Ethics and Independence in Higher Education
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Agenda

- Introductions

- Overview of Auditor Independence – Government Auditing Standards Updates

- Sample Ethical Situations Faced by Higher Education Business Officers

- “Real Life” Examples of Higher Education Fraud

- Understanding and Mitigating Ethical/Fraud Risks With Your Institution
Overview of Auditor Independence –
*Government Auditing Standards* Updates
Auditor Independence

Why Should Business Officers Be Concerned About Auditor Independence?
- To ensure that the institution is receiving an appropriate audit
- To clearly understand management’s responsibilities
- Awareness of representations you will be asked to sign

2011 Yellow Book
- Chapter 3 – “General Standards”
  - Defines independence of mind and in appearance
  - Emphasizes the importance of considering individual threats to independence both individually and in the aggregate
Auditor Independence – Yellow Book Chapter 3

- Paragraph 3.02 – “In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.”
- Nonaudit services - certain services may be permitted
- New approach combines certain rules (prohibitions) with a conceptual framework
- Certain prohibitions remain
  - Generally consistent with Rule 101 AICPA
    - GAO requires documentation of client's skill, knowledge and/or experience
    - GAO requires application of CF when a nonattest service isn't expressly prohibited
    - GAO considers financial statement preparation a nonattest service
- Beyond a prohibition - Apply the conceptual framework
Examples of prohibited non-audit services:

- Setting policies/strategic direction of audited entity;
- Design or develop an IT system that would be subject to or part of an audit;
- Accepting responsibility for management of an audited entity’s project;
- Having custody of an audited entity’s assets;
- Accepting responsibility for designing, implementing, or maintaining internal control;
- Providing services that are intended to be used as management’s primary basis for making decisions that are significant to the subject matter of the audit;
- Serving as a voting member of an audited entity’s management committee or board of directors.
Independence Threats

- Management participation threat
- Self-review threat
- Bias threat
- Familiarity threat
- Undue influence threat
- Self-interest threat
- Structural threat

Most Common

Threats to Independence Require

- The application of safeguards,
- Assessment of audited entity management’s ability to effectively oversee non-audit services, including whether management possesses suitable skills, knowledge, or experience (SKE);
- Documentation
Documentation

- Impact on Institution Being Audited = Clearly Documenting Responsibilities

You agree to be responsible to: make all management decisions and perform all management functions; designate an individual who possesses suitable skill, knowledge, and/or experience, preferably within senior management to oversee our services; evaluate the adequacy and results of the services performed; and accept responsibility for the results of the services.
Examples of Independence Threats and Safeguards

- **Audit firm**
  - Prepares financial statements and/or footnotes
  - Prepares Schedule of Expenditures of Federal Awards (SEFA)
  - Maintains depreciation schedules for client
  - Assists with preparation of account reconciliations
  - Provides numerous year-end adjustments

- **Possible Safeguards**
  - Management has “SKE” needed to perform
  - Management review / evaluate and approve
  - Management determines key criteria

- **Is the Audit Committee Monitoring (and Taking Responsibility for) Independence?**
  - Committee charter
  - SAS 114 Letter
Sample Ethical Situations Faced by Higher Education Business Officers
Ethics

- The branch of philosophy dealing with values relating to human conduct, with respect to the rightness and wrongness of certain actions and to the goodness and badness of the motives and ends of such actions.
- moral principles, as an individual
- code of morality: a system of moral principles governing the appropriate conduct for a person or group
Ethical Situations

- Have you ever been put in this position?
- Many items may be permissible by policy or law, but potentially violate personal values and morals.
- Why do people behave unethically?
  - “Everyone else does it.”
  - “No one will ever know.”
  - “I can’t control what ‘they’ do.”
  - “It’s not my job.”
  - “I can’t risk losing my job.”
  - “Nobody is getting hurt.”
  - “The company has plenty of money.”
Why Do These Situations Exist?

- There is not always a clear right or wrong answer
  - Personal morals and values
  - Multiple parties involved, all with different morals or values
  - Possible outcomes and repercussions drive the decision process
  - Many things fall into the “gray zone”

- Key considerations for a not-for-profit organization like a college/university:
  - What would your Board think?
  - What would donors think?
  - The media won’t “know the whole story”
  - Reputational damage can be significant in relation to things that seem insignificant

“That’s it agreed then - the company’s new motto is going to be “We didn’t do anything illegal”.”
Ethical Dilemma #1

**Background**
- VP-Finance is in the Board of Trustees meeting
- VP-Development is presenting a status update on the University’s capital campaign
- President really wants to break ground on new academic building
- VP-Development receives bonus based on hitting goals
- Board of Trustees hears – “We Met our Goal!”’ and votes to start construction.

**The Issues**
- VP-Finance understands the difference between GAAP accounting and Development “counting”
- VP-Finance knows that we only have received $20 million in cash, even though Development is reporting that we’ve met $40 million goal (with long-term pledges and planned gifts)
- VP-Finance is a direct report to President - who wants to start construction.
- Can’t pay construction contractor with long term pledges… who will be “on the hook” when the bills come in?
Ethical Dilemma #1 – Outcomes & Suggestions

Say Something Now:
- Construction may not start
- President angry
- Lose my job?
- Implies lack of trust in VP – Development
- Upholding personal values and morals

Let it Go:
- Can’t pay construction bills
- Bad publicity
- Damaged donor relations and reputation
- Accusations that VP-Finance is irresponsible or lacks necessary skill-sets.

Preventative Steps:
- Capital campaign planning includes VP Finance
- “Gift counting” or “Fund before Building” policy implemented prior to starting campaign
- Schedule monthly meetings between Finance and Development to reconcile your systems
Ethical Dilemma #2

- **Background**
  - Science department received a grant for research
  - Research completed ahead of schedule
  - Grant funds 3 employees
  - 2 years still remain in the period of allowability

- **The Issues**
  - Employees will be terminated at conclusion of grant
  - Science department wants to keep these employees to continue research on other items
Ethical Dilemma #2 – Outcomes & Suggestions

- **Say Something Now:**
  - Employees terminated
  - Science department angry
  - Creates a theme that inefficiency is the best approach in these situations
  - Taking the “high road” – because IF we actually got caught…there would be big problems (loss of future funding, etc.)

- **Let it Go:**
  - We did great work – we “deserve it”
  - We don’t think the federal agency even reads our progress reports anyway
  - Federal government has “plenty of money” and we need this.
  - Employees keep jobs
  - Other research can be performed

- **Preventative Steps:**
  - Plan ahead
  - Detailed budgeting process when applying for grants
  - Encourage science department to start early when applying for new grants

"It doesn't matter that you never got caught!"
Ethical Dilemma #3

Background

- College President and Vice-Presidents all have corporate credit cards
- Bills come directly to the College and employees are required to submit supporting receipts and documentation of business purpose
- President does not turn in all receipts timely
- President charges things that VP-Finance feels may not have a business purpose
- VP-Finance is the designated reviewer for the President’s charges and expense reimbursements

The Issues

- VP-Finance is a direct report to President
- President “just forgot” and will bring in the receipts soon
- Missing receipts every month
- VP-Finance is not clear on all discussions between Board and President – some items may be permitted without the VP’s knowledge. For example:
  - Expensive meals & entertainment – multiple times per week
  - Spousal and/or first class travel
  - 4-star hotels
Ethical Dilemma #3 – Outcomes & Suggestions

Say Something Now:
- President thinks VP doesn't trust him/her
- Will I lose my job?
- Honoring your job responsibilities
- Good steward of the institution’s assets

Let it Go:
- Everything could be fine and President is just unorganized
- If there are problems – someone will be blamed for missing this (VP-Finance?)
- Media publicity
- Reputational damage
- Under-reported taxable income – now the IRS is involved

Preventative Steps:
- Create a policy where designated Board member signs-off on President’s expenses and credit card charges periodically
- Institution-wide policy stating that receipts must be submitted within a specified time frame, or amounts will be:
  - Recovered from next paycheck
  - Added to taxable income
Ethical Dilemma #4

- **Background**
  - University has tax exempt bonds outstanding
  - Letter of credit required as security for bondholders
  - Bond and letter of credit agreements fill 3 large binders – nearly impossible to read everything
  - New auditor arrives and asks about the existence of any covenants - discovers financial and non-financial covenants

- **The Issues**
  - University has met the requirement to submit audited financial statements within 180 days (non-financial covenant)
  - Financial covenants exist – but University had accidentally overlooked this before, and thus did not calculate them
  - Bank didn’t ask for anything other than signing an annual form and submitting audit report
  - Annual form contained reference to financial covenant compliance in the “fine print”
Ethical Dilemma #4 – Outcomes & Suggestions

- **Say Something Now:**
  - Could be subject to penalties
  - What if the letter of credit is cancelled?
  - Pretty sure we passed – but are we interpreting covenants the same way as bank?
  - VP-Finance is the one signing the annual statement to bank

- **Let it Go:**
  - We’ve met the covenants anyway
  - They haven’t asked for it
  - We’re doing going things here!
  - What about those “waived audit adjustments”
  - The cost of a covenant waiver would be too significant for our tight budget

- **Preventative Steps:**
  - Communicate openly with bank about all ongoing compliance up front.
  - Make sure that VP-Finance is involved throughout all stages of bond transaction
Ethical Dilemma #5

**Background**
- University enrollment has grown significantly over the past few years.
- Housing is very tight – not enough dorm space
- University decides to build a new dorm
- RFP issued to construction companies
- Five qualified companies submit proposals

**The Issues**
- Board member (who is also a very large donor) is the President of one of the proposing construction companies
- Board member’s company is the second most expensive proposal
- Discussions were already ongoing between Board member, President and VP-Development about a large contribution with naming rights for the dorm
- VP-Finance works with procurement department to rate each proposal – and Board member’s company is not first.
- Board approves contract with Board member’s company
Ethical Dilemma #5 – Outcomes & Suggestions

**Say Something Now:**
- No contract likely means no large contribution.
- President and VP-Development will be furious.
- My job security?
- Personal integrity
- I am the one signing the Form 990

**Let it Go:**
- President, VP-Development and Board member are happy
- College receives large gift
- How will this be reported on the Form 990?
- What if the other proposing companies read our Form 990?
- Publicity
- IRS issues – private benefit, penalties

**Preventative Steps:**
- Conflict of interest policy with annual disclosure statements
- Report all disclosed conflicts (and actual transactions) to Board or designated Board Committee
- Multiple levels of approval for large contracts
Additional Examples of Ethical Dilemmas Faced by Business Officers

- Student Financial Aid Director’s family members receiving excess awards and scholarships
- Large pledges contingent upon child’s acceptance to University
- Embellishing program outcomes on grant reports
- Investment Committee Chairman granted access to private investment vehicles as a result of leading the College’s business to specific advisor(s)
- Investment Committee recommends investment vehicles that VP-Finance does not feel are appropriate (illiquid, high risk, etc.)
- Others?
“Real Life” Examples of Higher Education Fraud
Why Does Fraud Occur in Higher Education

- Inherent “trust” that everyone is doing what is best for the institution

- Business officers have many responsibilities (admin/operations, IT, etc.), and their departments are often times thinly-staffed
  - Board wants to spend money on mission….not administration
  - Segregation of duties and other internal control functions could be compromised

- Some programs have heightened inherent risk to fraud
  - Scholarships – easy to just “slip in” one more distribution and nobody will notice
  - P-Cards and credit cards
  - Research grants involving individuals

- Many instances of fraud are not reported or prosecuted
  - Sets a tone that these things are OK, or “swept under the rug”
  - Fear of publicity – resulting in damage to reputation with donors, grantors and public
Elements of Fraud

Excerpt from: *A Violation of Trust: Fraud Risk in Not-for-Profit Organizations*
By Jonathan T. Marks, CPA, CFF, CITP, CFE, and Pete A. Ugo, CPA
Online Scheme Highlights Fears About Distance-Education Fraud

By Marc Parry

An Arizona woman pleaded guilty on Tuesday to running an elaborate scam that highlights what federal authorities describe as the vulnerability of online education to financial-aid fraud. The scheme embroiled [redacted] home to one of America’s largest online programs, in a half-million-dollar con.

The defendant, 38-year-old Trenda L. Halton, blended in with the working-adult students at [redacted] But the neatly organized records in her suburban Phoenix home held clues to a double life.

Social Security numbers. Tax returns. High-school diplomas. Ms. Halton used those records in a scheme that defrauded the federal government of about $539,000 in student-aid dollars—a scheme that involved dozens of people recruited to pose as phony "straw" students, according to court records.

Ms. Halton pleaded guilty in federal court to conspiracy, mail fraud, and financial-aid fraud. Her lawyer has not responded to requests for comment.

But the high-tech methods she admitted using have already set off alarms at the U.S. Education Department. Ms. Halton made her bogus recruits look like real students by assuming their identities online to "participate" in classes and collect a share of their aid money, authorities say.
Fraud in Higher Education – Headlines

As of late September, 17 people have pleaded not guilty after stealing $770,000 of financial aid money from 15 college campuses in California. Sixteen of the 17 suspects have been released on bail and are facing up to 20 years in prison if found guilty.

The 17 accused scam artists allegedly pretended to be students—or in some cases posed as existing students who attended the schools—to apply for financial aid. The crime was detected when some schools noticed duplicate phone numbers and handwriting on applications that were submitted.

"At this time of year, as college students begin classes at schools throughout the state, it is important to send the message that fraud against student assistance programs will not be tolerated," said Benjamin B. Wagner, U.S. attorney for the Eastern District of California, in a statement. "Those who rip off federal aid funds can expect to find themselves in a prison cell instead of a classroom." Since this past August, each criminal has been put on trial and charged with six cases of fraud.
Fraud in Higher Education – Headlines

College Pays Millions In Whistleblower Suit

settled federal fraud charges yesterday following a suit filed by a whistleblower under the federal False Claims Act. University administrators agreed to repay the government $3 million although admitted no wrongdoing. False claims act cases against non-profits are still rare but are increasing in frequency.

According to the complaint unsealed yesterday, Professor Charles Bennett was a cancer researcher in the university’s School of Medicine. While employed by the school, Bennett oversaw research monies from the National Institute of Health. NIH is an agency of the U.S. Department of Health and Human Services meaning its funding comes from taxpayers.

The lawsuit, originally filed by a whistleblower, says that Bennett took taxpayer monies earmarked for research and used it for family trips, hotels and to hire unqualified family and friends. He was caught when an alert purchasing coordinator filed a federal whistleblower complaint.

In announcing the settlement, Chicago’s U.S. Attorney, Gary Shapiro, said, “Allowing researchers to use federal grant money to pay for personal travel, hotels, and meals, and to hire unqualified friends and relatives as ‘consultants’ violates the public trust and federal law. This settlement, combined with the willingness of insiders to report fraud, should help deter such misconduct, but when it doesn’t, federal grant recipients who allow the system to be manipulated should know that we will aggressively pursue all available legal remedies.”

As noted above, cases against nonprofits and schools are still rare. The “conventional wisdom” says that fining a school only hurts students. In recent years, however, some universities now have hospitals and research centers that rival the biggest and best private sector facilities. In other words, they act like big business.

The whistleblower in this case, Melissa Theis, is slated to receive $498,100 for her efforts. Federal law permits cash awards of 15 to 30% of whatever is collected by the government.
Fraud in Higher Education – Headlines

$3 Million Research Fraud

When undergrads plagiarize and falsify research, it’s unfortunate, but when it happens at the graduate and professor level, it’s federal fraud. At [redacted], professor Craig Grimes has been accused of defrauding the National Institutes of Health and Advanced Research Projects Agency of federal grant monies, to the tune of $3 million. Grimes requested grants to study the measurement of gases in a patient’s blood, but the money was not spent for this research. Instead, clinical trials were never performed, and the grant funds were misappropriated, largely for the personal use of Grimes. Grimes has been charged with making false statements, money laundering, and fraud. He faces up to 35 years in prison and a fine of $750,000.
Fires Student-Activities Director Over Alleged $300,000 Embezzlement

The director of student activities at [redacted] was fired last Friday for allegedly embezzling $300,000 of university money. The official, Jodie Nealley, who had worked at the Massachusetts institution for 11 years, admitted only to taking a portion of the money, the university said.

According to a statement issued by Bruce Reitman, dean of student affairs, Ms. Nealley misappropriated the money from revenue-generating activities and accounts under her control, and the university’s Audit and Management Advisory Services Office discovered the alleged theft during a preliminary audit.

“We are shocked, disappointed, and angered by Ms. Nealley’s actions,” Mr. Reitman said in the statement. “She breached the trust that all of us at [redacted] had placed in her.”
Fraud in Higher Education – Headlines

Former University Employee Arrested in Connection with Fraud Case

Investigation Uncovered “Shell Companies” Used to Commit Fraud

KENNESAW, Ga. (March 28, 2013) — A former employee was arrested tonight in connection with an area crime ring that created “shell companies” to conduct fraud – including within a unit the employee managed at the university.

Gerald Donaldson, former executive director of environmental health and safety at the university, was charged with “conspiracy to defraud the state.” Five others have been charged in the criminal case, which alleges the crime ring collectively defrauded the state of nearly $1 million. Warrants for all six individuals were sworn by the Georgia Bureau of Investigation (GBI) and the today, which also jointly made this evening’s arrest of Donaldson.

Donaldson was terminated from the University on October 5, 2012, after University officials – aided by an informant’s tip – uncovered his direct involvement in fraudulent business transactions that fell under his supervision. Donaldson’s prosecution was delayed while university officials collaborated with state law enforcement agencies in a months-long investigation, which identified that the fraud extended well beyond the University, to include private organizations and additional individuals outside of the University System.

The Georgia Bureau of Investigation and the State Attorney General’s office conducted the investigation. Identified irregularities include alleged fraudulent purchasing practices that exploited loopholes in the State purchasing process, which enabled the creation of false vendor profiles and resulted in payments to fictitious vendors.

“Malfeasance and fraudulent behavior absolutely are not tolerated, and we will prosecute any and all employees who abuse their roles to steal from this institution,” said Vice President of Operations Randy Hinds. “We will exercise the full extent of the law to prosecute such criminal activity.”

University employees being vigilant in the course of their duties initially prompted the discovery of the alleged fraud. Concerns arose when employees reviewed invoices that normally had been reviewed by the accused, and recognized that unusual invoices were submitted for payment. Employees and managers reported their concerns to other University officials. An on-going campus-wide review of University business practices and a recently implemented fraud prevention hotline also verified fraudulent activity.

University officials conducted an audit that revealed exceptions to standard protocols, and alleged acts of wrongdoing that included the awarding of contracts to shell corporations and billings for duplicate work. Donaldson, who joined the university in February 2001, allegedly was responsible for approving the fraudulent contracts and for verifying that the work was completed as specified.

As soon as the fraudulent transactions were revealed, officials placed the executive director on administrative leave, and initiated a comprehensive audit and subsequent investigation. Findings resulted in Donaldson’s dismissal one month later, and the referral of the case to the State Attorney General’s...
Gambling nun blames "childhood demons" for embezzlement

Tue, Nov 8 2011

By Aman Ali

NEW YORK (Reuters) - A Catholic nun with a gambling habit was sentenced on Tuesday to community service and repayment of less than half of the $850,000 she embezzled from [redacted], where she worked as vice president of finance.

An attorney for Sister Marie Thornton, better known as Sister Susie, blamed "childhood demons" for the addiction that prompted her to send phony invoices to the [redacted] to cover up for gambling sprees in Atlantic City, New Jersey.

The teary nun, who pleaded guilty to embezzlement, apologized in U.S. District Court in Manhattan for the crime she committed.

"I'm sorry I hurt so many people I genuinely loved," said Thornton. "I'm sorry for embarrassing my religious community, my family and my friends."

Judge Kimba Wood ordered Thornton to complete 2,000 hours of community service and pay back $350,000, noting insurance covered the remaining $500,000. Thornton faced a maximum penalty of three years in prison.

Defense attorney Sanford Talkin told the judge that Thornton had been diagnosed as having a pathological gambling addiction. He said she gambled to deal with "childhood demons," although he declined to elaborate.

"Gambling gave her a freedom, a freedom of feeling like it was about her for a change," Talkin said. "For the first time in her life, she was able to stop the suffering internally."

The thefts began in 1999 and ended in 2009, when Thornton resigned from her position as vice president of finance at the [redacted].
Additional Frauds in the News – Not All are Big Headlines

- Top-level university administrators take university-funded trips to overseas locations to set up exchange programs that never come to fruition.
- Deans and chairpersons create unnecessary positions – and then employ related parties in them.
- Faculty members develop software and other products through their university-sponsored research funds, and then market or sell the products through their own private companies.
- Professors send a paper to various conferences in their native countries to have paid trips back home.
- Instructors order desk copies of books from publishers under the guise of considering them for adoption as a textbook, then turn around and sell them online. Professors can make several hundred dollars per month in this scheme.
Common schemes

- Fictitious vendors
- Theft of ‘small dollar’ computer equipment or other inventory for re-sale
- Pocketing cash receipts meant for deposit – rent, tuition/fees, student run businesses
- Fraudulent expense reports
- Abuse of institution credit card for personal use
- Business Office staff with improper IT access – used to circumvent internal control steps
- Issuing additional paychecks/bonus checks
- Forging checks
- Wire transfers
- Identity theft for student aid applications
- Related-party financial aid awards
- Improper use of grant funds
Lingering Effects

- Institutional reputation
- Alumni relations
- Donor relations
- Employee productivity
- Enrollment
Fraud Prevention Steps

- Routinely brainstorm with other members of management regarding fraud risks
- Establish – and enforce – a system of effective controls
  - Segregation of duties, contracting/purchasing processes, vendor approval, thresholds
- Evaluate whether the internal controls in place are mitigating this risk area
- Form an effective and empowered audit committee or equivalent
- Establish the right tone from the top
- Internal audit
- Provide a clear process for reporting suspicious behavior
- Document compliance at all levels
- Develop a response plan
- Confront the issue openly and directly
Ways to Encourage Ethical Behavior

- Code of conduct and/or Ethics policy for employees to sign
- Conflict of interest policy
- Whistleblower policy
- Policies clearly prohibit retaliation against employees
- “Tone” starts at the top – management needs to set a good example
- Town hall meetings/other entity wide communications
- Ethics hotline
- Clear reporting processes for any concerns
- Fraud prevention and detection program
Questions?
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