness(es) identified? X yes ___ no
- Significant deficiencies identified? X yes ___ none reported

Types of auditor's report issued on compliance for major federal programs: *Qualified*

Any audit findings that are required to be reported in accordance with 2 CFR 200.516(a)? X yes ___ no

Identification of major federal programs:

Federal Program	Federal CFDA Number
Family Violence Prevention and Services/Domestic Violence Shelter and Support Services	93.671
Victims of Crime Act (VOCA)	16.575
Injury Prevention and Control Research and State and Community based programs	93.136

Dollar threshold used to distinguish between type A and type B federal programs: $987,237

Auditee qualified as low-risk auditee? ___ yes X no

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From Some of the Federal Award Findings in the First Single Audit After the State Investigation

Finding [redacted]-002 – Material Weakness – Financial Reporting – CFDA #s 93.671 & 93.136

Criteria: In accordance with the grant agreement [redacted] with the [redacted] Department of Children and Families, quarterly expenditure reports are required to be submitted.

Condition: We reviewed 1 of 4 quarterly reports required to be filed. In the sampled report we noted that 3 funding sources which we could not reconcile expenditures in the report to the general ledger. Additional reports were requested and were not able to be provided.

Cause: The Organization is currently in liquidation and documentation or access to documentation is limited. We were unable to obtain an explanation as to the difference in the quarterly report tested.

Effect: We are unable to reconcile the reported quarterly expenditures to the general ledger.

Questioned Costs: None identified.

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From Some of the Federal Award Findings in the First Single Audit After the State Investigation

Finding [redacted]003 – Material Weakness – Procurement – CFDA #s 93.671, 93.136 & 16.575

Criteria: Non-Federal entities other than States, including those operating Federal programs as subrecipients of States, must follow the procurement standards set out at 2 CFR sections 200.318 through 200.326. They must use their own documented procurement procedures, which reflect applicable State and local laws and regulations, provided that the procurements conform to applicable Federal statutes and the procurement requirements identified in 2 CFR part 200.

Condition: The Organization was not able to provide supporting documentation on procurement for 3 of the 5 vendors with expenditures over $35,000 in the fiscal year.

Cause: The Organization is currently in liquidation and documentation or access to documentation is limited. We were unable to obtain an explanation as to the difference in the quarterly report tested.

Effect: We are unable to test 3 of the 5 sampled vendors for Procurement applicable to funds expended for federal program 93.671, 93.136 and 16.575.

Questioned Costs: 93.671: $43,389, 93.136: $72,084, 16.575: $51,836

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A Few Additional Thoughts About This Case – The Below Is an Excerpt From Some of the Federal Award Findings in the First Single Audit After the State Investigation

Finding [redacted]-004 – Significant Deficiency – Allowable Costs – Executive Paid Time Off – CFDA 93.671

Criteria: In accordance with 2 CFR Part 200.404, a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The question of reasonableness is particularly important when the non-Federal entity is predominantly federally-funded.

Condition: The President & CEO was provided additional compensation by receiving 1,280 hours of paid time off in addition to the policy that the organization had in place. This amounted to $284,121 in benefits. The entire balance of the paid time off account was paid to the President & CEO during the fiscal year in the amount of $535,033 prior to retirement.

Cause: Compensation was approved by the Board of Directors and has been performed in prior years as well.

Effect: Amounts allocated to federal and state grants, including indirect allocations, are considered to be questioned costs.

Questioned Costs: 93.671: $18,511, 93.591: $65,426, 16.556: $3,673, 93.558: $8,520, 16.588: $17,438

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Section 4

Education Pays

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Section 4 – Learning Objective

- In this fraud case, we will move to the governmental sector and see how a long-time school district employee stole a significant amount of funds by exploiting a few holes in the controls at the government

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Education Pays

- Our fourth fraud to discuss involves a school district (D ISD) and its former senior director of fiscal services (Frank) who fraudulently obtained more than $14,000,000 over a seven-year period
- D ISD is a medium-sized district
  - Enrollment runs a little over 5,000 students
- D ISD received a variety of federal programs (e.g., 84.027 Special Education Grants, 10.555 National School Lunch Program, etc.)

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Education Pays

- The fraud was detected when Frank's bank notified D ISD about potential fraud involving deposits from a district account
  - The Superintendent of D ISD searched Frank's office and discovered altered district bank statements
- The FBI's criminal complaint against Frank described the fraud as embezzlement concerning programs receiving federal funds and the Superintendent stated that "The money he stole was mostly targeted for students with special needs."

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Profile of the Fraudster

- Frank was in his mid-40s to mid-50s during the time of the fraud
- Frank worked for D ISD for over 15 years and had seen his title and salary increase over the years
  - Frank had risen to be senior director of fiscal services at an annual salary of $220,000
- Frank also ran a musical/live events production company and enjoyed living large
  - The chief business official for the district noticed that Frank appeared to live a lifestyle beyond the means of someone in his position but assumed Frank had additional income from the production company

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Profile of the Fraudster

- On the prior slide, we said Frank enjoyed living large. The FBI's criminal complaint contained the following examples of Frank's purchases:
  - $60,000 at Louis Vuitton stores
  - $127,000 for a BMW
  - $150,000 in transfers to foreign banks
  - $180,000 at a jewelry store
  - $190,000 on cosmetic treatments
  - $350,000 at Gianni Versace stores
  - $1,500,000 on a new residence

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The Steps Frank Followed to Commit Fraud

- As senior director of fiscal services at D ISD, Frank managed the district's funds and had check writing responsibilities. For his fraud, Frank primarily relied on two of the district's accounts
  - An account used for student fundraising activities
  - A temporary cash funds account
    - The temporary cash funds account was supposed to function like a petty-cash account and was not supposed to have a balance over $50,000
- Over a seven-year period, more than $14,000,000 was deposited into Frank's personal bank account from over 250 checks drawn on the two D ISD bank accounts discussed above
  - It appears that most of the checks were from the temporary cash funds account

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The Steps Frank Followed to Commit Fraud

- The chief business official's signature was required on checks drawn from the temporary cash funds account
  - Frank would submit checks for signature to the chief business official typically in amounts less than $2,000 (which seemed consistent with the account's supposed petty cash nature)
  - The checks often used three initials for the payee line and the letters were spaced apart
    - The same three initials were used routinely and consisted of **D S D** (i.e., D ISD without the I) so the chief business official may have thought the initials stood for the D School District and were going to be converted to cash for petty cash purposes

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The Steps Frank Followed to Commit Fraud

- After obtaining the chief business official's signature, Frank would then alter the checks
  - The check amounts were typically changed to be somewhere between $11,000 to $95,000
  - The payee on the checks were changed to an individual's full name with the initials D S D (e.g., Debra Sally Davis)
    - Frank routinely used the same name (or a slight variant of it) which was not his name
- Frank appeared to favor the use of drive-thru ATMs to deposit the over 250 checks from D ISD into his personal bank account
  - The use of ATMs for deposits likely gave Frank some comfort that fewer questions would arise (e.g., from tellers at his bank) particularly as the altered checks were made out to Debra Sally Davis

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The Steps Frank Followed to Commit Fraud – The Below Are Excerpts From the FBI Criminal Complaint Against Frank



Image of Frank making a $73,500 deposit at ATM



Image of Frank making a $85,350 deposit at ATM



Image of Frank making a $89,150 deposit at ATM

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The Steps Frank Followed to Commit Fraud

- Frank used the funds deposited into his personal bank account to make extravagant purchases as we discussed earlier
  - In the final year of the fraud (which had not been audited as this course was written but had been investigated by the FBI) it is estimated that Frank embezzled over $4,000,000 from the district, which his bank account for that period reflected
    - $1,900,000 in credit card payments
    - $325,000 in ATM withdrawals
    - $130,000 in transfers to Frank's fiancée
- Frank was responsible for reconciling the temporary cash funds account
  - Every six months, Frank submitted the reconciliations, hard copy bank statements, and support to the chief business official for review

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The Steps Frank Followed to Commit Fraud

- Frank altered D ISD's hard copy bank statements to make it appear that far less funding was going into the temporary cash funds account and flowing out of it
  - As an example, in one month, the altered hard copy bank statement reflected an ending balance of $50,000 (i.e., the maximum balance the account was supposed to hold) and the actual balance was $1,200,000
- **Author's Note**. The FBI's criminal complaint and other sources used for this case did not really discuss the sources of the cash inflows going to the temporary cash funds account. However, based on the charges of embezzlement concerning programs receiving federal funds it appears that grant funds were the source of at least some of the inflows

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Exercise 9

Having studied aspects of Frank's fraud, **what opportunities to commit fraud do you see at the school district that allowed the fraud to occur for so long?**

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Solution to Exercise 9

- With the gift of hindsight, some of the holes in the controls appear to have been
  - A lack of segregation of duties as Frank had a role in preparing checks, distributing checks, and reconciling the temporary cash funds account. While a compensatory control was in place in the form of the chief business official signing the checks and reviewing the bank reconciliations the compensatory control was flawed in that:
    - The reconciliations were only submitted every six months
    - The chief business officer was not reviewing the activity online but just based on the hard copy bank statements Frank submitted (**Author's Note. It is extremely easy to alter documents in today's world**)
    - Reviewers in key controls need to be those with questioning minds and not afraid to ask questions for things that seem odd (e.g., why are we writing so many checks out to D S D related to a petty cash account and how exactly does this account work?)

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Solution to Exercise 9

- With the gift of hindsight, some of the holes in the controls appear to have been
  - Allowing checks to be made out to just initials instead of a payee's full name, which is never a good idea for fraud purposes or banking purposes
    - Allowing the use of initials/abbreviations just makes the fraudster's job easier
    - Some banks may reject such checks
- **Author's Note**. If we knew more about the inflows of funds into the temporary cash funds account, we could likely identify more holes in controls

SURGENT ACCOUNTING & FINANCIAL EDUCATION

Exercise 10

One of the things that makes fraud hard to prevent or detect is the various methods that can be used to perpetrate it. **Can you think of any general controls that can be applied across the board at governments and NFPs to prevent or detect fraud?**

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Solution to Exercise 10

- Some of the author's favorite general controls from a fraud perspective include:
  - Some form of background check for employees in key financial roles (e.g., at least a review from online public records on the local county's website)
  - Job cross-training/rotations and mandatory vacation policies (e.g., avoid having one person over a key financial/operational area and no one else ever seeing what is going on)
  - Fraud reporting mechanisms (hotlines, monitored email accounts, etc.) as both internal and external tips have historically been a major source of frauds coming to light (e.g., in this case a tip from Frank's bank led to the discovery of the fraud)
  - Add online reviews of bank account activity by someone outside the receipt and disbursement process as it's just too easy to alter documents today

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A Few Additional Thoughts About This Case – The Single Audits Performed Prior to the FBI's Investigation

- As mentioned earlier, a tip reported to D ISD and initial search of Frank's office by the Superintendent led to an investigation by the FBI. In the seven single audits performed immediately prior to the FBI's investigation:
  - Clean opinions were issued on the financial statements
  - Clean opinions were issued on compliance for major programs
  - No financial statement or federal award findings were reported
  - The audits were performed by a medium-sized firm specializing in school district audits
    - The firm was a member of the AICPA Governmental Audit Quality Center
    - The firm received a peer review rating of pass in its most recent peer review

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A Few Additional Thoughts About This Case – The Below Are Excerpts From the Schedule of Findings and Questioned Costs for the Two Most Recent Single Audits Performed Prior to the Fraud Being Detected

SUMMARY OF AUDITORS' RESULTS
FOR THE YEAR ENDED [redacted]

FINANCIAL STATEMENTS

Type of auditors' report issued:	Unmodified
Internal control over financial reporting:	
Material weakness(es) identified?	No
Significant deficiency(ies) identified?	None Reported
Non-compliance material to financial statements noted?	No

FEDERAL AWARDS

Internal control over major program:	
Material weakness(es) identified?	No
Significant deficiency(ies) identified?	None Reported
Type of auditors' report issued:	Unmodified
Any audit findings disclosed that are required to be reported in accordance with Uniform Guidance 2 CFR 200.516(a)?	No
Identification of major programs:	

AL Number(s)	Name of Federal Program or Cluster
84.027, 84.027A, 84.173	Special Education Cluster
84.425	Education Stabilization Fund Discretionary Grants

Dollar threshold used to distinguish between Type A and Type B programs:	$ 750,000
Auditee qualified as low-risk auditee?	Yes

SUMMARY OF AUDITORS' RESULTS
FOR THE YEAR ENDED [redacted]

FINANCIAL STATEMENTS

Type of auditors' report issued:	Unmodified
Internal control over financial reporting:	
Material weakness(es) identified?	No
Significant deficiency(ies) identified?	None Reported
Non-compliance material to financial statements noted?	No

FEDERAL AWARDS

Internal control over major program:	
Material weakness(es) identified?	No
Significant deficiency(ies) identified?	None Reported
Type of auditors' report issued:	Unmodified
Any audit findings disclosed that are required to be reported in accordance with Uniform Guidance 2 CFR 200.516(a)?	No
Identification of major programs:	

AL Number(s)	Name of Federal Program or Cluster
84.425C, 84.425D	COVID-19 Emergency Acts Funding/ Education Stabilization Fund Discretionary Grants:
21.019	Coronavirus Relief Fund (CRF): Learning Loss Mitigation
84.010	Title I, Part A, Basic Grants Low-Income and Neglected

Dollar threshold used to distinguish between Type A and Type B programs:	$ 750,000
Auditee qualified as low-risk auditee?	Yes

SURGENT ACCOUNTING & FINANCIAL EDUCATION

Whatever Happened to Frank?

- Frank pled guilty to one count of embezzlement, theft, and intentional misapplication of funds from an organization receiving federal funds, a felony offense that carries a statutory maximum sentence of 10 years in federal prison
- Frank was sentenced to 70 months in federal prison and ordered to pay $16,694,942 in restitution
- The following slide has two pictures of Frank's stash of cash presented at his trial

Whatever Happened to Frank?





Section 5

Pennies From Heaven

SURGENT ACCOUNTING & FINANCIAL EDUCATION

Section 5 – Learning Objective

- A popular song (and movie) from the 1930s to 1950s stated that "You'll find your fortune falling all over town. Be sure that your umbrella is upside down."
- Federal grants can sometimes feel like a fortune falling from the sky to governments and NFPs
  - The OMB estimated outlays for both discretionary and mandatory federal grants for 2023 exceeded a trillion dollars (i.e., about $3,200 per person in the U.S.)
- However, it is important to remember that things falling from the sky are often accompanied by lightning (i.e., in this case fraud allegations)

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Pennies From Heaven

- Our fifth fraud case involves NFP E and its two founders (George and Harriet)
- NFP E's mission was to engage in scientific research focused on the better understanding of meteorological phenomena (i.e., essentially storm chasing)
- NFP E was heavily dependent on various direct awards it received from federal agencies including:
  - The National Science Foundation (NSF)
  - NOAA
  - NASA

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Pennies From Heaven

- An NSF site visit at NFP E led to an investigation involving several federal agencies
- Among other matters, the investigation concluded that over a number of years, NFP E had:
  - Improperly requested drawdowns from federal grants for expenses it had not incurred
  - Improperly retained interest accrued on federal funds received but not yet needed
    - At the time of the investigation, NFP E had sufficient excess federal funds on hand to invest in a $3,000,000 CD
  - Paid George and Harriet excessive rent

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Pennies From Heaven

- As a result of the investigation,
  - NFP E repaid the federal government over $2,400,000
  - George and Harriet personally repaid the federal government over $200,000
- Since the above payments were made, NFP E has essentially ceased to operate

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Pennies From Heaven

- For the remainder of our discussion of NFP E, we will use a different format than we've used in our earlier cases. Essentially, we will look at:
  - The two single audits completed immediately **prior** to the federal agency investigation
  - A few additional takeaways from the federal agency investigation
  - The two single audits completed immediately **after** the federal agency investigation (as the operations of NFP E were winding down)

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The Two Single Audits Completed Immediately Prior to the Federal Agency Investigation

- For the two single audits leading up to the federal agency investigation, NFP E was audited by a sole practitioner
  - Clean opinions were issued on the financial statements
  - Clean opinions were issued on compliance for major programs
  - No financial statement or federal award findings were reported
- While the reporting did not indicate the detection of any issues at NPF E, the reporting did at least indicate possibly a few issues with the audit. For example,
  - The audit reporting incorrectly referred to the superseded OMB Circular A-133 instead of the Uniform Guidance
  - The overall reporting had some unconventional aspects to it [see following slide which is an excerpt from the notes to NFP E's Schedule of Expenditures of Federal Awards (SEFA) that appears to describe the audit procedures performed]

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The Two Single Audits Completed Immediately Prior to the Federal Agency Investigation

NOTE A - SIGNIFICANT ACCOUNTING POLICIES

This accompanying schedule of expenditures of federal awards is a summary of the [redacted] federal programs presented on the accrual basis of accounting in accordance with generally accepted accounting principles.

[redacted] did not elect the 10% de minimis indirect cost rate as the [redacted] uses the negotiated rate with the US Department of the Interior.

Procedures used to verify the above amounts include, but are not limited to:

1. Reviewed totals by program and by account/line item.
2. Performed tests of off-the-shelf accounting software to ensure operation supported accounting reports.
3. Identified Individually Significant Items (ISI) which are material based upon materiality calculations and performed compliance and internal control tests.
4. From accounts included in (1) above, scanned account entries for unusual items in amount, by description, by vendor, etc.
5. Judgmentally selected transactions which by description or amount were of interest.
6. Selected random sample from selected accounts for transaction testing.
7. Transaction tests included Compliance Supplement tests and tests of internal controls where applicable.
8. Summarized results of findings in work papers for inclusion in reports.

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A Few Additional Takeaways From the Federal Agency Investigation

- In addition to the issues we noted earlier (i.e., improperly requested drawdowns for expenses not incurred, improperly retained interest revenue on federal awards, and the excessive rent paid to George and Harriet), the federal agency investigation also found that NFP E had:
  - Inadequate internal controls;
  - Inadequate documentation;
  - Inadequate accounting procedures in place; and
  - An inability to link drawdowns to specific award expenses

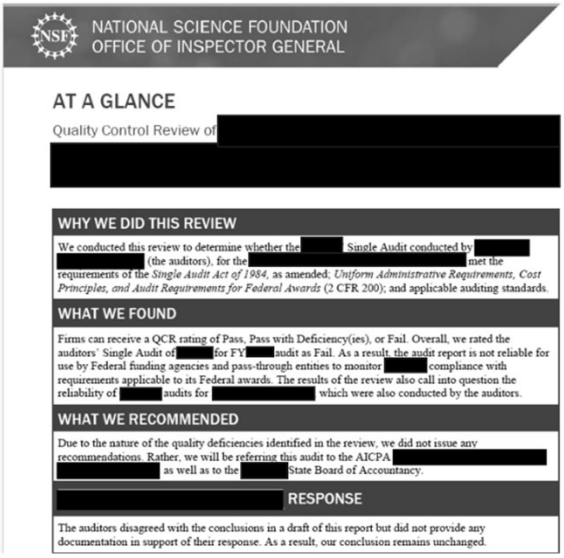
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A Few Additional Takeaways From the Federal Agency Investigation

- As the two single audits performed immediately prior to the federal agency investigation had no findings and clean opinions on the financial statements and compliance for major programs, this led the NSF Office of Inspector General to launch a **quality control review** (QCR) of the audit of NFP E
- A QCR is a somewhat extensive review of a single audit including a review of audit documentation
- The following slide contains an excerpt from the results of the quality control review

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A Few Additional Takeaways From the Federal Agency Investigation



NATIONAL SCIENCE FOUNDATION
OFFICE OF INSPECTOR GENERAL

AT A GLANCE

Quality Control Review of [redacted]

WHY WE DID THIS REVIEW

We conducted this review to determine whether the [redacted] Single Audit conducted by [redacted] (the auditors), for the [redacted] met the requirements of the *Single Audit Act of 1984*, as amended; *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (2 CFR 200); and applicable auditing standards.

WHAT WE FOUND

Firms can receive a QCR rating of Pass, Pass with Deficiency(ies), or Fail. Overall, we rated the auditors' Single Audit of [redacted] for FY[redacted] audit as Fail. As a result, the audit report is not reliable for use by Federal funding agencies and pass-through entities to monitor [redacted] compliance with requirements applicable to its Federal awards. The results of the review also call into question the reliability of [redacted] audits for [redacted] which were also conducted by the auditors.

WHAT WE RECOMMENDED

Due to the nature of the quality deficiencies identified in the review, we did not issue any recommendations. Rather, we will be referring this audit to the AICPA [redacted] as well as to the [redacted] State Board of Accountancy.

[redacted] RESPONSE

The auditors disagreed with the conclusions in a draft of this report but did not provide any documentation in support of their response. As a result, our conclusion remains unchanged.

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A Few Additional Takeaways From the Federal Agency Investigation

- In the prior slide, the NSF indicated that they reported the QCR findings to the AICPA and state board of accountancy for the state that the auditor operated in
- The AICPA Professional Ethics Executive Committee (AICPA PEEC) determined that there appeared to be prima facie evidence that the auditor had violated standards related to professional competence and due professional care in the AICPA Code of Professional Conduct
- As a result of the AICPA PEEC investigation, the auditor agreed to generally refrain from performing audits, reviews, or compilations with disclosures for a three-year period [i.e., if the auditor resumes those activities earlier, an extensive list of conditions will apply (e.g., external pre-issuance reviews, CPE, etc.)]

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A Few Additional Takeaways From the Federal Agency Investigation

- Some of problems noted by the AICPA PEEC included:
  - Problems with the financial statement audit
  - Problems with clustering of programs and major program determination
  - Failing to obtain sufficient appropriate evidence to express an opinion on compliance for major programs
  - Failing to plan and perform tests of controls over compliance for the major programs to support a low assessed level of control risk for noncompliance
  - Outdated report wording
  - Failing to meet the Yellow Book CPE requirements

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The Two Single Audits Completed Immediately After the Federal Agency Investigation

- The final two single audits of NFP E occurred after the federal agency investigation as the operations of NFP E were winding down
- A different auditor performed the single audits, and they had the benefit of knowledge gleaned from the federal agency investigation
- A small firm was chosen to perform the audit
  - The firm was a member of the AICPA Governmental Audit Quality Center
  - The firm received a peer review rating of pass in its most recent peer review

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The Two Single Audits Completed Immediately After the Federal Agency Investigation

- As you might suspect, in the first single audit performed after the federal agency investigation things took a significant turn
  - While the auditor issued a clean opinion on the financial statements, he also reported a material weakness and material noncompliance finding under the Yellow Book
  - The auditor issued a qualified opinion on compliance with a compliance finding and material weakness
- The following slides are excerpts from the single audit reporting

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The First Single Audit Completed Immediately After the Federal Agency Investigation

Schedule of Findings and Questioned Costs

Year Ended [redacted]

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unmodified

Internal control over financial reporting:

- Material weaknesses identified? yes
- Significant deficiencies identified? none reported

Noncompliance material to financial statements noted? yes

Federal Awards

Internal control over major programs:

- Material weaknesses identified? yes
- Significant deficiencies identified? none reported

Type of auditor's report issued on compliance for major programs: qualified

Any audit findings disclosed that are required to be reported in accordance with 2 CFR section 200.516(a)? yes

Identification of programs tested as major programs:

CFDA Number	Name of Federal Program or Cluster
Various	Research and Development Cluster

Dollar threshold used to distinguish between type A and type B programs: $750,000

Auditee qualified as low-risk auditee? no

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The First Single Audit Completed Immediately After the Federal Agency Investigation

Schedule of Findings and Questioned Costs

Year Ended [redacted]

Section II - Financial Statement Findings

[redacted]**-001 Finding**

Material Weakness in Internal Control over Financial Reporting

[redacted] is responsible for establishing and maintaining effective internal controls over financial reporting. Effective internal controls are an important component of a system that helps ensure transactions are recorded correctly and in the proper period, thereby providing accurate financial data. Specifically, [redacted] should have controls in place to assure revenues are correctly recorded.

[redacted] receives federal grant fund reimbursements for allowable costs, according to federal grant agreements. During the year ended [redacted] recorded federal revenues that were $598,734 higher than related expenditures, overstating revenues by that amount. [redacted] does not have adequate oversight over the grant revenue recording and reconciliation process. The lack of controls over revenue recording and reconciliations could have significant impact on the financial reporting [redacted]

Management was not aware of reimbursements in excess of related expenditures, and was not aware of revenue recognition rules that would limit reporting those excess revenues.

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The First Single Audit Completed Immediately After the Federal Agency Investigation

Schedule of Findings and Questioned Costs

Year Ended [redacted]

III - Federal Award Findings and Questioned Costs

[redacted]**-002 Finding – C. Cash Management and H. Period of Performance**

Program: Research and Development Cluster
CFDA Number: Various
Sponsoring Agency: National Science Foundation
Sponsor Award Number: Various
Award Period: Various

1) Criteria: Uniform Guidance. When entities are funded on a reimbursement basis, program costs must be paid for by entity funds before reimbursement is requested from the Federal Government. Where a funding period is specified, a non-Federal entity may charge to the award only costs resulting from obligations incurred during the funding period.

2) Condition: We noted in our testing that [redacted] did have allowable costs to support amounts reported as expenditures of Federal Awards, but the amount of associated revenue was recorded at $598,734 higher than the allowable costs. We further noted in [redacted] cutoff testing that [redacted] had requested and received an additional $743,100 without costs in either [redacted] or [redacted] to support the request.

3) Cause: [redacted] requested grant reimbursements in excess of related costs by $598,734 during [redacted], and $743,100 in [redacted].

4) Effect: Grants were overcharged by amounts that could not be explained.

5) Questioned Costs: None.

6) Identified as a repeat finding: Not applicable.

7) Recommendation: We recommend [redacted] establish procedures to conform to the requirements of Uniform Guidance as soon as possible. Federal grant reimbursement requests should be supported by recorded expenses and in the proper period.

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The First Single Audit Completed Immediately After the Federal Agency Investigation

CORRECTIVE ACTION PLAN

Year-ended [redacted]

Finding: [redacted]-001

Views of responsible officials and planned corrective actions:

Explanation of disgreement with audit finding: There is no disagreement with the audit finding.

Actions planned in response to finding: Effective [redacted] has appointed [redacted] as new CFO who supervises [redacted] staff overseeing [redacted] financial mangement, accounting and strengthened internal control over financial reporting and cost reimbursement. Requests for reimbursments are reviewed by [redacted] staff and approved by the CFO. Procedures have been developed to include reasonableness of account balances and activity analytics (including comparing costs against federal grant revenues, and reasonableness of grant receivables). [redacted] has proposed a repayment plan to NSF to resolve the revenues in excess of expenditures and is awaiting NSF response and direction. New procedures have been established to conform to the requirements of Uniform Guidance.

Responsible party: [redacted]

Planned completion date for corrective action plan: New CFO already appointed in [redacted]. New policies and procedures have been in effect since that time. Discussion with NSF concerning repayment of excess grant disbursements is ongoing.

Plan to monitor completion of corrective action plan: CFO already appointed. Awaiting NSF guidance concerning how to repay excess revenue.

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The First Single Audit Completed Immediately After the Federal Agency Investigation

Corrective Action Plan (Continued) [redacted]

Finding: [redacted]-001

Views of responsible officials and planned corrective actions:

Explanation of disgreement with audit finding: There is no disagreement with the audit finding.

Effective [redacted] has appointed [redacted] as new CFO who supervises [redacted] staff overseeing [redacted] financial mangement, accounting and strengthened internal control over financial reporting and cost reimbursement. Requests for reimbursments are reviewed by [redacted] staff and approved by the CFO. Procedures have been developed to include reasonableness of account balances and activity analytics (including comparing costs against federal grant revenues, and reasonableness of grant receivables). [redacted] has proposed a repayment plan to NSF to resolve grant reimbursements in excess of expenditures, and is awaiting NSF response and direction.

Responsible party: [redacted]

Planned completion date for corrective action plan: New CFO was already appointed [redacted], and new policies and procedures were placed in effect at that time. Discussion with NSF concerning repayment of excess revenue is ongoing.

Plan to monitor completion of corrective action plan: CFO already appointed. Awaiting NSF guidance concerning how to repay excess grant draws. New procedures have been established to conform to the requirements of Uniform Guidance.

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The Second Single Audit Completed Immediately After the Federal Agency Investigation

- The second single audit performed after the federal agency investigation was completed just four months after the prior audit and was performed by the same firm
  - The auditor issued a clean opinion on the financial statements and reported no findings
  - The auditor also issued a clean opinion on compliance without any findings
- The following slides are excerpts from the single audit submission

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The Second Single Audit Completed Immediately After the Federal Agency Investigation

Schedule of Findings and Questioned Costs

Year Ended [redacted]

Section I - Summary of Auditor's Results

Financial Statements

Type of auditor's report issued: unmodified

Internal control over financial reporting:

- Material weaknesses identified? no
- Significant deficiencies identified? none reported

Noncompliance material to financial statements noted? no

Federal Awards

Internal control over major programs:

- Material weaknesses identified? no
- Significant deficiencies identified? none reported

Type of auditor's report issued on compliance for major programs: unmodified

Any audit findings disclosed that are required to be reported in accordance with 2 CFR section 200.516(a)? no

Identification of programs tested as major programs:

CFDA Number	Name of Federal Program or Cluster
11.459, 47.050	Research and Development Cluster

Dollar threshold used to distinguish between type A and type B programs: $750,000

Auditee qualified as low-risk auditee? no

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The Second Single Audit Completed Immediately After the Federal Agency Investigation

SUMMARY SCHEDULE OF PRIOR AUDIT FINDINGS
Year-ended [redacted]

[redacted] submits the following summary schedule of prior audit findings for the year ended [redacted]. The findings from the prior audit's schedule of findings and questioned costs are discussed below. The findings are numbered consistently with the numbers assigned in the prior year.

Section II – Financial Statement Findings

Finding: [redacted]-001

[redacted] received federal grant fund reimbursements for allowable costs, according to federal grant agreements. During the year ended [redacted] recorded federal revenues that were $598,734 higher than related expenditures, overstating revenues by that amount. [redacted] did not have adequate oversight over the grant revenue recording and reconciliation process. The lack of controls over revenue recording and reconciliations could have significant impact on the financial reporting of [redacted].

Management was not aware of reimbursements in excess of related expenditures, and was not aware of revenue recognition rules that would limit reporting those excess revenues.

Status: Resolved for the year ended [redacted]

Section III – Findings and Questioned Costs – Major Federal Programs

Finding: [redacted]-002

Federal Agency: National Science Foundation
Program: Research and Development Cluster
CFDA Number: 47.050

Condition: We noted in our testing that [redacted] did have allowable costs to support amounts reported as expenditures of Federal Awards, but the amount of associated revenue was recorded at $598,734 higher than the allowable costs.

Status: Resolved for the year ended [redacted]

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Exercise 11

In this section, we have seen how undetected problems at an auditee can lead to questions from federal agencies and eventually problems for the auditor. **If you could go back in time and give each of the auditors discussed in this section some brief generic advice going into the single audit, what would you say?**

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Solution to Exercise 11

- There could be many great answers to this question. The course author might start by suggesting:
  - **Make sure that you have the current knowledge and training to perform the engagement**
    - We saw that the first auditor was not aware that the Uniform Guidance had superseded OMB Circular A-133
  - **Make sure that your single auditing practice aids are current**
    - We saw the first auditor was confused about what the notes to the SEFA were supposed to discuss (**and not discuss**)
  - **Avoid doing anything too creative/different that will raise questions later**
    - If a federal agency looks at the second auditor's financial statement finding, they might question why the traditional finding format was not used and ask more questions (e.g., Is this trying to be summary form reporting of the same finding in the federal awards section? Should there have been questioned costs for the federal award finding? etc.)

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Section 6

Classless Behavior

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Section 6 – Learning Objective

- As we have seen, grant fraud comes wrapped around all sorts of different bad behaviors. However, when stripped to its core, it is going to involve:
  - False claims **and**
  - False statements
- In our sixth fraud, we will see how six employees of an NFP colluded to fraudulently take $12,000,000 in federal student financial aid over an eight-year period

Classless Behavior

- NFP I was an institution providing various degrees in religious studies
- NFP I operated a central campus and several satellite learning centers where a mix of online and on-campus instruction was provided
  - The satellite learning centers had both faculty and administrative employees
- The $12,000,000 fraud at NFP I occurred at a satellite learning center (Satellite J) located 500 miles away from the central campus
  - Satellite J was also located 500 miles away from NFP I's auditors
- After the fraud came to light, student aid programs were suspended and NFP I was forced to sell its central campus property and end its operations (as 95% of its revenues related to student aid programs)

Profile of the Fraudsters

- As mentioned earlier, six employees of NFP I were involved in the fraud and they all worked at Satellite J
  - One employee was the director of Satellite J
  - One employee was a recruiter (who also had a side-business owning/managing a tax preparation service)
  - One employee was an administrative assistant
  - Three employees were instructors
- During their fraud, the above employees' ages ranged from their early-30s to early-60s
- **Note**. It does not appear that any personnel at NFP I's central campus were involved in the fraud. In fact, it appears that the six employees worked extensively to misrepresent information to NFP I's central campus personnel

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The Steps Followed to Commit Fraud

- The six employees recruited people to enroll at NFP I's Satellite J campus with promises of "free money"
  - One source of the recruits were customers of the employee who also ran a tax preparation service
- The six employees told recruits that they would not have to attend classes or do any of the work — all they had to do was agree to split their student aid award balances with them
- The recruits were essentially told that the six employees would take care of everything, and all that was needed was their Social Security numbers, dates of birth, addresses, etc.

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The Steps Followed to Commit Fraud

- The federal student financial assistance involved in the fraud included 84.063 Federal Pell Grant Program and 84.268 Federal Direct Student Loans
- In general, to receive federal student financial assistance, students are required to:
  - Submit a Free Application for Federal Student Aid (FAFSA)
  - Apply and be accepted to an institution
  - Meet certain course enrollment requirements/benchmarks
  - Possess a high school diploma/GED
  - Be working toward a degree
  - Maintain satisfactory progress

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The Steps Followed to Commit Fraud

- The six employees colluded to:
  - Create false application packages to get recruits admitted to NFP I's Satellite J campus
  - Create false FAFSA applications for Pell Grants and student loans
  - Create false GEDs
  - Create email accounts in the false students' names to be used in communicating with NFP I's central campus
  - Create usernames and passwords in the false students' names to submit falsified homework, tests, and other coursework
    - The three employees that were instructors were key in this process

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The Steps Followed to Commit Fraud

- When students received federal student financial aid, the amounts would be applied to their tuition, fees, etc. at NFP I's central campus and excess amounts (in the form of refund checks to be used in theory for educational purposes) were mailed to the students' addresses listed on the FAFSA or a different address if requested by students
- The six employees used the email accounts created in the false students' names to request that NFP I's central campus send their refund checks directly to the Satellite J campus

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The Steps Followed to Commit Fraud

- The six employees would receive the refund checks at the Satellite J campus and convert them to their personal benefit
  - In some cases, it appears the six employees converted the checks directly
  - In other cases, the recruited students were told to cash the checks and give the six employees a portion
- After reviewing data for the students at Satellite J, federal investigators estimated that 40% of students at a period of time were recruited fake students

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Opportunities to Commit Fraud Observed at NFP I

- Due to the extensive nature of the fraud (e.g., the completion of false applications, assignments, tests), it took a bad mix of factors coming together to pull the sham off. Such a mix existed at NFP I as,
  - Six employees at Satellite J were readily willing to commit fraud and work together as a team for a long period of time to perpetrate it
  - Hundreds of citizens were willing to assist the fraudsters on some level (e.g., by providing their personal data, cashing checks, etc.) to get "free money"
  - Satellite J was located 500 miles away from NFP I's central campus which meant that NFP I's personnel did not have the normal interaction/knowledge of Satellite J's activities that they needed
- NFP I's management and those charged with governance did not oversee/question Satellite J to the extent needed

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A Few Additional Thoughts About This Case – The Single Audits Performed Before and During the Federal Investigation

- As mentioned earlier, the fraud at NFP I eventually led to its closure
- The fraud appears to have come to light after the IRS notified the Department of Education of some suspicions which led to a federal investigation
- For the remainder of our discussion of NFP I, we will look at:
  - The two single audits completed immediately prior to the federal investigation
  - The final two single audits of NFP I which were completed while the federal investigation was underway
- A small audit firm performed all four audits
  - The firm is based in the city that NFP I had its central campus
  - The firm was a member of the AICPA Governmental Audit Quality Center
  - The firm received a peer review rating of pass in its most recent peer review

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The Two Single Audits Completed Immediately Prior to the Federal Investigation

- In the earliest of the four single audits that we will discuss the auditor
  - Issued a clean opinion on the financial statements and reported no financial statement findings
  - Issued a qualified opinion on compliance for the Student Financial Assistance Cluster with three reported federal award findings (see following slides)
    - Author's Note. The auditor did somewhat depart from the normal formatting of a finding (e.g., omitting cause, effect or potential effect, questioned costs, etc.)

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The Two Single Audits Completed Immediately Prior to the Federal Investigation

Finding [redacted]-001:

Federal Program:	Student Financial Assistance Cluster
CFDA Numbers:	84.063 Federal Pell Grant Program and 84.268 Federal Direct Student Loans
Award Numbers:	None
Federal Agencies:	U.S. Department of Education
Pass-through Entities:	None
Federal Award Year:	[redacted]
Criteria:	Maintaining a comprehensive student accounts ledger that identifies institutional charges (tuition and fees), cash payments, Title IV funds disbursed, outstanding balances, payment of Title IV credit balances and dates of these transactions.
Condition:	The Institution was not able to demonstrate that a clear audit trail exists showing how Title IV funds are received, how cash payments are received and how non-Title IV funds are accounted for in its ledger.
Recommendation:	The Institution should implement a system that will provide a clear audit trail for each Title IV recipient. The student's account ledger must include institutional charges, cash payments, Title IV disbursements, scholarship, credit balance payments to students, and Return of Title IV funds on one ledger for each Title IV student.
Management Response:	The Institution has contracted with a third party to perform certain financial aid management and processing services. The system will provide the school a transaction register for all of the student's activities including attendance on a student by student basis. The Student Accounts Receivable Manager reconciles transaction register to the student accounts system monthly, on a student by student basis. The reconciliation is reviewed and approved by the Institution's accountant.

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The Two Single Audits Completed Immediately Prior to the Federal Investigation

Finding [redacted]-002:

Federal Program:	Student Financial Assistance Cluster
CFDA Numbers:	84.063 Federal Pell Grant Program and 84.268 Federal Direct Student Loans
Award Numbers:	None
Federal Agencies:	U.S. Department of Education
Pass-through Entities:	None
Federal Award Year:	[redacted]
Criteria:	Satisfactory Academic Progress Policy does not meet the requirements under Title IV.
Condition:	Satisfactory Academic Progress Policy is inadequate.
Recommendation:	The Institution must establish a Satisfactory Academic Progress Policy and apply the new policy to all Title IV recipients for the [redacted] award years to identify all students who failed to meet the new SAP quantitative (pace) and qualitative (GPA) requirements. If Title IV funds were disbursed for a term in which a student did not meet the Satisfactory Academic Progress requirements, the funds must be reported as ineligible by the program.
Management Response:	The Satisfactory Academic Progress Policy has been updated to meet the current requirements. A review of the Title IV recipients has been performed. These funds have been reported as ineligible.

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The Two Single Audits Completed Immediately Prior to the Federal Investigation

Finding [redacted]-003:

Federal Program:	Student Financial Assistance Cluster
CFDA Numbers:	84.063 Federal Pell Grant Program and 84.268 Federal Direct Student Loans
Award Numbers:	None
Federal Agencies:	U.S. Department of Education
Pass-through Entities:	None
Federal Award Year:	[redacted]
Criteria:	Establish a Return to Title IV (R2T4) policy that satisfies all of the required components.
Condition:	The Institution does not have a policy in place to identify all unofficially withdrawn students. As a result, the institution did not identify, calculate and return unearned Title IV funds to the applicable federal program for students who unofficially withdrew prior to the sixty percent (60%) point of the payment period.
Recommendation:	The Institution must revise its R2T4 policy that adequately addresses each of the required components.
Management Response:	The Institution has revised its R2T4 Policy that addresses official withdrawals, unofficial withdrawals, and other required components under Title IV.

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The Two Single Audits Completed Immediately Prior to the Federal Investigation

- In the second of the four single audits that we will discuss (i.e., the single audit immediately before the federal investigation began)
  - A clean opinion was issued on the financial statements
  - A clean opinion was issued on compliance for the Student Financial Assistance Cluster
  - No financial statement or federal award findings were reported
  - The Summary Schedule of Prior Audit Findings indicated that the findings we discussed on the preceding three slides had been corrected

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The Final Two Single Audits of NFP I Which Were Completed While the Federal Investigation Was Underway

- In the third of the four single audits that we will discuss (i.e., the first single audit completed while the federal investigation was underway)
  - A clean opinion was issued on the financial statements
  - A clean opinion was issued on compliance for the Student Financial Assistance Cluster
  - No financial statement or federal award findings were reported
  - **However**, the notes to the financial statements did include a Note D (see following slide) discussing the investigation

SURGENT ACCOUNTING & FINANCIAL EDUCATION

The Final Two Single Audits of NFP I Which Were Completed While the Federal Investigation Was Underway

NOTE D - CONTINGENT LIABILITY

The Institution was notified in [redacted] by the Department of Education that fraudulent activity had been discovered by the Internal Revenue Service. The fraud involves a tax preparer, an off-site coordinator, and various students that obtained the services of the tax preparer. The fraud involved various students receiving financial aid for a period of years.

After lengthy negotiations with the U.S. Department of Education, the estimated contingency is $3,027,000. The Institution plans to file a civil lawsuit against various persons for the amount of the final settlement with the Department of Education.

The Institution has recorded the probable loss in accordance with FASB ASC 450-20.

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The Final Two Single Audits of NFP I Which Were Completed While the Federal Investigation Was Underway

- In the fourth of the four single audits that we will discuss (i.e., the second single audit completed while the federal investigation was underway)
  - A clean opinion was issued on the financial statements
    - The auditor did include a going concern paragraph related to the federal investigation (see following slide)
    - The notes to the financial statements also contained a contingencies disclosure (see following slide excerpt from Note G)
  - A clean opinion was issued on compliance for the Student Financial Assistance Cluster
  - No financial statement or federal award findings were reported

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The Final Two Single Audits of NFP I Which Were Completed While the Federal Investigation Was Underway

Substantial Doubt about the Organization's Ability to Continue as a Going Concern

The accompanying financial statements have been prepared assuming that the Organization will continue as a going concern. As discussed in Note B to the financial statements, the Organization has suffered a significant change in status with The Department of Education and has stated that substantial doubt exists about its ability to continue as a going concern, Management's evaluation of the events and conditions, and management's plans regarding those matters also are described in Note B. The financial statements do not include any adjustments that might result from the outcome of the uncertainty. Our opinion is not modified with respect to this matter.

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The Final Two Single Audits of NFP I Which Were Completed While the Federal Investigation Was Underway

NOTE G - CONTINGENCIES

The institution was notified in [redacted] by the Department of Education (Department) that the Department was investigating potential fraudulent activity at the institution's [redacted] Learning Center. The activity involved some students possibly receiving financial aid erroneously.

After continuous discussions with the Department, the [redacted] is unable to reasonably estimate any contingent liability. Moreover, because the investigation is on-going, no potential penalty has been established. Lastly, within fiscal year [redacted] has spent considerable efforts attempting to bring this investigation to a close, which at the time of this audit is still on-going.

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Section 7

A Recipe for Disaster

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Section 7 – Learning Objective

In today's course we've seen some bad frauds. Unfortunately, we've saved the worst for last. In our final fraud, we will see how corrupt management, scores of colluding citizens, substandard auditing (the auditor's license was subsequently revoked) and weak state and federal oversight all came together in an alleged $250 million fraud scheme. The fraud primarily occurred over a 2-3 year time period.

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A Recipe for Disaster

- NFP J had a mission of helping youth and seniors access healthy foods by sponsoring community organizations participating in federal nutrition programs
- NFP J received essentially all its revenue from two USDA programs
  - 10.558 Child and Adult Care Food Program
  - 10.559 Summer Food Service Program for Children
  - For the rest of the case, we will refer to these as **the federal nutrition programs**
- The federal nutrition programs provide reimbursements for meals and snacks served at participating child-care centers, afterschool care programs, summer camps, and adult day care centers, among other locations
- A state's department of education (State K) administered the federal nutrition programs (i.e., State K was the pass-through entity charged with monitoring NFP J)

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A Recipe for Disaster

- NFP J was primarily a **sponsor** for the federal nutrition programs
  - **Sponsors** (which include school districts, childcare programs, and nonprofits like NFP J) enter into an agreement directly with State K to oversee the provision of food at **sites** (including monitoring site compliance with program requirements)
  - **Sites** enter into an agreement with a **sponsor** (e.g., NFP J) to serve food to eligible children and adults at various locations. Sites are responsible for verifying eligibility of participants, taking attendance, serving meals and snacks, and counting the number of meals and snacks served
- As a sponsor, NFP J received claims from sites for reimbursement that were supposed to reflect the number of meals and snacks served on a given day

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A Recipe for Disaster

- Each month, NFP J would then submit claims for reimbursement from the sites to State K. State K would then reimburse NFP J
  - During COVID, when this fraud occurred, the total federal nutrition programs' reimbursements made by State K to NFP sponsors grew from $70 million in 2020 to $336 million in 2021
- After retaining a percentage of reimbursements (to cover the costs of providing or facilitating food service and ensuring compliance with federal program rules, among other responsibilities) NFP J would then reimburse the sites under its sponsorship
- State K was responsible for overseeing NFP J's compliance with applicable federal and state laws

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Profile of the Fraudsters

- Irene was the executive director of NFP J
- Irene was in her late-30s during the fraud and appears to have had a strong personality
  - State K had received a complaint just a couple of years before the fraud that Irene had improperly taken control of NFP J from the other founding members
  - The USDA had also received a complaint that Irene had taken control of NFP J through theft and forgery
- Irene was not intimidated by government actions or requirements
  - Just before the fraud began in earnest, the IRS had revoked NFP J's nonprofit status (for failure to meet reporting requirements for three consecutive years). However, Irene continued to operate NFP J as though nothing had happened
  - At times, when State K questioned aspects of NFP J's applications or reimbursement requests, NFP J would respond by taking State K to court

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Profile of the Fraudsters

- Irene was assisted in the fraud by NFP J staff
- NFP J staff recruited individuals and entities to open illegitimate food distribution sites
- Overall, the federal government indicted 70 individuals associated with NFP J, alleging they used the federal nutrition programs for personal gain
  - The individuals are believed to have used the proceeds they received to pay off debts, travel, purchase commercial and residential real estate (in multiple states and countries), purchase expensive items (e.g., luxury cars, boats, electronics, clothing, jewelry, etc.)

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The Steps Irene Followed to Commit Fraud

- As mentioned on the prior slide, NFP J employees recruited individuals and entities to open food distribution sites
- The sites submitted claims for reimbursement of meals and snacks that were never served, falsified attendance records, and created fake invoices intended to document the purchase of food purportedly served to children at their sites
- Irene gave false assurances to State K that NFP J was monitoring the sites it sponsored and that the sites served the meals and snacks they claimed to be serving
- NFP J submitted the fraudulent claims for reimbursement and received bribes and kickbacks from the sites it sponsored in return

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Opportunities to Commit Fraud That Irene Observed

- USDA waivers issued in response to COVID gave sites and sponsors significant flexibility in how to distribute food. However, they also created some confusion and made oversight more challenging
  - During a virtual oversight visit of one of NFP J's sites, State K staff witnessed about 30 kids receiving meals in 15 minutes. Then, Irene's phone connection died and was not restored. NFP J claimed that an additional 1,800 kids came in the next hour. State K did not appear to have investigated the matter further
- In some cases, State K noted items in its oversight and also received complaints about NFP J. However, the subsequent follow up appears to have mainly consisted of inquiry of Irene

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Opportunities to Commit Fraud That Irene Observed

- NFP J's bold use of litigation and public relations against State K appears to have affected the oversight provided by State K
  - NFP J basically alleged in court filings and in news media that State K was preventing tens of thousands of hungry children from accessing food by refusing to approve NFP J's site applications
  - In at least a couple of cases, some courts appear to have been sympathetic to NFP J in having State K ease up on oversight
  - According to State K officials, the threat of legal consequences and negative media attention affected State K's decisions about the regulatory actions it did and did not take against NFP J

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How the Fraud at NFP J Came to Light

- Approximately a year after the onset of COVID, the FBI notified State K of allegations it received involving NFP J. The allegations were that Irene was:
  - Accepting kickbacks for participation in federal nutrition programs;
  - Submitting reimbursements for meals without proper or insufficient paperwork; and
  - Not providing meals they said they provided
- Two months after the above, State K provided information to the FBI regarding fraud suspicions with NFP J and sites under its sponsorship
  - State K believed some of NFP J's sites were submitting fraudulent documents and artificially inflating the number of individuals receiving meals and snacks
- The FBI began an investigation into NFP J
- NFP J was effectively shut down a little short of two years after the onset of COVID

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What About the Single Audit?

- As you can imagine, NFP J was well over the single audit threshold for the years of the fraud
  - The federal nutrition programs flowing through NFP J went from $3.4 million in the year prior to COVID to nearly $200 million in the second year of COVID
- State K noticed that single audits were not being performed and inquired about their status
- When NFP J did ultimately submit single audits for two years, there were severe issues with the audits performed

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Problems With the Single Audits That Were Eventually Submitted

- The audited financial statements had some clear departures from NFP GAAP (in terms of presenting net assets with and without donor restrictions) that were not noticed by the auditor
- The single audit submissions to the Federal Audit Clearinghouse contained **many missing items** including:
  - The SEFA
  - Yellow Book reporting on controls and compliance at the financial statement level
  - Uniform Guidance reporting on controls and compliance at the major program level
  - The Schedule of Findings and Questioned Costs

What Happened to the Auditor?

- The auditor of NFP J was not a member of the AICPA Governmental Audit Quality Center
- The auditor is not enrolled in a peer review program
- The auditor of NFP J had his license revoked by his state board of accountancy for a minimum period of two years
  - The auditor is allowed to reapply for a certificate in the future under certain restrictions (CPE, oversight, etc.)
- The auditor also had to pay the state board a financial penalty

Thank you!

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