Fraud Considerations in Nonprofit Organizations

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Fraud can be particularly troublesome in nonprofit organizations given the public trust needed by those organizations to be funded and fulfill their missions. Unfortunately fraud in general and in nonprofits is rather widespread. An October 2013 article in the Washington Post, http://www.washingtonpost.com/investigations/inside-the-hidden-world-of-thefts-scams-and-phantom-purchases-at-the-nations-nonprofits/2013/10/26/825a82ca-0c26-11e3-9941-6711ed662e71_story.html, highlighted how prevalent frauds in nonprofits can be and described some specific examples .

The Association of Certified Fraud Examiners is the largest organization dedicated to the study of fraud and how to prevent or detect it, http://www.acfe.com/. Every other year they publish a report to the Nations on occupational fraud and abuse – the most recent being 2014, http://www.acfe.com/rttn/docs/2014-report-to-nations.pdf.

The numbers reported in the 2014 report are staggering with some interesting observations which can prove helpful in designing internal controls to prevent fraud.

- Asset misappropriation schemes made up 85 % of reported frauds.
- Reported frauds last approximately 18 months before detection.
- Some 77 % of frauds were committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service, purchasing.
- Fraud committed by owners/executives was for significantly higher amounts than fraud committed by others.
- The median fraud loss for nonprofit entity cases reported was $108,000.
- The most common red flags for fraud were someone living beyond their means or with financial difficulties or addiction problems. Being too close with vendors or customers is another red flag, as is unwillingness to share duties.
- Most frauds are uncovered through tips from either employees or outsiders (42 %). External audits were low on the list (3%).
- The most frequent fraud schemes are check tampering, billing schemes, expense reimbursement padding.

Common Fraud Schemes (there are many others)

Ponzi Schemes

- Most people have heard of these schemes and names like Madoff come to mind. It is an investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors. The organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little to no risk.

Diverted Contributions

- Contributions intended for certain programs are directed elsewhere. Often includes pocketing incoming contributions or making deposits to personally controlled bank accounts.

Misrepresented Fund Drives

- Revolves around deceptive fundraising as to what the donor's gift will be used for or lack of compliance with donor-imposed restrictions on the gift

Phantom Vendors

- The employee establishes a fictitious vendor and submits false invoices for processing.

Other Disbursement Schemes

- These can cover a wide range of territory – everything from payroll schemes to kickbacks from vendors and many others

Collusion

- This is defined as secret cooperation between people to do something illegal or underhanded. A vendor receives preferred bidding status or pricing in exchange for a kickback for example.

Excessive Compensation

- Defined as compensation that is above the fair market value of the employment services actually being provided. An important concept because of possible intermediate sanctions but also potentially a very subjective standard.

FRAUD

After that introduction let's go back to the beginning and define what fraud is and some of the elements thereof and the "fraud triangle",

Blacks dictionary defines fraud as a "generic term embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trickery, cunning, dissembling and any unfair way by which another is cheated. "

The auditing standards define fraud as an intentional act that results in a material misstatement in the financial statements. Intent, which is often difficult to determine, is what distinguishes fraud from unintentional error. Fraud is generally accompanied by attempts to conceal it. Errors tend to be chaotic whereas fraud will typically follow a pattern.

The elements of fraud include:

- A false representation / willful omission about a material fact.
- The perpetrator intended to mislead the victim.
- The victim relied on the misrepresentation.
- The victim suffered damages as a result of the misrepresentation.

The Fraud Triangle

The fraud triangle is a model for explaining the factors that cause someone to commit occupational fraud. It consists of three components which, together, lead to fraudulent behavior:

1. Perceived unshareable financial need

2. Perceived opportunity

3. Rationalization

The triangle developed from the work of Donald Cressey who was a professor at UC – Santa Barbara and a criminologist who was a leader in thought on fraud. According to Cressey:

The fraud triangle originated from Donald Cressey's hypothesis as follows:

Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.[1]

The first element of the fraud triangle is not hard to understand; an employee feels mounting financial pressure such as growing debts, high medical bills, a need to support a habit like gambling or a penchant for a lifestyle beyond their current means.

The second element is a perceived opportunity to commit a fraud whether by a lack of segregation of duties, lack of oversight, an organization continually operating in a “fire drill“ or lack of mandatory vacation .

The third element is the ability to rationalize their fraudulent actions. This could be bitterness at the Company for perceived slights or convincing themselves that they will pay it back later etc.

Prevention and Detection of Fraud

Any discussion of prevention and detection of fraud begins with the concept of an Organization having good internal controls. Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: 1. Effectiveness and efficiency of operations. 2. Reliability of financial reporting. 3. Compliance with applicable laws and regulations.

General information on internal controls (probably more than you will want to know) is the COSO report on Internal Control-Integrated Framework, http://www.coso.org/IC.htm . For those not wanting to purchase the volume a Google search on New COSO report will yield a variety of hits from the big accounting firms with their analysis of the report. According to COSO the 5 components of internal control are:

- Control Environment – Effectively the tone at the top. Does the Board and top management display good ethics and their commitment to internal controls.
- Risk assessment – The on-going identification of risks and forming a basis to manage them
- Control Activities – Actions established by policies and procedures to mitigate risk. These are the nuts and bolts of internal control such as segregation of duties, separate reviews etc.
- Information & Communication –Methods to ensure reliable and accurate information is utilized and responsibilities are communicated.
- Monitoring – Ongoing evaluation to determine if controls are functioning and policies are followed.

The Fight Against Fraud

Fighting against Fraud

This involves elements of Prevention, Deterrence and Detection. Prevention is controls designed to reduce the risk of fraud from the beginning such as hiring the right people. Deterrence involves policies and procedures to deter someone from wanting to commit fraud and detection relates to finding something if it has occurred.

Examples of Controls that can be effective include:

- Employee background checks in hiring decisions
- A Code of Conduct for employees and Board members
- A review of computer security
- Segregation of duties
- Job rotation , mandatory vacations , cross-training of workforce and fraud training
- Proper employee dishonesty insurance
- Monthly financial statement preparation and review by different people
- Budget to actual comparisons
- Monthly reconciliation of accounts
- A fraud hotline or some way to receive tips on fraud –important since tips are #1 source of discovery of fraud
- Surprise internal audits
- External audits

Conducting even an informal risk assessment periodically can be a good thing to assess what controls are in place and whether some should be added. It is not practical to have controls that would prevent all fraud as it would be too expensive so you have to find a happy medium.

Small nonprofits are limited in the extent of internal controls they can have but there are some perhaps basic controls and segregation of duties they can implement.

Fraud Investigations

Some difficult decisions need to be made if you suspect that fraud is occurring. In some cases some strong evidence is surfaced early allowing you to place the suspected employee on leave while a more thorough investigation can be conducted. It is obviously more difficult if the person still is in the job and all you have are suspicions with no proof. While never easy to plan or implement some investigation must be done to determine if something is going on. Obviously legal counsel should be consulted as to ways to proceed.

If your investigation does uncover fraud additional decisions / actions are necessary such as:

--documenting the fraud for any insurance recovery

--generally employees caught in a fraud are terminated

--do you make a criminal referral of the fraud or seek a private settlement?

--- what disclosure of the matter is made to donors and other constituents?

There are no easy answers to these questions and not a universal answer.