

Risky Business

A school leader's job is to evaluate and manage threats, both internal and external, but sometimes help is needed from outside the district

Risk is defined as any factor that could stop your school district from accomplishing its mission. Preventing or minimizing danger is the driving force behind holding fire and lockdown drills and creating disaster recovery plans.

However, many districts do not have the expertise necessary to identify less commonplace risks. Consequently, they do not develop strategies to forestall many damaging events.

Districts face a wide range of threats that arise both internally and externally. Every district must continually evaluate and manage risk if it is to successfully achieve its goals and objectives.

Lessons beyond education

Education can learn valuable lessons from other industries. Banking may seem far removed from the everyday experiences of school districts, but the impact of risk can be equally threatening in either field. The following story is an example:

American and British banking regulators in April inquired about some extremely large derivative transactions that were distorting financial markets in London and other financial centers. Derivative transactions are complex financial contracts used to protect against credit risk or changes in inter-

est rates. Sometimes they are so uniquely structured that even the transaction participants may not totally understand their potential impact. Frequently they are used to protect a portfolio or trading position.

The bank under scrutiny, one of the world's largest and best managed, emerged from the financial turmoil of 2007-08 relatively unscathed. Its management team was routinely praised for its cautious style and expertise in controlling risk. These bankers believed they understood their business completely and considered themselves skilled in avoiding financial disasters. Unfortunately, neither the board of directors nor the chairman provided effective oversight.

The chairman announced in May that the bank had lost more than \$2 billion as a result of several risky derivative trades that had not been fully understood. He acknowledged the bank's strategy was flawed and poorly managed. Furthermore, he noted the bank did not implement control procedures when high-risk limits were breached.

With Congressional hearings investigating the loss, investors worldwide wonder about banking safety. The final economic and psychological impact on stockholders and bank depositors will not be known for some time. However,

projections suggest that losses may reach as much as \$5 billion.

Closer to home

What does this banking debacle have to do with school districts? Plenty. It demonstrates that bad things can happen in highly respected, efficient organizations. They can happen to any school district as well.

Board members may become complacent when unaware of risk and the internal controls necessary to mitigate it. If nothing has gone seriously wrong for an extended period of time, it is easy to imagine all is well and will continue to be so. However, risk is always lurking. Control measures must be analyzed and their effectiveness verified. If no one is watching, there is little likelihood risks will be identified in your district before a problem occurs.

Unfortunately, fraudsters can exploit school districts for years before their crimes are discovered. For example, in March, the New Jersey Attorney General's office reported that an engineer overseeing construction projects for three school districts was sentenced to three years in state prison. He pleaded guilty to bid rigging, inflating contracts, and accepting kickbacks from contractors. From 2001 to 2010, he prepared fraudulent estimates for school district contracts and advised contractors to inflate their quotes.

Similarly, in North Carolina's Wake County School District, a transportation department scam continued from 2002 through 2004. Five former school system employees and two employees of an auto supply company pleaded guilty to charges of conspiracy and

obtaining property under false pretense. The fraud was simple to execute.

School employees submitted orders for auto parts that were never delivered. In most cases the orders were below the district's \$2,500 bid limit. School employees received kickbacks from the company's co-conspirators and purchased trailers, boats, wide-screen televisions, trucks, and gift cards. The fraud cost the district between \$4 million and \$5 million, much of which has since been recovered.

Risk assessment

It is essential that your board and administrators be aware of potential threats. A risk assessment can help. The International Professional Practice Framework, which was developed by the Institute of Internal Auditors, describes risk assessment as a process that includes ongoing monitoring activities and periodic comprehensive evaluation of all functions.

A group called the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the mid-1980s gathered ideas from governments and corporations regarding risk management, internal control, and fraud deterrence. The COSO framework is a comprehensive plan designed to manage threats identified through risk assessment.

Together, these two models inform an in-depth risk assessment process.

A thorough review of how your district operates is essential. Risk assessments typically evaluate organizational structure, governance, policies, operations, and information systems. Special attention is given to examining effectiveness and efficiency in these areas. The district's compliance with state and federal laws and regulations, policies, procedures, and contracts also is scrutinized. In addition, the prevalent ethical values, management style, and philosophy of the district are examined.

Identifying and evaluating multiple,

cross-district risks ensures that the response to one risk does not have unintended consequences in another area of the district or impact the budget negatively. For example, delaying a building project to save cash may significantly impact state aid payments or student outcomes. Assessing risk requires considering a wide range of potential events so that resources are effectively deployed throughout the district.

Measuring risk

Various methods are used to identify, analyze, and quantify risk. Most methods focus on two primary elements. The first evaluates the potential impact of each risk on the organization. Then, the likelihood of the risk occurring is ascertained.

Sometimes a number is calculated that ranks the probability of a dangerous outcome occurring for each identified risk factor. Lower numbers indicate less of a threat. Other systems use colors to suggest various levels of risk. Red identifies high risk, yellow highlights a moderate degree, and green is used to label low levels.

Every school district decides how much risk it will accept and how to manage it. You can choose to accept risk, reduce risk, or avoid risk altogether.

For example, in cases where risk is low with minimal capacity to impact district goals, you may decide to do nothing. For example, you may simply accept the risks associated with not blacktopping the faculty parking lot. In circumstances where risk is greater and the cost to eliminate it is higher, you may decide to share the risk by partnering with other districts. Such a solution may be effective to reduce the financial impact of providing health and disability benefits to employees. Finally, you may sometimes choose to avoid risk completely. For example, you may eliminate a kindergarten class section in anticipation of loom-

ing state aid reductions.

Selecting an internal auditor

In most cases, assigning the probability of a risk event occurring is a matter of judgment and relies on the evaluator's expertise. Therefore it is essential to choose an evaluator who understands the problems and risks unique to school districts.

The auditor conducting the assessment must be knowledgeable about your district's goals and objectives. In addition, it is important that an auditor grasps how education policies, along with state and federal regulations, impact the budget and student outcomes.

Savvy school districts work closely with their internal auditor. In addition, they strengthen their own risk management capability by sending personnel to conferences and training programs to learn about new threats and internal controls.

Although a risk-related event may not yet have happened in your district, the possibility of danger occurring in the future is real. Being informed about the potential for trouble is an essential aspect of board oversight.

Board members are ultimately responsible for the success of the district's educational program and the financial stewardship of resources. Without risk assessment, your board cannot be certain that internal controls and procedures are operating effectively. Unfortunately, districts cannot avoid all risk. However, it is possible to identify many threats and take appropriate precautions. Remember, while risks are ever present, they need not be ruinous. ■

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