



# **PERFORMANCE AUDIT REPORT**

## **Limited-Scope Audit**

### **Topeka School District: Determining What Factors Led to Delays In the District's Detection of a Check Fraud Scheme**

**A Report to the Legislative Post Audit Committee  
By the Legislative Division of Post Audit  
State of Kansas  
October 2004**

# ***Legislative Post Audit Committee***

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## ***Legislative Division of Post Audit***

**THE LEGISLATIVE POST** Audit Committee and its audit agency, the Legislative Division of Post Audit, are the audit arm of Kansas government. The programs and activities of State government now cost about \$10 billion a year. As legislators and administrators try increasingly to allocate tax dollars effectively and make government work more efficiently, they need information to evaluate the work of governmental agencies. The audit work performed by Legislative Post Audit helps provide that information.

We conduct our audit work in accordance with applicable government auditing standards set forth by the U.S. Government Accountability Office. These standards pertain to the auditor's professional qualifications, the quality of the audit work, and the characteristics of professional and meaningful reports. The standards also have been endorsed by the American Institute of Certified Public Accountants and adopted by the Legislative Post Audit Committee.

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October 5, 2004

To: Members, Legislative Post Audit Committee

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This report contains the findings, conclusions, and recommendations from our completed performance audit, *Topeka School District: Determining What Factors Led to Delays in the District's Detection of a Check Fraud Scheme (Limited-Scope Audit)*.

The report includes several recommendations for improving school districts' ability to prevent or detect check fraud schemes. This report recommends that the Topeka School District review bank reconciliations in more depth, and recommends that school district officials throughout the State review their financial practices and related management oversight procedures for preventing and detecting check fraud.

We would be happy to discuss these recommendations or any other items in the report with any legislative committees, individual legislators, or other State officials.

Barbara J. Hinton  
Legislative Post Auditor

## Get the Big Picture

Read these Sections and Features:

1. **Executive Summary** - an overview of the questions we asked and the answers we found.
2. **Conclusion and Recommendations** - are referenced in the Executive Summary and appear in a box after each question in the report.
3. **Agency Response** - also referenced in the Executive Summary and is the last Appendix.

### *Helpful Tools for Getting to the Detail*

- In most cases, an “**At a Glance**” description of the agency or department appears within the first few pages of the main report.
- **Side Headings** point out key issues and findings.
- **Charts/Tables** may be found throughout the report, and help provide a picture of what we found.
- **Narrative text boxes** can highlight interesting information, or provide detailed examples of problems we found.
- **Appendices** may include additional supporting documentation, along with the audit **Scope Statement** and **Agency Response(s)**.

# EXECUTIVE SUMMARY

LEGISLATIVE DIVISION OF POST AUDIT

## Question 1: What Factors Prevented the Topeka School District from Promptly Detecting and Dealing with the Check Fraud Scheme?

**Between June 2001 and April 2003, the district lost more than \$500,000 to fraudulent checks.** *Seventeen counterfeit checks, made to look like Topeka school district checks, totaled \$554,149.70. Two personal checks with Topeka school district bank and account information totaled \$307.48. The banking system caught one of the counterfeit checks and restored \$38,249.60 to the district's bank account.* ..... page 3

**The district had reasonable financial procedures in place for trying to prevent or detect check fraud, but they weren't always followed.** *One of the main procedures for detecting check fraud is reconciling the checking account to the bank statement. Although the district's then-accountant had the key information needed to complete a thorough reconciliation, he didn't actually reconcile the checking account to the bank statement. He prepared a reconciliation report for management, but according to district officials he used a process that assumed all checks paid by the bank were accurate and legitimate. Proper reconciliations would have identified the fraudulent checks.* ..... page 5

*Many of the reconciliations weren't done on a timely basis, but even if they had been timely, they wouldn't have found the fraudulent checks given the process the accountant appeared to be following.*

**The district generally had reasonable management oversight procedures in place, but some of those procedures weren't always carried out well.** *District management didn't review the bank reconciliation reports in depth. As a result, they didn't see indications of problems that were present in some of the reports. Had they seen them, district management could have questioned whether the reconciliations were being done properly, which should have led to discovery of the fraudulent checks.* ..... page 9

*In addition, the district contracted with independent auditors who looked at the year-end bank reconciliations annually. Over the years, the auditors routinely cited problems with timeliness of reconciliations and integrity of financial data prepared by the district's computer staff. The auditors told us that in fall 2003, the differences between the amount shown on the district's outstanding checks register and the amount the accountant had used in his reconciliation report was so great they had to temporarily stop their audit until the district could reconcile its accounts satisfactorily.*

**After it became aware of problems with the bank reconciliations, the district took a number of actions. *The district did the following:***

- *Hired two temporary accountants to review previous bank reconciliations, which helped identify the fraudulent checks.*
- *Filed reports with the Topeka Police Department and Federal Bureau of Investigation.*
- *Notified its Board of Education about the problems.*
- *Filed a claim with its bank to recover the moneys paid out for the counterfeit checks. (That claim was denied by the bank.)*

The district also hired a law firm and filed a lawsuit against the bank.

**Question 1 Conclusion** ..... page 12

**Question 1 Recommendation** ..... page 12

***Question 2: What Procedures Should School Districts Have in Place To Ensure that Similar Schemes Are Detected and Dealt With Promptly?***

**All school districts should have basic financial and management oversight procedures in place. *In some cases, deciding which practices to follow—and how far to carry them out—can be a matter of judgment. In such cases, there may be a balance between the potential risk involved and the additional costs or staff resources required. Whether to use positive pay bank services and the level of management oversight are specific issues to be considered.*** ..... page 13

**Question 2 Recommendations** ..... page 15

**APPENDIX A: Scope Statement** ..... page 16

**APPENDIX B: Example Bank Reconciliation Report** ..... page 17

**APPENDIX C: Responses to the Draft Audit Report** ..... page 22

This audit was conducted by Randy Tongier and Jill Shelley. Cindy Lash was the audit manager. If you need any additional information about the audit’s findings, please contact Mr. Tongier at the Division’s offices. Our address is: Legislative Division of Post Audit, 800 SW Jackson Street, Suite 1200, Topeka, Kansas 66612. You also may call us at (785) 296-3792, or contact us via the Internet at LPA@lpa.state.ks.us.

# Topeka School District: Determining What Factors Led to Delays in the District's Detection of a Check Fraud Scheme

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The local press recently reported that the Topeka school district (USD 501) was the victim of an international counterfeit check scam that resulted in \$554,000 being illegally withdrawn from the district's bank account over a period of 23 months. The counterfeit checks—ranging from \$9,852 to \$64,918—were deposited in such faraway locations as China, Latvia, and Taiwan. The scam apparently continued even after the banking system had identified one counterfeit check in November 2002.

Local legislators subsequently expressed concerns about why the district hadn't detected the counterfeit checks earlier, and about what procedures school districts in general needed to help promptly detect such scams in the future. In response to that interest, the Legislative Post Audit Committee authorized a limited-scope audit to answer the following questions:

- 1. What factors prevented the Topeka school district from promptly detecting and dealing with the check fraud scheme?**
- 2. What procedures should school districts have in place to ensure that similar schemes are detected and dealt with promptly?**

To answer these questions, we interviewed district officials and reviewed district accounting records, bank statements, internal reports, and related documents. We also interviewed the district's independent auditors and reviewed certain of their audit workpapers. In addition, we interviewed representatives of financial institutions and reviewed accounting and auditing textbooks and literature from the Government Finance Officers Association to identify recommended practices in this area.

The limited scope of this audit did not include determining how the check fraud operated; assessing any liability the bank, district employees, or the independent auditors may have; or identifying and evaluating the financial practices of any other school district.

A copy of the scope statement the Legislative Post Audit Committee approved for this audit is included in Appendix A. In conducting this audit, we followed the applicable government auditing standards set forth by the U.S. Government Accountability Office. In the interest of full disclosure, Legislative Post Audit has a current and ongoing

contractual relationship with Berberich Trahan & Co., the Topeka school district's independent auditors. Legislative Post Audit has contracts with that firm (as part of a joint venture) for the annual audit of the State's financial statements and the financial-compliance audits of the Lottery and the Kansas Public Employees Retirement System. By law, those contracts are awarded by the State's Contract Audit Committee, not by Legislative Post Audit. The scope of this audit didn't call for us to evaluate the firm's work.

## Question 1: What Factors Prevented the Topeka School District From Promptly Detecting and Dealing with the Check Fraud Scheme?

**ANSWER IN BRIEF:** *Between June 2001 and April 2003, the district experienced fraudulent check losses of more than \$500,000. Those losses went on so long without being detected because, although the district had put in place reasonable procedures to prevent and detect check fraud, the bank reconciliation process wasn't done properly. As a result, that process didn't find any of the fraudulent checks. In addition, although the district had put in place generally reasonable procedures to ensure that bank reconciliations were done properly, those procedures weren't always done as well as they could have been. There were several times when district management could have seen indications that the reconciliations weren't done properly, but apparently they didn't. If those indications had been seen and pursued, the fraudulent checks could have been discovered earlier, and the district's losses could have been limited. These findings and others are presented in the following sections.*

### ***Between June 2001 and April 2003, The District Lost More Than \$500,000 To Fraudulent Checks***

The district had identified a total of 19 fraudulent checks totaling about \$554,000 that were paid from the district's account with US Bank during that time. Those checks fell into two groups:

- 17 counterfeit school district checks that were written to such entities as Don Hua Electric Stock Co. Limited and Best Grade Trading Limited, and that were deposited into overseas accounts and paid from the district's account. These 17 checks totaled \$554,149.70.
- 2 personal checks—not counterfeit district checks—that had the district's bank, bank number, and checking account number printed on them. These checks totaled \$307.48. We could tell that one check was written to Super Wal-Mart; the other payee was illegible.

**Table I-1** on the next page summarizes these 19 fraudulent checks.

**The banking system identified one counterfeit check for \$38,249.60 in October 2002, and reimbursed the district for the full amount in March 2003.** Apparently after that check cleared the bank, banking officials contacted the district's accountant to confirm that the check was counterfeit. The bank reimbursed the district the full amount in March 2003. That discovery and reimbursement left the district's losses at about \$516,000.

**Table I-1  
List of Counterfeit and Non-USD 501 Checks Paid From the District's Bank Account**

<b>Counterfeit Checks:</b>				
<b>Check Number</b>	<b>Date Written</b>	<b>Payee</b>	<b>Date Cleared Bank</b>	<b>Amount of Check</b>
176847	5/14/2001	Codjo Gilbert Semasse	6/4/2001	\$ 9,852.63
176983	7/19/2001	Best Grade Trading Limited	8/15/2001	15,269.74
176987	7/24/2001	Bruin Taiwan Company Ltd	8/27/2001	13,958.00
177352	10/10/2001	Best Grade Trading Limited	11/9/2001	24,758.36
177364	10/18/2001	Bruin Taiwan Company Ltd	11/13/2001	19,526.40
177948	12/20/2001	Best Grade Trading Limited	2/8/2002	29,488.00
179827	4/18/2002	Best Grade Trading Limited	6/3/2002	35,294.68
179839	4/24/2002	Zhang Zhong Gian	6/20/2002	32,956.00
179884	9/9/2002	Wang Xiangai	9/23/2002	13,400.00
179850	8/14/2002	Swanghai Waygiam Imp & Exp Co	9/30/2002	45,920.00
179865	8/23/2002	Tsai Chia Wen	10/7/2002	29,574.38
179873	8/27/2002	Don Hua Electric Stock Co, Ltd	10/9/2002	44,839.91
179857	8/20/2002	Zhang Zhong Gian	10/17/2002	(a) 38,249.60
179879	8/30/2002	Sun's Co (SUNNY)	10/23/2002	36,427.00
179912	11/14/2002	Jesper Madsen	12/18/2002	59,863.00
179918	11/19/2002	Jorgen Lisberg Jensen	12/19/2002	64,918.00
179973	2/9/2003	Twinmos Technologies, Inc.	4/21/2003	39,854.00
<b>TOTAL OF COUNTERFEIT CHECKS</b>				<b>\$ 554,149.70</b>
<b>Non-USD 501 Checks:</b>				
<b>Check Number</b>	<b>Date Written</b>	<b>Payee</b>	<b>Date Cleared Bank</b>	<b>Amount of Check</b>
7072	12/24/2002	(illegible)	12/30/2002	\$ 120.00
7073	12/24/2002	Super Wal-Mart	12/30/2002	187.48
<b>TOTAL OF NON-USD 501 CHECKS</b>				<b>\$ 307.48</b>
Source: Topeka School District records.				
(a) This check later was identified as fraudulent, and the district was reimbursed this amount.				

***The District Had Reasonable Financial Procedures in Place For Trying To Prevent or Detect Check Fraud, But They Weren't Always Followed***

Anyone with a checking account can be the victim of a check fraud attempt, although the likelihood of such an attempt may be small. Organizations can put certain practices in place to try to prevent some frauds from occurring, and to help detect frauds that do occur so they can be stopped and losses recovered. **Table I-2** shows the major practices recommended in this area.

<b>Table I-2 Financial Practices for Preventing or Detecting Check Fraud</b>	
<b>Recommended Financial Practice</b>	<b>What it's primarily designed to do</b>
<b>Practices primarily designed to try to prevent check frauds from occurring in the first place</b>	
Use security features in printing the checks themselves.	Prevent someone from being able to easily counterfeit a check.
Keep unused checks secure.	Prevent someone from having unauthorized access to legitimate blank checks.
Keep signature plates or other signature apparatus secure.	Prevent an unauthorized person from issuing a legitimate check with legitimate signatures.
Have bank reconciliations done by employees who don't handle cash, write checks, initiate the check-writing process, or record cash transactions in the accounting records.	Prevent the possibility of one person writing a bogus check, taking the cash, and covering it up by falsifying bank reconciliations and accounting records.
<b>Practices primarily designed to help detect any check frauds that have occurred</b>	
Reconcile the bank account each month on a timely basis, and investigate any differences identified.	Detect a fraudulent check <u>after</u> the bank has paid it, but within a reasonable time frame so that the fraud can be caught, the bank notified, and the customer's liability limited.
Use a "positive pay" service, if available. (The customer periodically gives the bank a list of check numbers and amounts, and the bank won't pay any checks presented that don't match that list unless it checks with the customer first.) This service generally has a fee associated with it.	Detect a fraudulent check <u>before</u> the bank pays it.
Keep signature cards current.	Demonstrate that an unauthorized person has signed a check.

At the time this counterfeit check fraud scheme was successfully operating, the Topeka school district's established procedures called for essentially all these financial practices to be followed, except for the use of a positive pay service. The district switched banks in Fall 2003, and signed up for the positive pay service at a cost of \$50 per month for each account covered.

Even without the positive pay service, the bank reconciliation procedures the school district established should have been sufficient for

the district's accountant to detect fraudulent checks in time to question the transactions with the bank, and have the district's moneys restored to the account. Every month, the following key information was available:

- the monthly bank statement showing the beginning account balance, all deposits recorded, all checks paid, all other transactions (such as interest earned on the account), and the ending account balance.
- a compact disk containing an electronic image of all checks the bank processed through the account that month.
- the district's monthly outstanding check register (called the APJ 600 Report), which is a computer-generated list of the individual check numbers and amounts that hadn't yet cleared the bank, plus a total outstanding check amount. District computer staff prepare this report each month by combining district information about checks written and bank information about checks paid by the bank.

The district's reconciliation procedures called for the accountant to use this information to compare the district's checking account records with the bank statement, identify any differences, and investigate any differences that didn't appear to be typical. Such atypical differences could be errors on the part of the district or bank in recording a transaction, or they could be fraudulent transactions.

**The accountant didn't really reconcile the district's checking account balances with the balances on its bank statements.** The process for reconciling a large organization's bank statement and checking account balance every month is similar to the process anyone would use in reconciling his or her own checking account, except that it involves many more transactions, and some of them are very large.

In simplified terms, the reconciliation process looks like this:

The balance shown on the bank statement

- outstanding checks the district wrote that aren't included on this bank statement
- + outstanding deposits the district made that aren't included on this bank statement

**Should =** The balance shown in the district's checkbook.

If not, find out why.

District procedures called for the accountant to use the official amount from the outstanding check register (the APJ 600 report) as part of the reconciliation process. The accountant, who started with the district in June 2001, apparently used that report for the April and May 2001 bank reconciliations.

Beginning with the June 2001 reconciliation, however, the accountant stopped using the figure from the district's outstanding check register. Instead, according to district officials, he used a process that assumed all checks paid by the bank were accurate and legitimate, and didn't compare those checks with the checks originally written by the district. As a result, the bank account was never really reconciled. We weren't able to determine why the accountant followed this practice; he declined to talk with us.

We noticed two things about the reconciliations we reviewed:

- The difference between the outstanding checks amount used by the accountant and the amount from the district's outstanding check register gradually grew to more than \$500,000. **Table I-3** on the next page shows that the growth in this difference generally paralleled the accumulating losses from fraudulent checks.
- Many of the reconciliations weren't done timely. During the 2001-2002 fiscal year, only three bank reconciliations were done within 30 days. In fact, the first bank reconciliation report done for that year (covering July 2001) was dated April 27, 2002, or about eight months late. That situation improved for fiscal year 2003, when 8 of the 12 reconciliations were timely. Because the reconciliations weren't done properly, they wouldn't have found any fraudulent checks even if done timely.

#### **During This Audit We Also Did Limited Testwork on Timeliness of Receipt Deposits**

One additional way to limit the risk of loss is to deposit receipts on a timely basis. During this audit, we did limited testwork on how timely the Topeka School District deposited its receipts. We found that a large portion of district receipts are collected by the individual schools. The schools deposit those receipts in their own separate bank accounts. They then write checks on their accounts to transfer moneys to the central offices of the district.

District officials told us that it's district policy for schools to deposit their receipts daily if possible, especially if large amounts are on hand, but at least weekly. Business Office staff used to do periodic reviews of school fiscal practices, including checking for adherence to this policy. District officials told us their independent auditors now do periodic reviews of selected school fiscal practices on a sample basis. Recent management letters from the auditors have not indicated any problems with timeliness of receipts.

During this audit, we checked a portion of one day's receipts at the district's main offices that were scheduled for deposit that day. The receipts were made up of checks from individual schools that all were dated the previous day, so the deposit of those receipts would be timely. The supporting documents for those receipts indicated that the receipts were book rental fees that had been collected by the schools within the most recent several weeks. The documents didn't show when those receipts had been deposited in the schools' bank accounts.

**Table I-3  
Differences Between District Registers' and Reconciliation Reports'  
Amounts for Outstanding Checks**

<b>Month</b>	<b>Amount on District Register (APJ600 Report)</b>	<b>Amount Used for Reconciliation</b>	<b>Difference</b>	<b>Cumulative Fraudulent Check Loss</b>
June 2001	\$ 1,541,784.12	\$ 1,530,701.99	\$ 11,082.13	\$ 9,852.63
July 2001	163,933.95	153,305.78	10,628.17	9,852.63
August 2001	3,963,335.96	3,917,804.31	45,531.65	39,080.37
September 2001	478,772.95	438,402.28	40,370.67	39,080.37
October 2001	174,532.46	135,590.10	38,942.36	39,080.37
November 2001	858,140.96	777,531.84	80,609.12	83,365.13
December 2001	889,048.15	809,584.33	79,463.82	83,365.13
January 2002	1,187,642.68	1,111,168.73	76,473.95	83,365.13
February 2002	1,096,427.49	990,532.47	105,895.02	112,853.13
March 2002	1,024,544.29	919,632.27	104,912.02	112,853.13
April 2002	228,367.26	123,605.24	104,762.02	112,853.13
May 2002	2,481,502.89	2,374,408.34	107,094.55	112,853.13
June 2002	272,239.06	96,949.17	175,289.89	181,103.81
July 2002	162,194.32	(12,981.57)	175,175.89	181,103.81
August 2002	847,689.01	672,645.42	175,043.59	181,103.81
September 2002	190,835.73	(42,340.31)	233,176.04	204,423.81
October 2002	417,698.06	40,454.51	377,243.55	389,514.70
November 2002	336,724.98	(41,181.04)	377,906.02	389,514.70
December 2002	192,300.49	(309,869.73)	502,170.22	514,603.18
January 2003	1,081,929.08	580,256.75	501,672.33	514,603.18
February 2003	1,087,343.55	587,333.42	500,010.13	514,603.18
March 2003	243,577.11	(216,209.42)	459,786.53	476,353.58
April 2003	588,148.26	90,206.65	497,941.61	516,207.58
May 2003	1,412,981.75	867,004.17	545,977.58	516,207.58
June 2003	2,192,862.30	1,646,205.72	546,656.58	516,207.58

Source: Topeka School District records.

***The District Generally Had Reasonable Management Oversight Procedures in Place, but Some of Those Practices Weren't Always Carried Out Well***

As noted earlier, the district's accountant wasn't using the figure from the district's outstanding check register for the reconciliation process, as called for. From the June 2001 bank reconciliation on, he used a process that assumed all checks paid by the bank were accurate and legitimate, and didn't compare those checks with the checks originally written by the district.

At the same time, the reconciliation reports the accountant prepared made it look like those reconciliations had been done properly. For each month from June 2001 through June 2003, the reconciliation report showed that the account had been reconciled with no indication of problems.

Given that, district management wouldn't suspect there were any problems unless it thought that its bank reconciliations weren't being done properly. In this case, the district had no reason to think that there were any problems with its bank transactions.

**The district generally had reasonable management oversight practices in place.** An organization's management must not only adopt appropriate financial practices, but it also must carry out appropriate management oversight to ensure that those financial practices are being followed.

We identified reasonable practices in this area and compared the district's procedures to them. The results are presented in **Table I-4**. That comparison showed that the district generally appeared to be following reasonable oversight practices to help ensure that bank reconciliations were done properly.

<b>Table I-4 Practices to Ensure Bank Reconciliation Procedures Are Properly Followed</b>	
<b>Standard management practice is to...</b>	<b>In the district's case...</b>
Hire and assign qualified staff.	The accountant responsible for the bank reconciliations appeared to be well-qualified.
Have enough staff to accomplish the assigned responsibilities.	Independent auditors raised a concern about insufficient staffing in their audit covering fiscal year 2001. District management agreed with the auditors but made no changes. Later audits didn't raise the concern again.
Provide adequate guidance.	The district had written procedures about how to do the bank reconciliations.
Have management staff periodically review bank reconciliations and investigate unusual reconciling items.	The chief fiscal officer told us he reviewed the accountant's reconciliation reports mainly for timeliness and agreement of balances.
Conduct periodic audits or review of procedures.	The district has an independent financial audit conducted each year.

**District management didn't review the reconciliation reports in depth.** Each reconciliation report is several pages long. The first page is a summary page, and the following pages list the individual reconciling items. An example reconciliation report is included as Appendix C. Management's review of the reports focused on the first page and not the reconciling items on the following pages. Because of that, management missed opportunities to see possible indications that the reconciliations weren't done properly.

We reviewed the accountant's reconciliation reports and related documents from June 2001 through June 2003 to try to identify any times or ways in which district management might have seen that reconciliations weren't being done properly. As summarized below, we found several:

- **For five months, the reconciliation report added the outstanding checks figure to the bank balance.** As pointed out on page 6, the normal reconciliation process involves subtracting outstanding checks from the bank statement balance. This process makes the outstanding check figure a negative number, not a positive one. However, it showed up as a positive number on five of the reconciliation reports the accountant prepared because for those months the amount of the accumulated fraudulent check losses exceeded the amount of the actual outstanding checks. The first instance of this could have been seen by management in late August 2002. That would have been an indication that the bank reconciliations weren't being done properly, and that could have been investigated at that time. Such an investigation likely would have found the counterfeit checks. By that time, the cumulative fraudulent check loss was about \$180,000.
- **One fraudulent check identified by the bank wasn't shown as a reconciling item.** As indicated on page 3, the bank identified a counterfeit check around the end of October 2002 and reimbursed the district for that in early March 2003. Although district management didn't know about that until the reimbursement, the accountant doing the reconciliation knew about it in early November 2002. Depending on how the counterfeit check was accounted for, at least one bank reconciliation report to district management should have shown that check as a reconciling item. If it had been reviewing individual reconciling items in detail, district management could have known that the reconciliations weren't being done properly when it found out about reimbursement for a counterfeit check it didn't already know about. Again, an investigation of the improper bank reconciliations likely would have found the counterfeit checks. By that time, the cumulative fraudulent check loss was about \$475,000.

**Independent auditors looked at the year-end (June) bank reconciliation to compare amounts to the district's cash accounting records for audits of 2001, 2002, and 2003.** However, the auditors told us they were not engaged to, nor did they, perform a

detailed review of the bank reconciliations for those years. Over the years, the differences between the outstanding check register and the number the accountant used in the reconciliation continued to grow.

- For June 2001, the difference between the amount shown on the district's outstanding check register and the amount the accountant used in the reconciliation was about \$11,000. In its management letter to the district, the audit firm identified the following problems as reportable conditions: reconciliations weren't being prepared in a timely manner, financial data prepared by the computer staff was not always consistent and couldn't be relied on without verification, and staffing levels in the financial area needed to be evaluated for adequacy.
- For June 2002, the difference between the amount shown on the district's outstanding check register and the amount the accountant used in the reconciliation was about \$175,000. Auditors said the accountant provided them with documentation and explanations that seemed reasonable at the time. In addition, they said the difference was below their materiality threshold (\$820,000) for the district as a whole. In its management letter to the district, the audit firm repeated the reportable condition concerning integrity of financial data, and added a reportable condition that the reconciliation contained numerous posting errors and untimely adjustments.
- For 2003, the difference between these amounts was more than \$500,000. According to the auditors, they told district officials they couldn't continue the audit until that difference was explained. Because the accountant was no longer with the district, temporary accountants were brought in to reconcile the accounts back to 2001. In its management letter, the audit firm repeated the reportable condition on integrity of financial data for the third time. In addition, the firm cited failure to do timely and thorough reconciliations as a material weakness—a higher level of concern than a reportable condition.

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***After It Became  
Aware of Problems  
With the Bank  
Reconciliations,  
The District Took a  
Number of Actions***

In Fall 2003, the district's independent auditors raised a concern about the bank reconciliation process. At about that same time, because none of the fraudulent checks which had already been paid by the bank out of the district's account had been recorded by the district, the district's records showed a bank balance much larger than its actual balance. Late in October, the district incurred 230 overdraft charges totaling almost \$7,000. By this time, the accountant responsible for the bank reconciliations had resigned to take another job. In responding to this situation, the district did the following:

- Hired temporary accountants to review and ultimately correct the previous bank reconciliations. They helped identify the fraudulent checks, and also found several other smaller corrections needed.
- Filed reports with the Topeka Police Department and the Federal Bureau of Investigation regarding the fraudulent checks.

- Notified the district's Board of Education about the situation. According to district officials, they provided an initial briefing to the Board on November 20, 2003, and a more detailed briefing on January 8, 2004. Because both these briefings were in executive session, no minutes exist.
- Filed a claim with its bank to recover the moneys for the fraudulent checks in early December 2003. The bank responded that, because the 30 days allowed for contesting paid items had expired, it was denying the claim.

The district also hired a law firm and filed a lawsuit against the bank to recover the moneys lost through the fraudulent checks. That lawsuit is still pending.

***Conclusion***

The Topeka school district suffered fraudulent check losses of more than \$500,000. Two problems contributed to the district's not detecting those checks on a timely basis, and preventing or limiting the losses. First, although the district had put in place reasonable procedures to prevent and detect check fraud, the district's bank reconciliation process wasn't operating properly. The process as operated wouldn't and didn't find the fraudulent checks. Second, although the district had put reasonable management practices in place to ensure that bank reconciliations were done properly, those practices as carried out didn't find problems with the reconciliations. District management could have seen indications that the reconciliations weren't done properly before the problems came to light. Had those indications been noticed and pursued, the district's losses could have been lessened.

***Recommendation***

To help ensure that bank reconciliations are done properly and that any future check fraud is detected on a timely basis, district management should review the detail of reconciling items on each reconciliation report.

## Question 2: What Procedures Should School Districts Have in Place To Ensure that Similar Schemes Are Detected and Dealt With Promptly?

**ANSWER IN BRIEF** *The Topeka School District was the victim of check fraud over a period of almost two years, with related losses of more than \$500,000. The check fraud continued for so long without being caught because a key financial practice designed to detect check fraud wasn't being followed, but reconciliation reports made it look like it was. That experience should make it clear that check fraud can happen, that if not promptly detected the related losses can be significant, and that staff may not always properly carry out key procedures. All districts should have the basic financial practices in place to help prevent and detect fraud, and the basic management oversight procedures in place to ensure that those practices are being followed. Districts also need to consider whether additional steps—like using positive pay services or performing additional management procedures—would reduce risks in a cost-effective manner.*

### ***All School Districts Should Have Basic Financial and Management Oversight Procedures In Place***

The Topeka school district experience demonstrates that the risks of check fraud and of employees not properly following adopted financial practices are real, not merely theoretical. With advancing technology, those risks are only likely to increase.

The Department of Education currently doesn't provide any specific guidance to school districts in this area. However, the practices we're talking about are basic accounting and management oversight procedures that all accountants and managers should be aware of anyway. Those practices were described in question 1, and are summarized again in **Table II-1** on the next page.

**In some cases, deciding which practices to follow—and how far to carry them out—can be a matter of judgment.** In such cases, there may be a balance between the potential risk involved and the additional costs or staff resources required. School districts will need to consider at least two issues in this area:

- **Whether to use positive pay services.** As discussed in question one, using a positive pay service means the customer periodically gives the bank a list of check numbers and amounts, and the bank won't pay any checks presented that don't match that list unless it checks with the customer first. This service, which is designed to detect a fraudulent check before the bank pays it, generally has a fee associated with it.

For a small school district that has relatively few checks and is following good bank reconciliation procedures, positive pay services may not be cost effective. These services also may not be available through some smaller banks. But for a larger district with significant numbers of checks going through, the additional cost may be worth it if that service is available. However, using positive pay services doesn't eliminate the need for a strong bank reconciliation process.

● **What level of management oversight to provide over experienced staff.** We identified at least two procedures school districts could follow on a periodic, ad-hoc basis to further reduce the risk that key financial practices aren't being followed without management's knowledge. These are:

- Having management staff occasionally test a bank reconciliation in detail, including tracing key amounts (such as the outstanding checks amount) to the accounting details supporting those amounts.
- Having an employee who doesn't normally do the bank reconciliation perform that reconciliation occasionally. This will keep the employee who regularly does the reconciliations from "hiding" an ongoing problem. In addition, this practice can have the added benefit of cross-training the financial staff.

<b>Table II-1 Good Financial and Management Oversight Practices</b>	
<b>Good financial practices for trying to prevent and detect check frauds</b>	<b>Good management oversight practices for ensuring that financial practices are being followed</b>
<ol style="list-style-type: none"> <li>1. Use security features in the printing of the checks themselves</li> <li>2. Keep unused checks secure</li> <li>3. Keep signature plates or other signature apparatus secure</li> <li>4. Keep signature cards current</li> <li>5. Have the bank reconciliations done by employees who don't handle cash, write checks, initiate the check-writing process, or record cash transactions in the accounting records</li> <li>6. Reconcile the bank account each month on a timely basis, and investigate any differences identified</li> <li>7. Make use of positive pay services, if needed and available</li> </ol>	<ol style="list-style-type: none"> <li>1. Hire and assign qualified staff.</li> <li>2. Have enough staff to accomplish the assigned responsibilities.</li> <li>3. Have enough staff to accomplish the assigned responsibilities.</li> <li>4. Provide adequate guidance.</li> <li>5. Have management staff periodically review bank reconciliations and investigate unusual reconciling items.</li> <li>6. Conduct periodic audits or review of procedures.</li> </ol>

***Recommendations***

1. To minimize their risk of loss, school district officials should do the following:
  - a. ensure that they have established adequate financial procedures for preventing and detecting check fraud, and adequate oversight practices for ensuring that those financial practices are being properly followed. At a minimum, those procedures should cover the recommended practices listed in this report, should be in writing, and should be made available to all employees with staff and management responsibilities in this area.
  - b. consider the benefit of conducting on a periodic basis a more detailed management review to ensure that financial practices are being followed. As noted in this report, these extended procedures could include having management staff occasionally test a bank reconciliation in detail, and having an employee who doesn't normally do the bank reconciliation perform that reconciliation occasionally.
2. To help ensure that school districts make informed decisions about the risks of check fraud and available ways of managing those risks, the Department of Education should make school districts aware of this audit's findings and recommendations.

## APPENDIX A

This appendix contains the scope statement that was authorized by the Chair of the Legislative Post Audit Committee on July 28, 2004. The audit was requested by the Shawnee County legislative delegation.

### SCOPE STATEMENT

#### **USD 501: Determining What Factors Led to Delays In the District's Detection of a Check Fraud Scheme**

The local press has recently reported that the Topeka School District has been the victim of an international counterfeit check scam that has resulted in \$554,000 being illegally withdrawn from the School District's bank accounts. It has been reported that 17 checks ranging in size from \$9,852 to \$64,918 drawn on District accounts have been deposited in such faraway locations as China, Latvia, and Taiwan. The scam apparently continued even after one counterfeit check was uncovered in November 2002. The School District has filed suit against US Bank, alleging the bank was negligent when it failed to flag checks that used an outdated set of signatures and check numbers.

Recently, local legislators have expressed an interest in knowing what factors have led to delays in the School District discovering the bogus checks, and what types of procedures school districts in Kansas may need to put in place to ensure any similar types of scams are promptly discovered in the future.

A limited-scope audit of this topic would address the following questions:

- 1. What factors led to delays in the Topeka School District's ability to detect and promptly deal with the check fraud scheme?** To answer this question, we would review the district's check-writing and bank-reconciliation procedures to determine whether the District follows good financial management practices in those areas. If good financial management practices weren't in place during the time of the scam, we would determine why. We also would look at audit reports or management letters issued by the District's external auditors to determine whether they had pointed out any weaknesses in the District's control of its bank accounts. In addition, we would interview the District's internal auditors and look at workpapers to determine what work they have done to look at the District's bank accounts. We would determine when the 17 fraudulent checks were presented to the District's bank for payment, and we would review bank reconciliations, bank statements, cancelled checks, correspondence and other records to test whether the District followed its procedures during those time periods, and if not, identify which procedures weren't followed and why. Finally, we would determine what information about the scheme was presented to the USD 501 School Board, when it was presented, and what actions the Board took in response to that information.
- 2. What procedures should school districts have in place to ensure that similar schemes are detected and dealt with promptly?** We would contact the State Department of Education to determine what guidance they have provided to school districts regarding procedures they should implement to safeguard their bank accounts. We would review that guidance, and suggest any changes or additions to it that may be needed based on our review of the recent scam in USD 501.

**Estimated time to complete:** 200 hours or less.

**APPENDIX B**

**BANK RECONCILIATION FOR  
US BANK  
DECEMBER 2002**

Entity	Begin Balance	Deposits	Checks & Wires	End Balance	Adjustments	Adjusted Balance
Bank	6,895,244.35	8,097,838.31	6,693,647.23	8,299,435.43	320,740.88	8,620,176.31
General Ledger	6,924,452.34	7,051,306.18	6,310,599.18	7,665,159.34	955,016.97	8,620,176.31
Activity Books	6,939,377.34	8,125,775.56	7,304,440.99	7,760,711.91	859,464.40	8,620,176.31

BANK RECONCILIATION FOR US BANK  
ADJUSTMENTS DETAIL  
DECEMBER 2002

Bank				General Ledger				Activity Books			
Date	Description	Source	\$Amount	Date	Description	Source	\$Amount	Date	Description	Source	\$Amount
07/01/99	chk outstanding	148789	(46.75)	04/26/01	kstax		(1,197.45)	12/13/02	service charge		(982.05)
07/08/99	chk outstanding	149139	(159.96)	04/12/01	dep cn		(347.00)	12/16/02	dep return		(937.00)
10/28/99	chk outstanding	152999	(7.00)	04/30/01	dep outstanding		17.80	12/03/02	dep return		(65.00)
11/04/99	chk outstanding	153196	(29.95)	04/11/01	kats		25.64	12/06/02	dep return		(8.00)
11/04/99	chk outstanding	153547	(1,318.68)	04/25/01	kats		50.00	12/31/02	unrecorded dep		620.89
12/09/99	chk outstanding	155078	(25.42)	04/27/01	dep outstanding		220.00	12/31/02	unrecorded dep		1,392.15
				04/25/01	dep outstanding		684.00	12/04/02	unrecorded dep		5,618.68
				04/19/01	sales tax		1,171.81	12/31/02	interest		8,911.85
05/31/01	dep outstanding	rc5005	33.00								
05/31/01	dep outstanding	rc5044	95.00								
05/31/01	dep outstanding	rc5044	112.00	05/29/01	kstax		(1,487.19)	12/04/02	fed tax wire outstanding		762,445.32
05/31/01	dep outstanding	rc4842	220.00	05/10/01	dep outstanding		122.40	12/31/02	kpers wire outstanding		119,938.54
05/04/01	dep outstanding	je956	1,668.91	05/03/01	dep outstanding		297.00	12/30/02	food svr wire outstanding		(36,553.62)
05/29/01	dep outstanding	je1031	9,643.00	05/25/01	dep outstanding		1,509.63	12/31/02	manual adjustment	apj600	(917.36)
05/24/01	dep outstanding	je1018	684.00	05/14/01	dep outstanding		2,900.00				
05/31/01	dep outstanding	rc6440	3.00	05/14/01	dep outstanding		3,125.00				
				05/14/01	dep outstanding		3,618.00				
				05/24/01	dep outstanding		27.00				
12/31/02	chks outstanding		309,869.73	05/04/01	dep outstanding		1,703.91				
				05/03/01	dep outstanding		30.00				
				05/21/01	dep outstanding		73.00				
				05/16/01	dep outstanding		10.00				
				05/03/01	dep outstanding		60.00				
				06/26/01	chk outstanding	kstax	(1,183.14)				
				06/05/01	dep outstanding	kats	95.76				
				06/29/01	dep outstanding		180.35				
				06/26/01	dep outstanding	kstax	1,047.14				
				07/26/01	chk outstanding	ksrvtax	(750.13)				
				07/17/01	chk prt fee		(45.00)				
				07/10/01	dep outstanding	kats	3.31				
				07/27/01	dep outstanding	saletax	746.82				
				07/06/01	dep outstanding		712.80				
				07/03/01	dep outstanding		183.16				
				07/31/01	voids		(14,660.45)				
				06/28/01	dep outstanding	je7	(11.46)				
				07/16/01	dep outstanding	je55	(11.46)				
				07/31/01	dep outstanding	5359	(101.66)				

BANK RECONCILIATION FOR US BANK  
 ADJUSTMENTS DETAIL  
 DECEMBER 2002

Bank				General Ledger				Activity Books			
Date	Description	Source	\$Amount	Date	Description	Source	\$Amount	Date	Description	Source	\$Amount
06/28/01	dep outstanding		(150.00)								
07/06/01	dep outstanding	je7	(712.80)								
		je31									
08/28/01	chk unrecorded	kstax	(394.61)								
08/01/01	dep unrecorded		1.91								
08/23/01	dep unrecorded		392.70								
08/20/01	dep unrecorded		1,067.75								
08/31/01	void checks	apj600	13,487.95								
08/01/01	error dup je93		221.37								
08/24/01	error je172		221.37								
08/23/01	error je162		(5.00)								
09/26/01	chk unrecorded	kstax	(3,190.40)								
09/17/01	dep unrecorded		169.46								
09/10/01	dep unrecorded		213.64								
09/12/01	dep unrecorded		456.00								
09/13/01	dep outstanding	je230	(456.00)								
09/30/01	manual adjustments	apj600	(5,487.68)								
10/02/01	refund svr charge		29.00								
10/05/01	dep unrecorded	salestx	3,190.40								
10/19/01	dep unrecorded	rc5946	2,169.28								
10/04/01	dep unrecorded	rc5809	7,060.24								
10/23/01	dep outstanding	rc5962	(402.32)								
10/08/01	chk outstanding	je329	221.37								
10/31/01	manual adjustments	apj600	(760.00)								
11/13/01	dep unrecorded		396.20								
11/29/01	dep unrecorded		400.00								
11/28/01	dep unrecorded	je521	0.01								
10/31/01	dep unrecorded	rc6004	0.30								
11/07/01	dep unrecorded	rc6066	(0.10)								
11/26/01	dep unrecorded	je514	(11.37)								
11/21/01	dep unrecorded	rc6149	(185.00)								
11/30/01	manual adjustments	apj600	(3,637.61)								
12/21/01	chk unrecorded	svgbds	(150.00)								
12/20/01	dep unrecorded	svgbds	2,220.50								

BANK REC. LIABILITY FOR US BANK  
ADJUSTMENTS DETAIL  
DECEMBER 2002

Bank				General Ledger				Activity Books			
Date	Description	Source	\$Amount	Date	Description	Source	\$Amount	Date	Description	Source	\$Amount
12/20/01	dep unrecorded	rc6349	1,697.30	02/28/02	chk unrecorded	memo	(100.00)				
12/21/01	dep recorded in error		(30.00)	02/19/02	dep unrecorded		156.55				
12/26/01	dep unrecorded		1,606.75	02/15/02	dep unrecorded	je821	(1.55)				
12/31/01	manual adjustments	apj600	(1,145.30)	02/28/02	manual adjustment	apj600	592.63				
01/30/02	dep unrecorded		1,249.45	03/31/02	manual adjustment	apj600	(2,554.37)				
01/02/02	wire outstanding	je646	95.54	04/16/02	refund		45.00				
01/11/02	wire outstanding	je681	0.07	04/17/02	dep unrecorded		65.04				
01/28/02	dep unrecorded	je745	(342.00)	04/01/02	dep rec incorrectly	rc7008	(0.05)				
01/31/02	manual adjustments	apj600	(3,088.42)	04/30/02	manual adjustment	apj600	(150.00)				
				05/31/02	manual adjustment	apj600	(123.12)				
				06/26/02	chk unrecorded	kstax	(1,840.43)				
				06/11/02	unrecorded dep		116.61				
				06/30/02	manual adjustment	apj600	(73.92)				
				06/24/02	kstax recorded	je1426	1,663.95				
				06/24/02	kstax recorded	je1428	59.88				
				07/31/02	unrecorded wire	usatax	(597.89)				
				07/31/02	manual adjustment	apj600	(114.00)				
				08/22/02	unrecorded w/d	stlad	(500.00)				
				08/31/02	manual adjustment	apj600	(9,486.55)				
				09/30/02	manual adjustment	apj600	10,560.94				

BANK RECONCILIATION FOR US BANK  
 ADJUSTMENTS DETAIL  
 DECEMBER 2002

Bank			General Ledger			Activity Books		
Date	Description	Source	\$Amount	Date	Description	Source	\$Amount	\$Amount
10/28/02	unrecorded chk	svgsbd	(2,050.00)					
10/31/02	manual adjustment	apj600	(10,733.00)					
11/26/02	unrecorded wire	kstax	(1,305.39)					
11/15/02	stop payment		29.00					
11/20/02	recorded in error	kats	(0.01)					
11/30/02	manual adjustment	apj600	(159.53)					
11/05/02	missing salestax wire	je560	1,128.83					
12/31/02	unrecorded wire		(103,582.78)					
12/31/02	unrecorded wire		(17,568.53)					
12/23/02	unrecorded wd	kpers	(1,248.48)					
12/13/02	service charge		(982.05)					
12/16/02	dep return		(937.00)					
12/20/02	unrecorded wd	kpers	(176.40)					
12/03/02	dep return		(65.00)					
12/03/02	unrecorded dep	chkrite	25.00					
12/18/02	unrecorded dep	chkrite	167.94					
12/31/02	unrecorded dep		620.89					
12/31/02	unrecorded dep		1,392.15					
12/31/02	interest		8,911.85					
12/31/02	unrecorded wire		1,105,230.44					
12/06/02	dep return		(8.00)					
12/30/02	food svr dep outstanding		(35,943.30)					
12/31/02	manual adjustment	apj600	(893.28)					
12/23/02	sales tax wire in error	je793	205.36					
Total			<u>320,740.88</u>				<u>955,016.97</u>	<u>859,464.40</u>

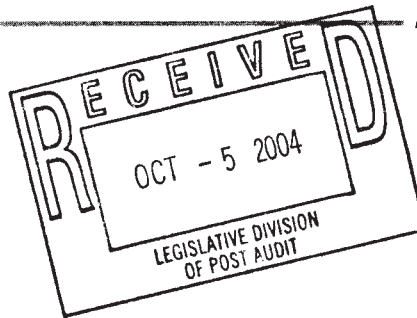
## **APPENDIX C**

### **Agency Responses**

On September 23, 2004, we provided copies of the draft audit report to the Topeka School District. We also provided a draft copy of Question II to the Department of Education. The responses of the school district and the Department are included as this Appendix. After carefully reviewing the school district's response, we made some minor clarifications to the draft audit that didn't affect any of our findings or conclusions.

October 4, 2004

Ms. Barbara J. Hinton  
Legislative Post Auditor  
Legislative Division of Post Audit  
800 SW Jackson Street, Suite 1200  
Topeka, Kansas 66612-2212



Dear Ms. Hinton:

Submitted for your review is the Topeka Public Schools' response to the completed performance audit titled, *USD 501: Determining What Factors Led to Delays in the District's Detection of a Check Fraud Scheme*, performed by the Legislative Division of Post Audit. After reviewing the recommendations made in your post audit I directed Mr. Michael Jones, the General Director of Fiscal Services and Board Treasurer, to review them as well and respond in writing to the steps that have been taken to address these concerns. I am pleased to note that we have already implemented all of the items recommended in the legislative post audit and provide this information for your perusal.

#### INTRODUCTORY COMMENTS:

The first paragraph indicates that the District's local bank, U.S. Bank, had identified one counterfeit check. This statement is not accurate. U.S. Bank never caught or identified a single fraudulent check before or after the USD 501 staff uncovered the fraudulent activity. Wachovia Corporation's banking operation detected a fraudulent check in October of 2002 and the USD 501 staff caught three more after the fraud was uncovered in November 2003.

It appears that the Legislative Post Audit staff did not interview or receive any input from US Bank, a major player in the events that lead to the loss of over \$500,000. Input from such a large national financial institution, like U.S. Bank, may have provided more complete and professional discussion on the matter of check fraud in today's world and would have allowed us to more fully address how such matters could be prevented or better handled in the future.

Input from the former accountant is also lacking. His perspective may have shed some light on the causes and assisted in the effort to develop better guidelines for all school districts.

Although there are some items we see differently than are reflected in the audit report, the audit provides a good overview of what transpired and what actions are available to prevent such an event from reoccurring.

#### QUESTION 1: WHAT FACTORS PREVENTED THE TOPEKA SCHOOL DISTRICT FROM PROMPTLY DETECTING AND DEALING WITH THE CHECK FRAUD SCHEME?

#### RESPONSE TO "ANSWER IN BRIEF":

As the audit report clearly states there were in place reasonable (written) procedures to detect and prevent the kind of check fraud that occurred. The District's former accountant who was responsible for performing the bank reconciliations simply elected to deviate from the written guidelines, after following them for the first two months, to a process he himself developed. The change in procedures opened the door that allowed the \$500,000

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loss to occur unnoticed. The modification or deviation from the written procedures dealt with how the outstanding check balance was obtained. The written procedures called for using a computer to generate a current listing of outstanding checks drawn from the District's general ledger files.

A simplified summary of his modification to the process is as follows:

Last month's outstanding check balance  
+ Amount of checks issued during the month-- PER GENERAL LEDGER  
- Amount of checks cleared-- PER BANK STATEMENT  
= This month's outstanding check balance

Note: With this process a fraudulent check would lower the bank balance but not our book balance and allow the reconciliation process to be completed without any indication that a fraudulent check had cleared the bank account.

The Legislative Post Audit report indicates District management could have detected this shortcoming in the reconciliation process when on 5 reconciliations the outstanding check balance, used in the reconciliation process, were negative numbers. While a negative balance for outstanding checks is very definitely an indicator that something is seriously wrong, that incorrect figure appears in the reconciliation documentation once, (in a spreadsheet included in the detail supporting the top summary page, that showed that all three sets of books were in balance) and once as a penciled in calculation on the unused computer generated listing of outstanding checks.

#### RESPONSE TO COMMENTS FOLLOWING ANSWER IN BRIEF:

PAGE 3: There were actually 22 fraudulent checks, not 19, drawn on the District's bank account at U. S. Bank. One check for \$38,249.60 was detected by Wachovia but for some unknown reason was able to continue completely through the check clearing process. Wachovia later reimbursed the District for the full amount of this check. The District's staff caught three more fraudulent checks that were in the process of clearing its account at U.S. Bank. The bad checks were caught in time so they could be returned before being permanently posted to the District's account. The other 18 checks did clear and resulted in a \$515,900 loss.

PAGE 4: Table I-1 shows the checks that actually cleared the District's account but does not reflect Wachovia reimbursing the District for the \$38,249.60 check that cleared due to their error.

PAGE 5: Table I-2 gives a good, short list of financial practices that can be taken to detect the type of check fraud the District encountered. Please note that USD 501 had implemented every suggested financial practice, with the exception of positive pay, prior to the problem arising.

It's worth noting that the District regularly (yearly) updated its signature cards with every bank it transacts business with, including U.S. Bank. But when the fraudulent checks, originally deposited in overseas financial institutions in amounts of \$45,920.00, \$59,863.00, \$64,918.00, and \$70,413 were presented to U.S. Bank for payment, the signature cards were never consulted or looked at to verify the check's authenticity. If any school district with a bank account at a large financial institution thinks the "required" signature cards provide protection, they are seriously mistaken. Signature cards provide only limited protection against fraudulent activity. They seem to provide the most protection at the smaller, local banks and the least protection at the large national/international type banks.

The recommended practice of using a process called positive pay was not used while the District had an active account at U.S. Bank. After the operating account was transferred to Commerce Bank & Trust of Topeka, the fraud was discovered. One of the actions the District took to limit its exposure to continued check fraud was to require Commerce Bank and Trust to develop a positive pay routine. This the bank did willingly. The District

has been utilizing this service since that time. We agree with the audit report in that if bank reconciliations are properly and timely done, a positive pay process is not needed. However, it provides a second level of protection and as such our district has elected to continue utilizing this service.

PAGE 6: The third group of items the Legislative Post Audit report listed, as key information available for the bank reconciliations, was the APJ 600 outstanding check register. This report was generated by taking the last month's outstanding check register and adding the check numbers and amounts of all checks written the current month **per the District's general ledger**, then eliminating all checks that cleared our bank account for the same month. The cleared check data was received from the bank via tape shortly after the end of each month. If a check that was not contained in the general ledger listing of checks issued cleared the account, the software simply dropped it from the process, instead of reflecting it on an error report. The software package (a Dun & Bradstreet product) used during the time that fraudulent checks passed through the District's bank account was replaced 6-30-2003. The replacement software would list such a transaction on an exception report.

The simplified reconciliation process, though basically accurate, tends to mislead one about the nature of a large school district's bank reconciliation. The process takes a full three to five days to complete. The audit report states that any differences between the bank balance and the District's book balance were due to "errors". While there are some errors, differences may include the numerous bank service fees, outstanding checks, wiring in deposits received that we have not received notification of by month's end, etc. Listing these items during the reconciliation process takes several pages—as many as ten. Each adjustment is the result of substantial investigation.

PAGE 10: The Legislative Post Audit report lists two types of occurrences that could have provided the management at the school district with indications that there was a problem with the bank reconciliation process. The first was the negative outstanding check number used in the reconciliation. As stated earlier in responding to the comment in the statement in the "Answer in Brief", this number was used only once during the reconciliation and reflected on a spreadsheet attached to the summarizing cover sheet which was reviewed. An in-depth review of the reconciliation, to include all activity detail utilized in the reconciliation would have revealed this discrepancy. Remember, the operating bank account reconciliation takes 3 to 6 days to complete, the supporting documentation is contained on 60+ pages of spreadsheets, reports, statements and other documentation. Also, the operating bank account is the District's largest account but is only one of 15 accounts that need to be reconciled each month. Reconciliations are reviewed to insure that the bank balance, general ledger balance and the District's bank activity book's balances all agree in total and that they are being done in a timely fashion. Our belief is that there are few school districts or public entities in Kansas that have written cash management procedures in place that exceed or even meet the level currently used in this District.

The second item mentioned was that the fraudulent check discovered by Wachovia should have been a tip-off of problems in the bank reconciliation. In hindsight that seems a good answer. The discovery occurred before the District ever received its monthly bank statement and at a time when the problem with untimely completion of the bank reconciliations had been remedied. Thus, management unknowingly felt confident its reconciliation process was functioning as designed and that the banking controls were in place to detect fraudulent checks before they even reached our accounts. In the same month Wachovia caught the fraudulent check, a criminally altered check on the same account was caught by U.S. Bank here in Topeka. The District periodically has to deal with fraudulent and altered checks. Simply hearing about a bad check that was caught was not a shocking or unusual event.

In the boxes at the bottom of page nine, the audit report indicated that the District's outside auditors were auditing the District's activity funds on a sample basis. Each and every activity fund has been audited yearly for at least the last 9 years. The outside auditors may have utilized some sampling techniques during their audits but they audited every school and site that has an activity fund or a petty cash account.

PAGE 11: The last point on the external auditors' review of the reconciliation process indicated that the external auditors told district officials they couldn't continue the audit until the more than \$500,000 difference in the reconciliation process was explained. To date we have been unable to locate anyone in the district who remembers such a conversation.

One of the bullets on what the District did after it became aware of the reconciliation problem stated that we hired two temporary accountants to review and ultimately correct the previous bank reconciliations. Actually, three accountants were employed, two of which were CPAs. These individuals worked with the new accountant and the General Director of Fiscal Services, to redo each and every reconciliation, on all of the District's 15 bank accounts, for every month from April 2001 through October 2003.

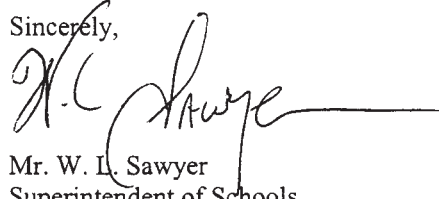
PAGE 12: CONCLUSION: See response to Answer in Brief.

RECOMMENDATION: We are pleased to acknowledge that all recommendations shown on page 12 were implemented months before this legislative post audit was authorized. The District started dealing with the Fraud in November 2003. Since there were written procedures already in place that should have ensured proper reconciliations, the major changes were simply a more in-depth review of the completed reconciliations and adding positive pay on our payroll and operating accounts at the District's new bank. As stated earlier, besides the procedural changes, the District also went back (31 months) and completely redid all reconciliations since the prior accountant left to ensure all fraudulent activity was detected.

I personally wish to thank your group for its thorough and fair investigation of this critical concern. Although we are pleased to note we have already implemented all of the committee's recommendations prior to your post audit, it is important to us to know that we are on the right track.

Again, we thank you for your assistance in this matter not only for Topeka Public Schools, but for other districts throughout the state of Kansas. It is our sincere hope that no district in the future will be victimized by similar fraudulent schemes.

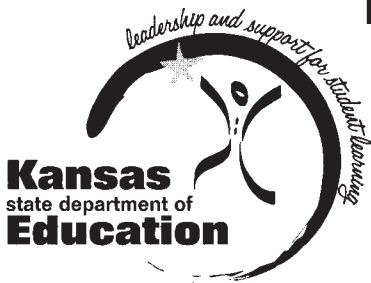
Sincerely,

A handwritten signature in black ink, appearing to read "W. L. Sawyer", with a long horizontal line extending to the right.

Mr. W. L. Sawyer  
Superintendent of Schools

Enclosure

c: Mr. Mike Wilson  
Mr. Mike Jones



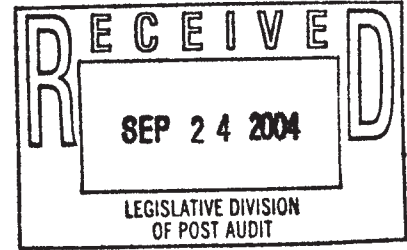
## Division of Fiscal and Administrative Services

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September 23, 2004

Mrs. Barbara J. Hinton  
Legislative Post Auditor  
Legislative Division of Post Audit  
800 S. W. Jackson Street, Suite 1200  
Topeka, Kansas 66612-2212



Dear Ms. Hinton:

Thank you for the opportunity to respond to your performance audit, *USD 501: Determining What Factors Led to Delays in the District's Detection of a Check Fraud Scheme*. Listed below is the recommendation applicable to the State Department of Education and our response.

**RECOMMENDATION:** To help ensure that school districts make informed decisions about the risks of check fraud and available ways of managing those risks, the Department of Education should make school districts aware of this audit's findings and recommendations.

**RESPONSE:** The State Department of Education would be pleased to notify unified school district superintendents of this audit's findings and recommendations and encourage each district to read the audit report carefully to ensure their district's compliance with the law.

Please feel free to contact this office if we can assist you further.

Sincerely,

Dale M. Dennis, Deputy  
Commissioner of Education

DMD:tjm