

April 26, 2019

Mary Barlow, Superintendent
Kern County Superintendent of Schools
1300 17th Street – City Centre
Bakersfield, CA 93301

Dear Superintendent Barlow:

The purpose of this letter is to communicate the findings of the Fiscal Crisis and Management Assistance Team (FCMAT) regarding the AB 139 extraordinary audit of the Taft Union High School District. On June 5, 2018, the Kern County Superintendent of Schools and the Fiscal Crisis and Management Assistance Team (FCMAT) entered into an agreement to conduct an AB 139 extraordinary audit to determine if fraud, misappropriation of funds or other illegal activities may have occurred at the Taft Union High School District.

Questions and concerns relative to the district's 2017-18 budget and business practices reportedly fed strained relationships between the superintendent and former chief business manager that ultimately led to the business manager separating from employment with the district. District staff reported finding documentation in or around September 2018 supporting a deposit of \$100,000 into an out-of-state bank account, thus raising questions about the investing practices of the business manager. Attempts by district staff to locate documentation relative to the identified account were unsuccessful, and ultimately the district contacted the bank seeking account records. Review of available documentation and records led the district to question whether fraud, misappropriation of funds or other illegal fiscal practices may have occurred. Specifically, the district asserts that a bank account was opened in the district's name without authorization, by the district's business manager, and that he failed to report information related to the account to the superintendent and governing board.

These concerns were shared with the Kern County Superintendent of Schools, prompting the request that FCMAT perform an AB 139 extraordinary audit to further review the matter to determine if there is sufficient evidence to warrant a referral to law enforcement. The primary focus of FCMAT's review is to determine, based on the sample testing performed and the auditor's judgment:

1. whether the former business manager opened an unauthorized district account using false documentation outside of the state of California, conducted unauthorized activity on the account, concealed the account and related documentation and failed to report information related to the account to the district's Board of Trustees and administration;

FCMAT

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2. whether the extent of any possible fraud, misappropriation of funds or other illegal practice is isolated to the testing period, and
3. whether, based on that assessment, fraud, misappropriation of funds or other illegal fiscal practices may have occurred.

Education Code Section 1241.5(b) permits a county superintendent of schools to review or audit the expenditures and internal controls of any school district in that county if he or she has reason to believe that fraud, misappropriation of funds, or other illegal fiscal practices have occurred that merit examination. This review is known as an AB 139 extraordinary audit. Because the purpose of an AB 139 extraordinary audit is to determine if fraud, misappropriation of funds or other illegal fiscal practices may have occurred, it is commonly referred to as a fraud audit. On completion of a fraud audit, if evidence exists that support the allegations and a finding is made that fraud or misappropriation of funds may have occurred, Education Code Section 42638(b) states “... the county superintendent shall notify the governing board of the school district, the State Controller, the Superintendent of Public Instruction, and the local district attorney.”

Fraud investigations consist of gathering information and documentation pertaining to specific allegations; establishing an audit plan; interviewing potential witnesses and assembling evidence from internal and external sources; gaining an understanding of internal controls applicable to the scope of the fieldwork; performing various audit test procedures; evaluating the loss associated with the alleged fraud; and, if possible, determining who was involved and how it may have occurred.

Fraud can include an array of irregularities and illegal acts characterized by intentional deception and misrepresentations of material facts. A material weakness is a deficiency in the internal control process whereby errors or fraud may occur or can be a violation of specific law or regulation. Because of the weakness, employees in the normal course of business may not detect errors in time to correct them. Although all employees have some degree of responsibility for internal controls, the governing board, district superintendent and senior management ultimately are responsible for the controls that employees under their supervision are expected to follow.

Occupational fraud occurs when an organization’s owners, executives, managers or employees use their occupation to deliberately misuse or misapply the employer’s resources or assets for personal benefit. Occupational fraud includes asset misappropriation, corruption, and fraudulent financial statements. Asset misappropriation is the largest group of occupational schemes that include 21 separate fraudulent disbursement schemes. Asset misappropriation includes the theft or misuse of district assets and may take place in the form of taking of cash, inventory or other assets, and/or fraudulent disbursements.

Corruption schemes involve an employee using his or her influence in business transactions to obtain a personal benefit that violates that employee’s duty to the employer or the organization. Financial statement fraud includes the intentional misstatement or omission of material information in financial reports.

FCMAT conducted fieldwork at the district office on February 8, 2019, and performed additional off-site work during the weeks preceding and following that date. The team reviewed several documents and financial reports including annual independent audits, documentation supporting bank and investment account activity, email communications, financial system exports and other pertinent financial information. FCMAT interviewed county office staff, current and former district administrative personnel, and district office staff to obtain an understanding of the district’s general business practices and events that transpired during the period under review, including any alleged financial mismanagement, fraud or abuse. FCMAT also reached out to representatives of the Washington Trust Bank to seek further information specific to the identified account.

During interviews, FCMAT team members asked questions pertaining to policies and procedures; job responsibilities; routine business and investing practices and the internal control structure, including control activities, lines of authority and oversight of financial activities. Open-ended questions were designed to elicit information about other possible irregularities related to the scope of work.

The fieldwork focused on determining whether there is sufficient evidence to indicate that fraud, misappropriation of district funds or other illegal fiscal practices may have transpired relative to a specifically identified bank account established in the district's name at the Washington Trust Bank located in South Wenatchee, Washington. The district made the following assertions:

1. The former business manager opened an account at the South Wenatchee branch of Washington Trust Bank, located in the state of Washington;
2. The former business manager prepared and executed a resolution to open the account without the knowledge of the superintendent and/or governing board; and
3. The funds deposited into this bank account may have been taken or otherwise used for the personal benefit of the former business manager.
4. The former business manager was the only signer on the Washington Trust Bank account.

To accomplish the objectives, FCMAT developed and conducted a number of audit test procedures to analyze and evaluate the allegations and potential outcomes. Testing and examination results are intended to provide reasonable but not absolute assurance of the accuracy of the transactions and financial activity and/or to identify if fraud, misappropriation of funds or other illegal fiscal practices may have taken place during the period under review.

FCMAT reviewed, analyzed and tested business records including year-end account statements for the account in question, resolutions, board agendas and minutes, general ledger account activity, investment account documentation and communication records between the former business manager and representatives of financial and investment institutions. Audit scope, objectives, and substantive transaction testing was based on the audit team's experience and professional judgment and did not include the testing of all available transactions and records. Transactions were analyzed to determine compliance with board policy, operational procedures and industry standard or best practice procedures.

FCMAT requested from the Kern County Superintendent of Schools and reviewed detailed general ledger exports and other financial reports from the district's financial system for fiscal years 2006-07 through 2017-18. Except for the establishment of the bank account in question, FCMAT's review of financial system entries identified an audit trail for the financial activity relative to that account.

The district had a long-standing practice of investing funds outside of the county treasury, primarily through certificate of deposit (CD) accounts managed by Merrill Lynch. However, the single CD investment with Washington Trust Bank was outside the district's long-standing investment practices.

FCMAT confirmed that a CD account was established at Washington Trust Bank. The account was funded through a wire transfer of \$100,000 from the district's Merrill Lynch institutional fund account on March 26, 2007. Wire instructions were provided by an individual identified as a branch manager of Washington Trust Bank via an email communication to the business manager, with one additional district employee copied on the communication. The wire instructions included the following:

- Account beneficiary: Taft Union High School District
- Account number xxxxxx2469
- Instructions-comments: “For the City of Chelan CD # xxxxxx2469”; “waive incoming wire fee”; “Charge to South Wenatchee Branch per branch manager ...”

Interviews with district staff indicated that no bank statements or other banking documentation could be located in district records. The district attempted to obtain detailed bank account information from Washington Trust Bank; however, due to the extended period of time that has passed since the account’s closure, little detail was available. Representatives of Washington Trust Bank provided the district with copies of year-end statements and one account resolution.

FCMAT contacted Washington Trust Bank to independently seek bank records. Bank representatives confirmed that the account was indeed a certificate of deposit (CD), and that the account had subsequently been closed. FCMAT received confirmation that the limited information accessible was the same year-end summary statements previously provided to FCMAT by the district.

The Washington Trust Bank account resolution reviewed by FCMAT was dated September 28, 2008 and listed the former business manager as the only signer on the account. No documentation was provided to determine authorized signers on the account prior to the September 2008 date.

The following table summarizes the data contained in the statements provided to the district by Washington Trust Bank.

Statement Period	03/23/07 - 12/31/07	12/31/07 - 12/31/08	12/31/08 - 06/26/09
Last Renewed*	12-23-07	9-23-08	6-23-09
Next Maturity*	9-23-08	6-23-09	3-23-10
Current Balance*	\$102,938.67	\$106,295.97	\$ -0-
Year to Date Interest*	\$4,081.49	\$3,357.30	\$2,279.45
Calculated Beginning Balance	\$98,857.18	\$102,938.67	\$106,295.97

* Source: Calendar year end reporting summary statements.

Year-end balances shown on the statements provided by Washington Trust Bank are composed of both principal investment plus interest earned during the calendar year. When the year-to-date interest is deducted from the “current” year-end account balance the difference agrees to the year-end balance for the preceding year, except for the initial year when the CD was established, with the exception of the first calendar year. When the interest is deducted from the year-end balance the beginning balance calculates to \$98,857.18, a difference of \$1,142.82. Because no detailed bank information could be provided by the district or the financial institution, the date, originating deposit and interest details could not be determined.

FCMAT’s review of the year end statements and district general ledger activity resulted in the following discoveries:

1. A nine-month CD account was established on March 26, 2007.
2. The CD was renewed at the end of the nine-month period for two successive nine-month renewals.
3. The CD account was closed on June 25, 2009 at the end of the third renewal term.

4. A cashier check of \$108,675.72 was issued to the Taft Union High School District on June 25, 2009.
5. The beginning statement date is three days earlier than when the account was actually funded, March 23, 2006 versus March 26, 2006.

FCMAT's review of the district general ledger activity resulted in the following discoveries:

1. A deposit of \$108,868.24 was made into the district's clearing account held at United Securities Bank on August 3, 2009; the total deposit included the cashier check issued by Washington Trust Bank for \$108,868.24 and \$192.52 in other miscellaneous cash collections.
2. An electronic transfer of funds of \$114,962.45 was made from the United Securities Bank account into the district's general fund on August 6, 2009, and recorded as an electronic data interchange payment to the County of Kern on August 10, 2009. \$108,675.42 was recorded to object account code 9150 (investments) on August 5, 2009, and the remainder recorded to abate various expenditure object account codes in the district's general fund, cafeteria fund and special revenue-capital projects fund. The offsetting entry to each of these accounts is cash (9110).
3. On June 30, 2010, a reclassification entry was made to reclassify the \$108,675.72 from object code 9150 (investments) to object account code 8662 (gain on investments).

By tracing the financial activity from the Merrill Lynch account to the Washington Trust account, through to account closure and to the subsequent deposit into the district's clearing account at United Security Bank, along with subsequent transfers to the district's general fund, it is evident that, with the exception of the \$1,142.82 in question, the proceeds from the original investment and interest earnings remained with the district. It is possible that because the CD account was established on March 23, 2006 but not funded until March 26, 2006, an adjustment was made to reduce the interest rate or the amount of interest paid and that the adjustment was not reflected in the statement provided.

During interviews, concerns were raised that South Wenatchee, Washington is the hometown of the former business manager; FCMAT confirmed this to be true. FCMAT also confirmed that the parents of the former business manager reside in the area. Further reports were made regarding rumors that the former business manager had acquired the family home, and some surmised that he may have used the funds transferred to the account at Washington Trust Bank for that acquisition. This raised question as to whether funds may have been withdrawn from the CD account prematurely, prompting an early withdrawal penalty, then returned to the account before year end.

The hypothesis that the funds may have been taken or used for a personal purpose and benefit, such as to demonstrate financial liquidity sufficient to qualify for a loan or other purposes, and then returned to the account before the calendar year ended, could not be proved by FCMAT. The lack of available detailed account information prevents FCMAT from making a determination on that hypothesis. Furthermore, FCMAT found no correlating evidence of a recorded loan or deed for property during the timeframe in question.

The lack of district records and knowledge of accounts held in the district's name demonstrates a weakness in internal control. The accounting industry defines the term "internal control" as "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reason-

able assurance regarding the achievement of objectives relating to operations, reporting and compliance.” [The Committee of Sponsoring Organizations of the Treadway Commission – May 2013] The reference to achievement of objectives fundamentally refers to an organization’s work of planning, organizing, directing, and performing routine tasks relative to operations, and monitoring performance.

An organization establishes control over its operations by setting goals, objectives, budgets and performance expectations. Several factors influence the effectiveness of internal control, including the social environment and how it affects employees’ behavior, the availability and quality of information used to monitor the organization’s operations, and the policies and procedures that guide the organization. Internal control helps an organization obtain timely feedback on its progress in meeting operational goals and guiding principles, producing reliable financial reports, and ensuring compliance with applicable laws and regulations.

A strong system of internal control is the cornerstone of a properly functioning accounting, financial, and operational system. Management is responsible for developing, implementing, monitoring, and improving the internal control system to ensure that mistakes and errors are corrected. While the district has established board policy recognizing the fiduciary duty of the governing board, superintendent and management relative to internal control in areas applicable to FCMAT’s review, controls do not appear to be established in practice and monitored to ensure they are functional.

Routine monitoring is essential to any documented policy and procedures to ensure controls are implemented in practice. The district should review its policies and procedures regarding records retention and make amendments that ensure all records retention requirements are met. Furthermore, the district should routinely monitor record retention practices to ensure they are implemented in practice as designed.

Because the district is very small, the division of duties and responsibilities is managed by fewer individuals, weakening the internal control system. It is essential that alternative controls are established to mitigate these weaknesses. No single individual should have the ability to complete a financial task from start to finish, i.e., initiate, execute and record a transaction. In the case under review, the business manager had the ability to open a new account at a financial institution, draw funds from district investment accounts, authorize activity on the account and close the account.

A system of strong internal control is among the most important aspects of any fraud prevention program. Superintendents, chief business officials and other managers are in a position of authority and therefore have a higher standard of care to establish the ethical tone and serve as examples to other employees. Employees with administrative responsibility have a fiduciary duty to the district to ensure that those activities are conducted in compliance with all applicable board policies, laws, and regulations.

Management personnel are entrusted to safeguard the district’s assets and ensure that internal controls function as intended. The internal control environment includes ethical values and integrity displayed by the governing board and management, as well as the underlying tone established by the organization’s site administrators. While the governing board and all district employees have some responsibility for internal controls, the superintendent and business manager have a fiduciary duty and responsibility to ensure that the governing board fiscal policies and procedures are applied and conducted responsibly and ethically.

The district’s existing board policies and administrative regulations, including BP 3400, Management of District Assets, speak to management’s responsibilities and fiduciary duties relative to effectively managing and safeguarding the district’s assets and resources. BP 3430 addresses the authorization provided to the superintendent or designee (generally the business manager) to invest surplus monies of the district as permitted by law. This policy also requires the superintendent or designee to “provide to the

Board quarterly reports with specified components, including a statement of how the district's portfolio compares with the district's investment policy.”

There were no apparent controls in place to discover these actions. There was no evidence that the account was brought before the governing board for consideration prior to establishment and no indication that the governing board was routinely informed of holdings in the account. It also does not appear that the investment was disclosed to the independent auditors. This action likely would have been detected if the duties of opening/managing bank accounts were isolated from the duties of processing financial activity on the account, opening and routing district mail and reconciling bank accounts.

AB 139 Extraordinary Audit Report Summary: Potential Fraud

Based on the findings noted in this letter, there is insufficient evidence to demonstrate that fraud, misappropriation of funds or other illegal fiscal practices may have occurred.

FCMAT would like to thank the Kern County Superintendent of Schools and the Taft Union High School District staff for their cooperation and assistance in this review.

Sincerely,



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Intervention Specialist