

Fraud Awareness: School Construction

California League of Bond Oversight Committees

Sacramento, CA

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The views expressed in this presentation are those of the presenter and not the views of the Defense Contract Audit Agency or other Department of Defense organizations.

“Public works disaster of biblical proportions.”

– Steve Cooley
L.A. County District Attorney











Overview

- ❑ Mind-Set
- ❑ Warning Signs
- ❑ Proactive Strategies

How Does Fraud Occur?

- ❑ Poor internal controls
 - ✓ Lack of proper authorizations
 - ✓ No separation of authorization, custody, and record keeping
 - ✓ No independent checks on performance
 - ✓ Lack of clear lines of authority
 - ✓ Inadequate documentation
- ❑ Management override of internal controls
- ❑ Collusion between employees and 3rd parties
- ❑ Collusion between employees and management
- ❑ Limited, unclear, or no policies and procedures
- ❑ Poor or non-existent ethics and/or policy

Internal Controls

❑ Hard Controls:

- ✓ Policies, procedures and systems.

❑ Soft Controls:

- ✓ Competence and integrity of people.

Mind-Set

Skepticism

- ❑ Never taught and not in personality.
- ❑ Accept answers on face value – blind trust.
- ❑ Attitude of doubt – trust but verify.
- ❑ Focus on exceptions, oddities, and patterns of conduct.

Skepticism

- ❑ Accept the fact that fraud does occur.
- ❑ If you aren't looking for fraud or don't believe it exists, you probably won't find it.
- ❑ If you don't want to find it, you probably won't.
- ❑ Think fraud to find fraud.

Think Fraud To Find Fraud

Veronica Klinefelt

- ❑ High school diploma.
- ❑ No financial experience.
- ❑ Stay-at-home mom.
- ❑ Newly-elected board member of East Detroit Public Schools.

Think Fraud To Find Fraud

School Board Member Veronica Klinefelt

- ❑ Helped uncover \$3 million construction fraud scheme.
- ❑ Federal grand jury indicted of 20 individuals, including two superintendents, finance director, maintenance & operations director, retired sheriff's inspector, and a contractor.

Think Fraud To Find Fraud

What were Veronica Klinefelt's techniques?

- ❑ Reviewed budgets and actual costs.
- ❑ Asked for supporting documentation.
- ❑ Focused on oddities.

Think Fraud To Find Fraud

John **Gardiner**, East Detroit Schools Superintendent

William J. **Hudson**, Jr., Owner, Hudson Construction, Inc.

David **Scothorn**, East Detroit Schools Finance Director

- ❑ **Gardiner** advised school board to hire his old boyhood friend [**Hudson**] to oversee the district's \$28 million school improvement bond program.
- ❑ **Hudson** overbilled the district thousands of dollars and Superintendent **Gardiner** signed the checks.

Think Fraud To Find Fraud

Hudson provided Superintendent **Gardiner**:

- ❑ Car for his wife.
- ❑ Home down payment (\$40,690).
- ❑ Home remodeling (\$47,000).
- ❑ Down payment on daughter's home (\$12,262).
- ❑ \$25,000 for daughter's credit card debt.
- ❑ Daughter's wedding (\$17,000: flowers, food/drinks, dress).
- ❑ Hired step-son.
- ❑ Down payment on step-son's home (\$15,000).
- ❑ Place step-daughter on subcontractor's payroll.

“In the real world, successful people do what they have to do to win, even if others consider it cheating.”

Skepticism

Former Government Senior Executive

- ❑ Bachelor's Degree (1993), Master's Degree (1995), and Doctorate (2000).
- ❑ Hamilton University.
- ❑ Unaccredited fee-for-degree “distance learning” center (“Diploma Mill”).
- ❑ Bachelor's Degree (2000), Master's Degree (2000), and Doctorate (2001).

Curious

- ❑ Common to human beings at all ages.
- ❑ Thirst for knowledge.
- ❑ Desire to learn or know more.
- ❑ Tendency to ask and learn.
- ❑ “Curious as a 2-year old.”

Curious

❑ Do you?

❑ Have you?

❑ Can you?

❑ Are you?

❑ Why?

❑ How?

❑ Who?

❑ Describe?

#1 Question

What reports or tools do you use to monitor the status of the program?

Principle of Common Sense

- Read the contract!
- Is there a signed contract?
- Does the contractor have an office?
- Do employees exist?
- Do employees meet qualifications?
- Do invoices describe services provided?
- Are services within scope of contract?
- Were “right materials” used?
- Were services performed?
- Were goods delivered?

SBS

Warning Signs

Warning Signs

- ❑ A set of circumstances that are unusual in nature or vary from normal activity.
- ❑ Warning signs not recognized or not adequately addressed or investigated.

Why Are Warning Signs Important?

“Average fraud schemes last a median of 18 months before being detected.”

-- ACFE 2014 Report to the Nations

Warning Signs

- ❑ Contractor address is mail drop or post office box.
- ❑ Multiple awards for similar work given to same contractor.
- ❑ Refusal to produce records, files, or documents.
- ❑ No exceptions or errors.
- ❑ Significant life-style change.
- ❑ Refusal to take vacation.
- ❑ Turning down promotions or transfers.

Warning Signs

- ❑ Lack of segregation of duties.
- ❑ Employee addresses match contractor addresses.
- ❑ Successful bidder subcontracts to losing bidders.
- ❑ Winning bidder is always last to bid.
- ❑ Losing bidder cannot be located in business directories.
- ❑ Single vendor.
- ❑ Costs billed inconsistent with contract progress.

Warning Signs

- ❑ Competitors continually submit bids that are unreasonably high, late, or are disqualified.
- ❑ Bids are higher than on similar jobs by same contractor.
- ❑ Bids submitted by contractors contain similarities or even identical items.
- ❑ Numerous or large dollar change orders.
- ❑ Multiple addresses or names listed for contractor.
- ❑ Invoices with minimal information.

Proactive Strategies

Basic Strategies

- ❑ Tone at the Top.
- ❑ Ethics Code.
- ❑ Fraud Hotline.

Best Practice Strategies

- ❑ Hire Internal Talent.
- ❑ Due Diligence Reviews of Contractors.
- ❑ Fraud Awareness Training.
- ❑ Aggressive Audit Function.
- ❑ Leverage Technology.

Leverage Technology

- ❑ Public school district awarded contract to provide school bus parts and supplies.
- ❑ Transportation Department Director authorized to approve invoices up to \$2,500 – competitive bids required > \$2,500.
- ❑ Internal auditor.
- ❑ \$3.8 million in fraudulent invoices over 2 ½ years.

Leverage Technology

- ❑ Payments to Company increased 342% from year 1 to year 2 (an increase in excess of \$3.7 million).
- ❑ Two-thirds of invoices were under the \$2,500 bid limit and didn't have a corresponding purchase order.
- ❑ 99.957% in one year and 100% in another year of all invoices were less than \$2,500.
- ❑ On 24 occasions, 50 or more invoices had the same invoice date and majority of invoices had consecutive invoice numbers.

Leverage Technology

Invoice Date	Total of Invoices	Number of Invoices	% Consecutive
6/4/2003	550,262.68	282	99%
6/6/2003	701,979.40	348	97%
6/9/2003	479,341.09	236	96%
6/10/2003	909,266.47	466	98%
5/24/2004	267,257.65	150	89%
5/26/2004	168,728.63	124	90%
6/9/2004	619,387.29	397	93%
6/10/2004	406,594.44	198	91%
6/11/2004	267,317.66	304	98%

Where Did the Money Go?

- ❑ Automobiles
- ❑ Campers
- ❑ Golf carts
- ❑ Televisions
- ❑ Jet skis
- ❑ Gift cards (\$100,000)
- ❑ Scooters
- ❑ Four-wheelers
- ❑ Carpet and furniture
- ❑ Treadmill
- ❑ Laptop computers
- ❑ Mexico cruise

Who Commits Fraud?

Vern Hatley, Transportation Director

- ❑ Natural born leader.
- ❑ Quarterback of high school football team.
- ❑ Started gospel choir when in college.
- ❑ Brother is church pastor.
- ❑ Retired Army colonel.
- ❑ Assertive and trusting individual who always went by the book.

“Trust is not a control.”

Summary

- ❑ Accept the fact that fraud does occur.
- ❑ Ask #1 question.
- ❑ Trust is not a control.

“Books and records don’t commit fraud – people do.”

– Dr. Joseph T. Wells
ACFE Founder & President
June 16, 2014

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