

## A Shell Game

*Today's fraudsters use sophisticated cons to victimize districts. Shell companies are a serious threat to district finances when internal controls are weak and board oversight is lax*

**H**ave you ever seen a con artist play the shell game on a street corner? Scammers seemingly hide a pea under one of three nutshells. Moving the shells around swiftly, the operator asks a player to bet on which shell is hiding the pea. Of course, the mark loses because the operator deftly replaces the pea under a shell not chosen. The scam has been around for centuries. Hieronymus Bosch, a Renaissance artist, depicted the scam in his painting "The Conjuror." The painting illustrates how people are tricked when they lack alertness and insight.

The shell game has not disappeared. Today's fraudsters use sophisticated cons to victimize school districts across

the country. Instead of nutshells, scammers use companies. Instead of stealing a pocket full of coins, the target is millions of taxpayer dollars. Rather than a pea, companies hide their true ownership and function. Shell companies are a serious threat to district finances when internal controls are weak and board oversight is lax.

### **The shell company**

Shell companies typically do not engage in ongoing legitimate business activities, although some may be used in the start-up stage. They usually have few or no assets. Using a shell company, fraudsters hide bribery payments, launder money, bill for fictitious ser-

vices, or keep a separate set of corporate financial records to conceal income. The identities of employees or co-conspirators doing business with school districts also can be hidden.

Recently, these faux companies have perpetrated a rash of high-profile, high-priced scams involving school districts. For example, in August 2012, two men were accused of using five shell companies to charge the New York City Department of Education for sign language services allegedly provided to nonpublic school students. Student names and personal information were submitted on fraudulent invoices that were allegedly signed by an administrator who had retired six years earlier. According to investigators, the men defrauded the city of at least \$1.5 million for services never provided to students.

In September 2012, the former superintendent of New Jersey's Toms River Regional School District pleaded guilty to influencing the placement of the district's insurance policies. He was sentenced to 135 months in prison. According to court records, the superintendent steered lucrative contracts to the district's former insurance broker. It is estimated that the superintendent accepted between \$1 million and \$2 million in bribes and other benefits. In order to hide the income and avoid paying taxes, his shell company distributed the funds using fictitious consulting contracts.

In October 2012, Ohio's State Auditor accused the Cuyahoga Heights School District's former technology director of diverting \$3.8 million. He allegedly used seven shell vendor companies, controlled by friends and relatives, to



accomplish the scam. According to auditors, no district records exist to prove that the goods or services were delivered. In addition, \$350,000 was spent on computers and cell phones at legitimate vendors. This equipment also was diverted to friends and family. Bank records suggest that the technology director received \$1.3 million in kickbacks for these scams.

Also in October 2012, New Jersey's Attorney General charged a mother and daughter with creating a shell transportation company to defraud Piscataway School District of \$336,570 and the Hazlet School District of \$229,202. The daughter, the districts' transportation manager, allegedly authorized payments to fictitious bus companies. Her mother deposited the checks into their personal accounts. Another employee's suspicions led to the investigation.

When it comes to being targeted by scammers, entities such as school districts are second only to banking and financial institutions. Shell companies doing business with districts are costly both in dollars and tarnished reputations.

### **Protect your district**

How can you ensure that you don't get victimized by shell company scammers? Begin by evaluating administrators' vendor approval guidelines. Determine whether a standardized form is used to gather information about potential vendors. Remember, screening and approval of vendors can be complicated.

Government bidding regulations are designed to ensure districts receive competitive prices for the goods and services they purchase. In most states, districts are required to accept the lowest responsible bid. But administrators or board members may not know the lowest bidder or have the opportunity to adequately investigate applicants before awarding the bid.

In order to address this dilemma, consider asking your district's attorney to review your request for proposal

(RFP) form. If necessary, this application can be expanded to request a range of relevant information. Naturally, you want to obtain basic data such as location of offices, phone numbers, state of incorporation, and other business documentation, such as "doing business as" filings. Require a reference list that includes other school district clients.

To aid in the vetting process, insist applicants include full disclosure of previous business dealings with your district, as well as a conflict of interest statement. Require full disclosure by all business owners as well as confirmation of their experience and credit standings.

When RFPs are submitted, administrators can verify business ownership by checking state incorporation records. Be especially cautious when a company's name is represented by initials only, as they could represent a district employee's name. Cross-checking employee and vendor addresses is an effective internal control to uncover this scam. An address match can identify a shell company with a possible conflict of interest.

Other strategies also can be used to check whether a company's address is valid. For example, check the street address in phone listings or Google maps. Consider sending a First Class letter to the company's reported street address to see if the envelope is returned. Of course, if a vendor's address is a numbered post office box, there must be a much higher level of scrutiny. And don't forget to check performance complaints that may be registered with the Better Business Bureau.

### **Ongoing vigilance**

While a thorough initial screening is essential, regular review of your approved vendor list is also a must. Be sure administrators eliminate dormant accounts because they provide an easy vehicle for insiders to redirect payments to shell companies. In addition,

scrutinize changes of address or banking information. Even small revisions of a vendor's name must be monitored.

Also encourage administrators authorizing payments to notice unusual invoicing patterns, such as increased activity near the end of billing periods, large dollar amounts, or a series of smaller charges. Financial transactions dated during vacation periods or weekends require especially close scrutiny.

In an effort to encourage ethical behavior, require all district officials and employees to sign a yearly statement attesting that there is no conflict of interest between themselves, board members, and vendors. This simple process reminds everyone of the high standards expected of district personnel and those conducting business with the district.

Another important tool in preventing shell company scams is a fraud reporting hotline. Tips are consistently the leading resource for fraud detection. Every district should consider instituting a hotline for tips and reporting.

Providing oversight for district expenditures is challenging. However, shell company fraud happens when no one is monitoring internal controls. Forward-thinking school districts recognize this responsibility. Consider creating an audit committee to assist the board and collaborate with administrators to ensure controls are operating effectively.

Don't hesitate to ask how your district vets vendors. Know who is providing goods and services to your district. Their payments represent a substantial portion of your school district's budget. Taxpayers will thank you for digging deeply to uncover buried shell companies. ■

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