



Expertise that Works

Fraud: What You Need To Know As A Non-Profit Organization

October 28, 2014



Introduction

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- Former Chief Audit Executive for the Commonwealth of Virginia and Director for professional services firms
- Broad experience in developing internal audit departments - conducting risk assessments, preparing plans & budgets, leading audit teams, interacting with senior management and Board members
- Conducted a variety of operational audits in the public sector

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- 18 years of professional experience (incl. 10 years of Big 4, professional services, and industry internal audit)
- Specializes in Operational and Performance Audits for Local Government and Utility clients – including telecommunications, cable and internet, water and sewage

Source Information Note

Some of the information contained in this presentation was provided by the Association of Certified Fraud Examiners (“ACFE”) through their bi-annual *Report to the Nations on Occupational Fraud and Abuse*, which was released earlier this year.

The 2014 edition of the Report was based on 1,483 cases of occupational fraud, as reported by the Certified Fraud Examiners (“CFEs”) who investigated them.

Objectives

- What is Fraud?
- What kinds of Fraud should you be worried about?
- What puts you at risk for Fraud, and what are the red flags to look out for?
- Who commits Fraud?
- What can you do at an organizational level to prevent and detect Fraud?

What is Fraud?

What is Fraud?

Fraud is an intentional deception perpetrated by an individual(s), either internal or external to an organization, which could result in tangible or intangible benefit to themselves, others, or the organization itself, or could cause detriment to the organization.

Fraud includes false representation of a matter of fact, whether by words or by conduct, by false or misleading statements, or by concealment of information which should have been disclosed, which deceives, or is intended to deceive.

What is Fraud?

Example: Greater Cornerstone Community Center

Earlier this month, the Rev. Willard Jones, former pastor at Greater Cornerstone Baptist Church in Tulsa, OK, plead guilty to embezzling almost \$1 million from a fundraising non-profit that he was in charge of.

- Rev. Jones was in charge of raising money for the creation and operation of the Greater Cornerstone Community Center between 2007 and 2013
- Rev. Jones transferred funds from community center accounts into church accounts, and then from the church accounts into his personal accounts
- The fraud was discovered when Rev. Jones had gone back to one of his major donors after the completion of the facility and asked for additional funds to operate the center

What kinds of Fraud should you be worried about?

What kinds of Fraud should you be worried about?

Types of Fraud- “The Big Three”

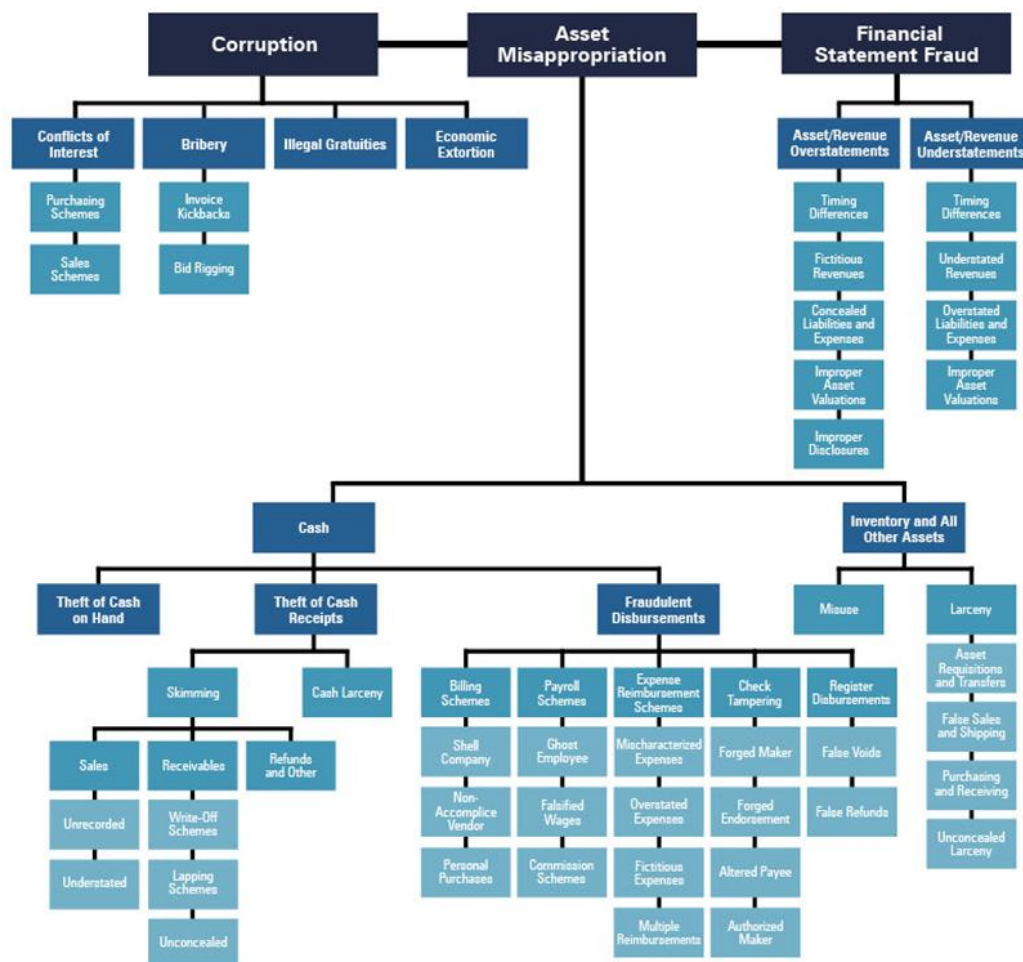
- Asset Misappropriation
 - Theft of cash, inventory, services, and other assets

- Corruption
 - Conflict of Interest, Bribery

- Fraudulent Statements and Reporting
 - Financial and Non-financial

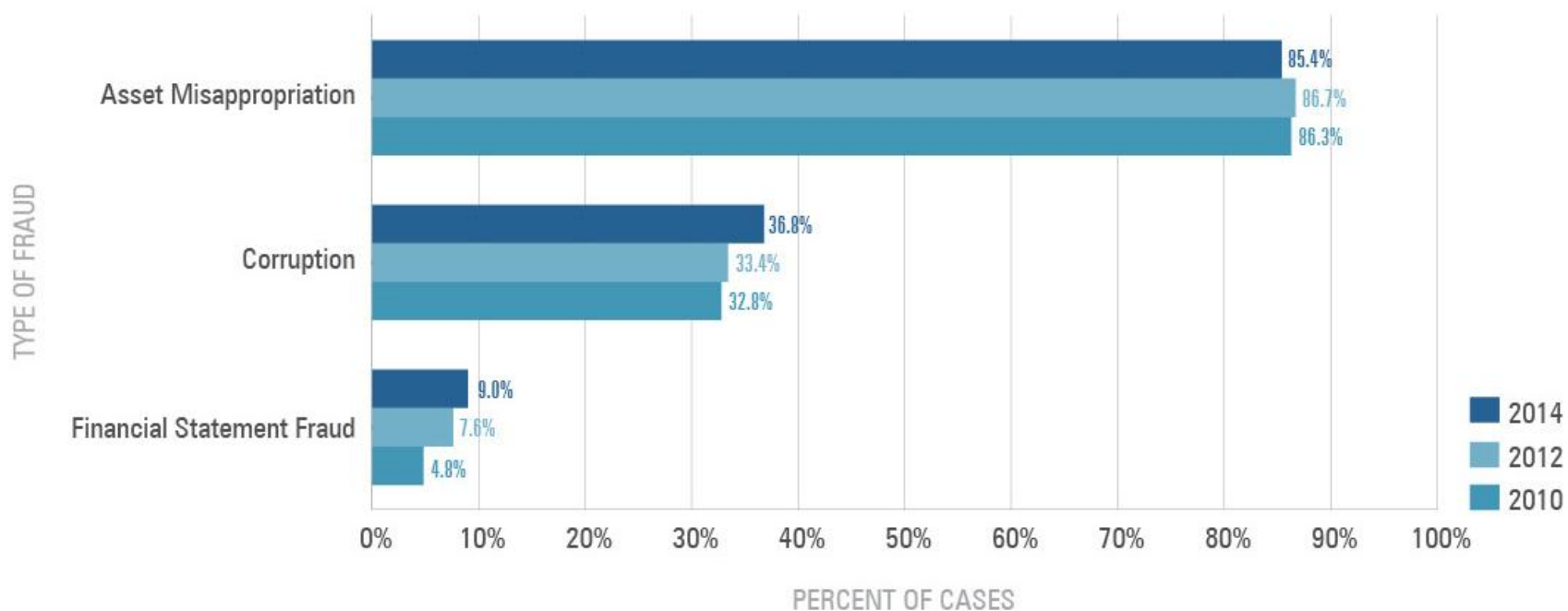
What kinds of Fraud should you be worried about?

Occupational Fraud and Abuse Classification System (Fraud Tree)



What kinds of Fraud should you be worried about?

Occupational Frauds by Category - Frequency



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What kinds of Fraud should you be worried about?

Frequency of Fraud Schemes Based on Industry

| Industry/Scheme | Banking and Financial Services | Government and Public Administration | Manufacturing | Health Care | Education | Retail | Insurance | Oil and Gas | Transportation and Warehousing | Services (Other) | Construction | Religious, Charitable or Social Services |
|---------------------------|--------------------------------|--------------------------------------|---------------|-------------|-----------|--------|-----------|-------------|--------------------------------|------------------|--------------|--|
| Cases | 244 | 141 | 116 | 100 | 80 | 77 | 62 | 49 | 48 | 45 | 43 | 40 |
| Billing | 5.7% | 19.1% | 22.4% | 29.0% | 33.8% | 10.4% | 17.7% | 24.5% | 33.3% | 28.9% | 34.9% | 32.5% |
| Cash Larceny | 13.1% | 10.6% | 6.0% | 12.0% | 6.3% | 15.6% | 6.5% | 2.0% | 2.1% | 11.1% | 14.0% | 7.5% |
| Cash on Hand | 18.9% | 12.1% | 7.8% | 16.0% | 16.3% | 22.1% | 1.6% | 2.0% | 10.4% | 11.1% | 7.0% | 12.5% |
| Check Tampering | 5.7% | 5.7% | 7.8% | 21.0% | 10.0% | 7.8% | 4.8% | 4.1% | 20.8% | 17.8% | 27.9% | 35.0% |
| Corruption | 37.3% | 36.2% | 54.3% | 37.0% | 36.3% | 22.1% | 33.9% | 57.1% | 29.2% | 35.6% | 46.5% | 30.0% |
| Expense Reimbursements | 4.1% | 12.8% | 7.8% | 23.0% | 31.3% | 3.9% | 4.8% | 14.3% | 14.6% | 17.8% | 27.9% | 32.5% |
| Financial Statement Fraud | 10.2% | 5.0% | 13.8% | 8.0% | 10.0% | 6.5% | 3.2% | 12.2% | 10.4% | 6.7% | 11.6% | 7.5% |
| Non-Cash | 13.1% | 17.7% | 34.5% | 12.0% | 12.5% | 33.8% | 12.9% | 16.3% | 33.3% | 17.8% | 20.9% | 15.0% |
| Payroll | 5.3% | 15.6% | 8.6% | 15.0% | 16.3% | 5.2% | 8.1% | 6.1% | 16.7% | 6.7% | 18.6% | 20.0% |
| Register Disbursements | 2.5% | 0.7% | 2.6% | 3.0% | 5.0% | 13.0% | 0.0% | 0.0% | 4.2% | 6.7% | 2.3% | 2.5% |
| Skimming | 5.7% | 11.3% | 4.3% | 18.0% | 20.0% | 18.2% | 22.6% | 2.0% | 6.3% | 33.3% | 7.0% | 12.5% |

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LESS RISK MORE RISK

What kinds of Fraud should you be worried about?

Frequency of Schemes Based on Perpetuator's Department

| Department/ Scheme | Accounting | Operations | Sales | Executive/ Upper Management | Customer Service | Purchasing | Finance |
|---------------------------|------------|------------|-------|-----------------------------------|---------------------|------------|---------|
| Cases | 230 | 203 | 166 | 156 | 102 | 95 | 69 |
| Billing | 31.3% | 22.2% | 9.6% | 35.9% | 10.8% | 25.3% | 26.1% |
| Cash Larceny | 19.1% | 8.4% | 3.6% | 7.7% | 17.6% | 1.1% | 10.1% |
| Cash on Hand | 18.7% | 15.8% | 10.2% | 9.0% | 24.5% | 4.2% | 14.5% |
| Register Disbursements | 3.0% | 3.9% | 4.2% | 2.6% | 4.9% | 1.1% | 2.9% |
| Check Tampering | 35.7% | 4.4% | 3.0% | 10.9% | 3.9% | 3.2% | 24.6% |
| Corruption | 22.2% | 37.9% | 29.5% | 51.9% | 24.5% | 73.7% | 31.9% |
| Expense Reimbursements | 15.7% | 14.8% | 10.2% | 26.9% | 7.8% | 6.3% | 13.0% |
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What kinds of Fraud should you be worried about?

Non-Profit Fraud – Asset Misappropriations

Revenue and cash receipts schemes:

- Skimming – Theft of cash before the funds have been recorded on the books. Skimming can be perpetrated by someone who either initially collects or opens incoming mail, the person who initially logs in cash receipts, prepares the deposit or takes the deposit to the bank, or door-to-door solicitors of charitable contributions.
- Theft of donated merchandise – Donated merchandise can be just as susceptible to theft as cash. While it may be a little harder for the perpetrator to carry the merchandise out, most organizations have poor controls or recordkeeping over donated items.

What kinds of Fraud should you be worried about?

Non-Profit Fraud – Asset Misappropriations (continued)

Purchasing and cash disbursement schemes:

- Credit card abuse – Perpetrators either use organization issued cards for personal use, or more damaging for the organization is the use of credit card numbers of donors
- Fictitious vendor schemes – Perpetrators set up a company and submit fake invoices to the organization for payment

What kinds of Fraud should you be worried about?

Non-Profit Fraud – Asset Misappropriations (continued)

Payroll and employee expense reporting schemes:

- Ghost employees – Whereby either terminated employees are left on the payroll system, or fake employees are set up in payroll. Payroll checks are then issued for nonexistent employees and the checks are cashed by the perpetrator.
- Overstatement of hours worked – Workers claim that they worked additional hours in order to obtain unearned pay.
- Fictitious expenditures – Submission of fictitious expenditures for reimbursement has become a significant problem especially with the evolution of desktop publishing. The effort involved in creating a bogus invoice for reimbursement can be rather minimal.

What kinds of Fraud should you be worried about?

Non-Profit Fraud – Asset Misappropriations (continued)

Other examples of asset misappropriations:

- Property and equipment schemes – Outright theft of an asset
- Personal use of organization's assets and other resources (corruption) – Use of organization's computers, software, and printers for personal projects. Personal long distance telephone calls. Utilizing the organization's Internet access and e-mail for personal use. Photocopying personal documents on the organization's copy machine.

What kinds of Fraud should you be worried about?

Non-Profit Fraud – Asset Misappropriations (continued)

While not as common as internal frauds, external frauds can occur in organizations and be just as detrimental. Common examples of external fraud are:

- Fraudulent billings by vendors – charging for goods or services not delivered or inflating prices, phony extra charges
- Fraud committed by service organizations to whom organizations outsource important internal functions – using funds for other purposes before remitting, charging for false transactions, receiving kickbacks from other vendors for subcontracting services
- Fraud by sub recipients – reporting fraudulent data or program costs to the non-profit that made the award from the original grant
- Financial assistance fraud – students who falsely receive financial aid or others who fraudulently apply for or use grant funds

What kinds of Fraud should you be worried about?

Frauds Committed By Non-Profit Organizations

The preceding examples are types of frauds committed against non-profit organizations; however, non-profit organizations also can and do commit frauds.

Fundraising is a particularly sensitive area that can be ripe for fraud. Fraudulent fundraising practices include:

- Charging fund-raising costs to programs to improve expense ratios scrutinized by donors, potential donors and charity watchdogs
- Misrepresenting the portion of donations that will be used in charitable programs
- Misrepresenting the extent of a charitable contribution deduction to which a contributor is entitled, such as in some car donation programs

What kinds of Fraud should you be worried about?

Frauds Committed By Non-Profit Organizations (continued)

- Failing to comply with donor-imposed restrictions pertaining to the use of a gift
- Other fraudulent practices by non-profit organizations could include:
 - Knowingly failing to comply with Internal Revenue requirements related to housing allowances or compensation reporting
 - Knowingly misclassifying employees or using them as volunteers to avoid paying overtime
 - Using or selling donor data collected under false pretenses

What kinds of Fraud should you be worried about?

Fraudulent Financial Reporting

Fraudulent financial reporting is intentionally making false assertions relating to financial statements.

Fraudulent financial reporting is most often committed by management and includes such misrepresentations as:

- Failing to disclose significant related party transactions
- Failing to disclose noncompliance with debt requirements or lack of waiver of noncompliance from lender
- Misclassifying restricted donations to mislead donors or charity watchdogs

What kinds of Fraud should you be worried about?

Fraudulent Financial Reporting (continued)

- Holding records open beyond the period end in order to inflate revenues
- Misclassifying expenses to mislead donors and others regarding the funds used for programs
- Failing to correctly value receivables, inventory, donated assets, and liabilities under split-interest or gift annuity obligations
- Failing to report trade payables in the correct period in order to understate expenses
- Failing to correctly report obligations for deferred compensation or retirement benefits

What kinds of Fraud should you be worried about?

Example: The city of Dixon, Illinois

From 1990 to 2012, Dixon's comptroller, Rita Crundwell, embezzled \$53 million from the city of Dixon, IL.

- Ms. Crundwell opened a secret bank account named RSCDA (Reserve Sewer Development Account), making it appear to be a city account. She was the only signatory.
- She would create false state invoices, and then write checks from city accounts payable to "Treasurer," which she would deposit into the RSCDA account.
- Ms. Crundwell picked up the city's mail, including the bank statements for the RSCDA account.
- The fraud was discovered in the fall of 2011 after another city employee assumed Ms. Crundwell's duties during an extended unpaid vacation.

What puts you at risk for Fraud, and what are the red flags to look out for?

What puts you at risk for Fraud, and what are the red flags to look out for?

Do you have....?

- Large amounts of cash on hand
- Small items with a high cash value (laptops, cell phones, etc.)
- Easily convertible assets (tools, vehicles, PII)
- Lack of segregation of duties
- Management with ability to override
- Managers and Employees with access to significant assets
- Poor physical safeguards over cash and other assets
- Lack of mandatory time off for employees performing key control functions
- Inadequate supervision, especially where employees are in remote locations
- Too much information on your website

What puts you at risk for Fraud, and what are the red flags to look out for?

Do you have....?

Lack of segregation of duties

- Same person:
 - Opens mail with checks
 - Records checks received
 - Prepares bank deposit
 - Deposits money into bank
 - Reconciles bank statements

What puts you at risk for Fraud, and what are the red flags to look out for?

Do you have....?

Resource Constraints

- Not enough staff to perform the current work
- Not enough staff to supervise work performed
- Lack of funds for monitoring tools
- Lack of staff time to devote to anti-fraud activities

What puts you at risk for Fraud, and what are the red flags to look out for?

Do you have....?

Times of Change

- Change in leadership
- Reorganization
- Layoffs
- Upgrades / Promotions
- New programs without new resources

What puts you at risk for Fraud, and what are the red flags to look out for?

Do you have....?

External Pressure on Employees

- Recognize and acknowledge the pressure when possible
- Financial Issues (Mortgage, Student Loans)
- Medical Bills
- Divorce
- Child Support

What puts you at risk for Fraud, and what are the red flags to look out for?

Do you have....?

Changes in Employees Behavior

- Unwilling to take vacation / time off
- Working off hours: early, late, weekends
- Refusing promotion to a different area
- Overly protective of information and reluctant to train others
- Social relationship with vendor
- Change in lifestyle, suddenly living beyond means

What puts you at risk for Fraud, and what are the red flags to look out for?

Procurement Fraud Red Flags

- Watch for different contractors making identical errors on bids
- Contractors that hire losing bidders as subcontractors
- Insufficient justification for change orders
- Vendor address is incomplete or matches an employee's address
- Vendor invoices for goods not received
- Photocopies or scanned documents sent when originals are expected
- Timecards filled out by supervisors instead of employees

Why do people commit Fraud?

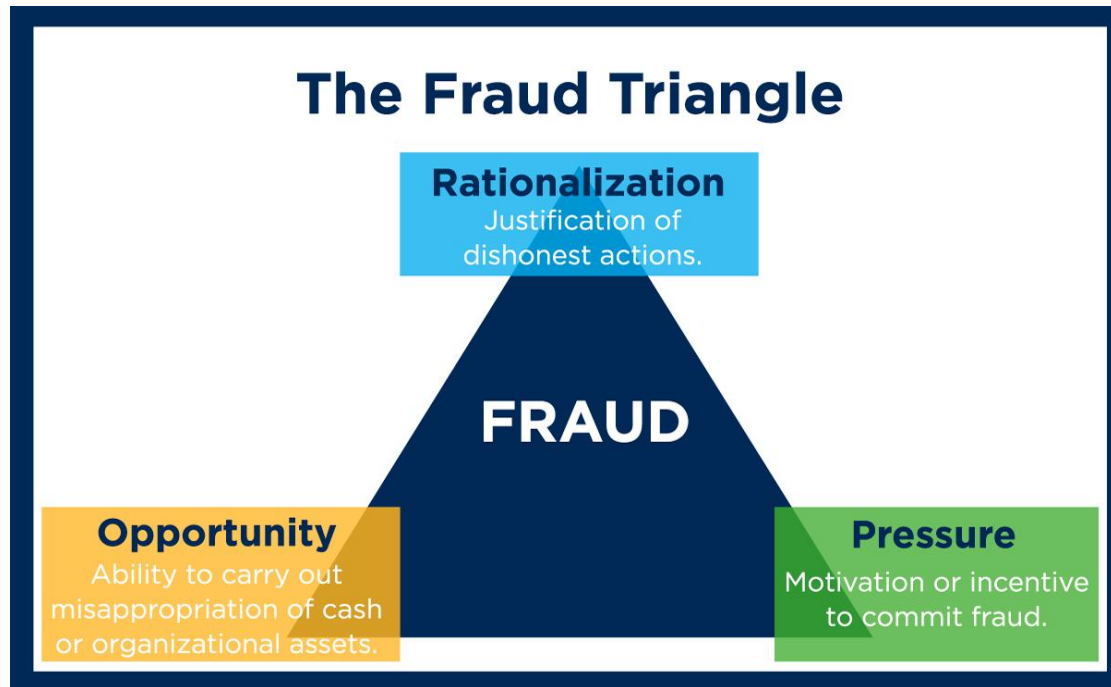
Why do people commit Fraud?

Example: Kennedy Little League

Stephen Verhage, of Madison, WI, is facing multiple felony counts for allegedly embezzling \$200,000 of little league funds.

- Mr. Verhage was the president of the league and had been affiliated with the league for 30 years.
- Since he handled all the money and controlled the bookkeeping, Mr. Verhage was able to make personal purchases and mark them down as legitimate expenses, such as uniforms or grounds crew expenses.
- In October, 2012, the vice-president of the league – a 25-year friend of Mr. Verhage – noticed some discrepancies in a league bank account used to finance improvement projects.
- When admitting the fraud to his long-time friend, Mr. Verhage explained “it got to be too easy.”

Why do people commit Fraud?



In the 1950s, famed criminologist Donald R. Cressey came up with this hypothesis to explain why people commit fraud. The three key elements in the fraud triangle are opportunity, motivation, and rationalization.

Why do people commit Fraud?

Rationalization – “Everyone is doing it”

The employee finds a way to rationalize the fraud. Such rationalizations can include :

- Perceived injustice in compensation as compared to their colleagues,
- Unhappiness over promotions,
- The idea that they are simply “borrowing” from the organization and fully intend to return the assets at a future date, or
- A belief that the organization doesn’t really “need” the assets and won’t even realize they are missing.

Why do people commit Fraud?

Opportunity

The employee has sufficient access to assets and information that allows him or her to believe the fraud can be committed and also successfully concealed.

Such opportunities can include flaws in Internal Controls (for example controls that are not enforced, not monitored or ineffective), lack of controls, too much trust is placed in employees and no segregation of duties.

Why do people commit Fraud?

Pressure

Economic factors such as personal financial distress, substance abuse, gambling, overspending, or other similar addictive behaviors may provide external pressure to motivate someone to commit fraud.

The pressure to perform, meet established expectations or having excessive quantities of work may provide internal pressure to motivate someone to commit fraud.

Why do people commit Fraud?

The Fraud Triangle

You can't reasonably control:

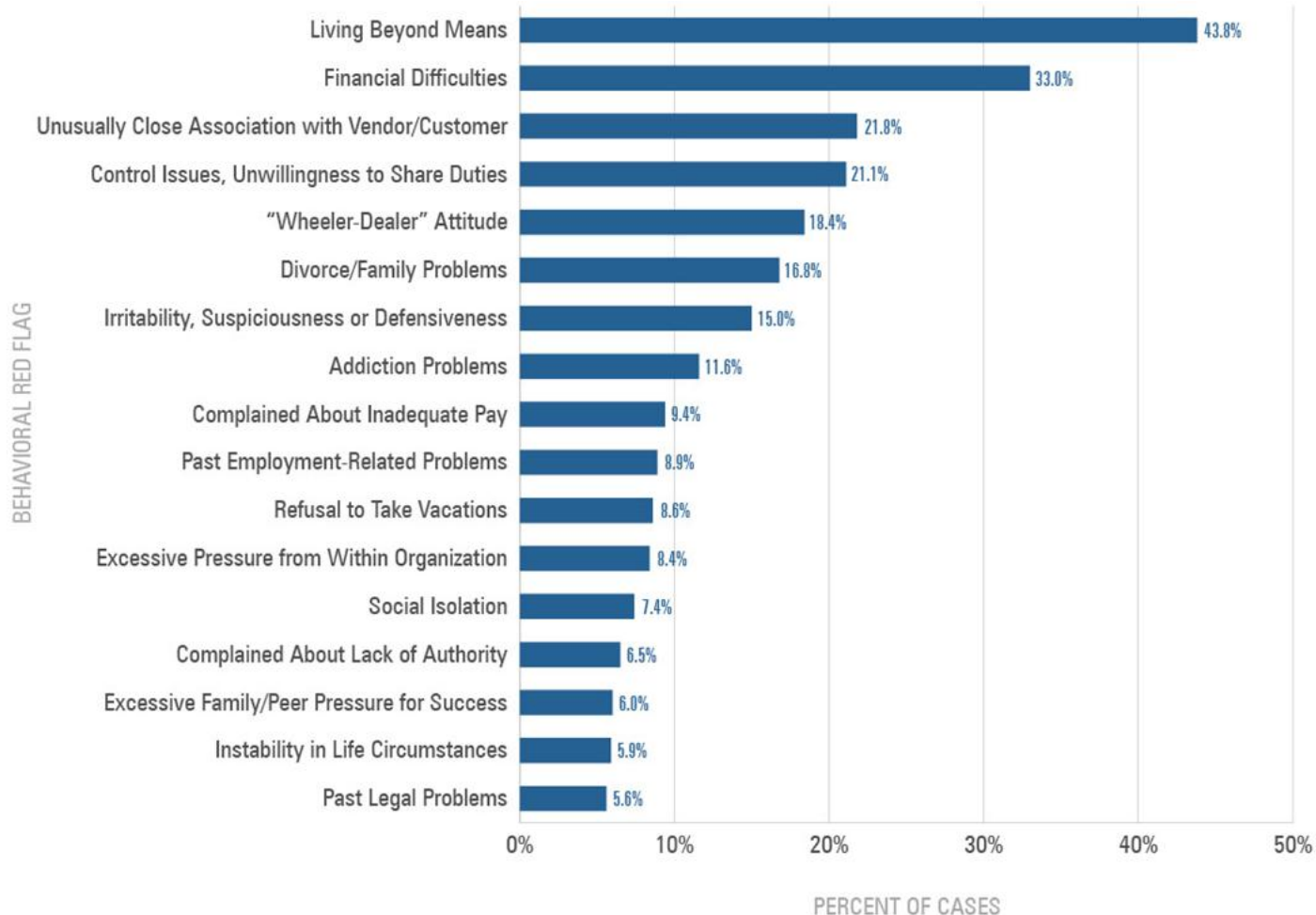
- Pressure
- Rationalization

You can control:

- Opportunity

Why do people commit Fraud?

Behavioral Red Flags Displayed by Perpetrators



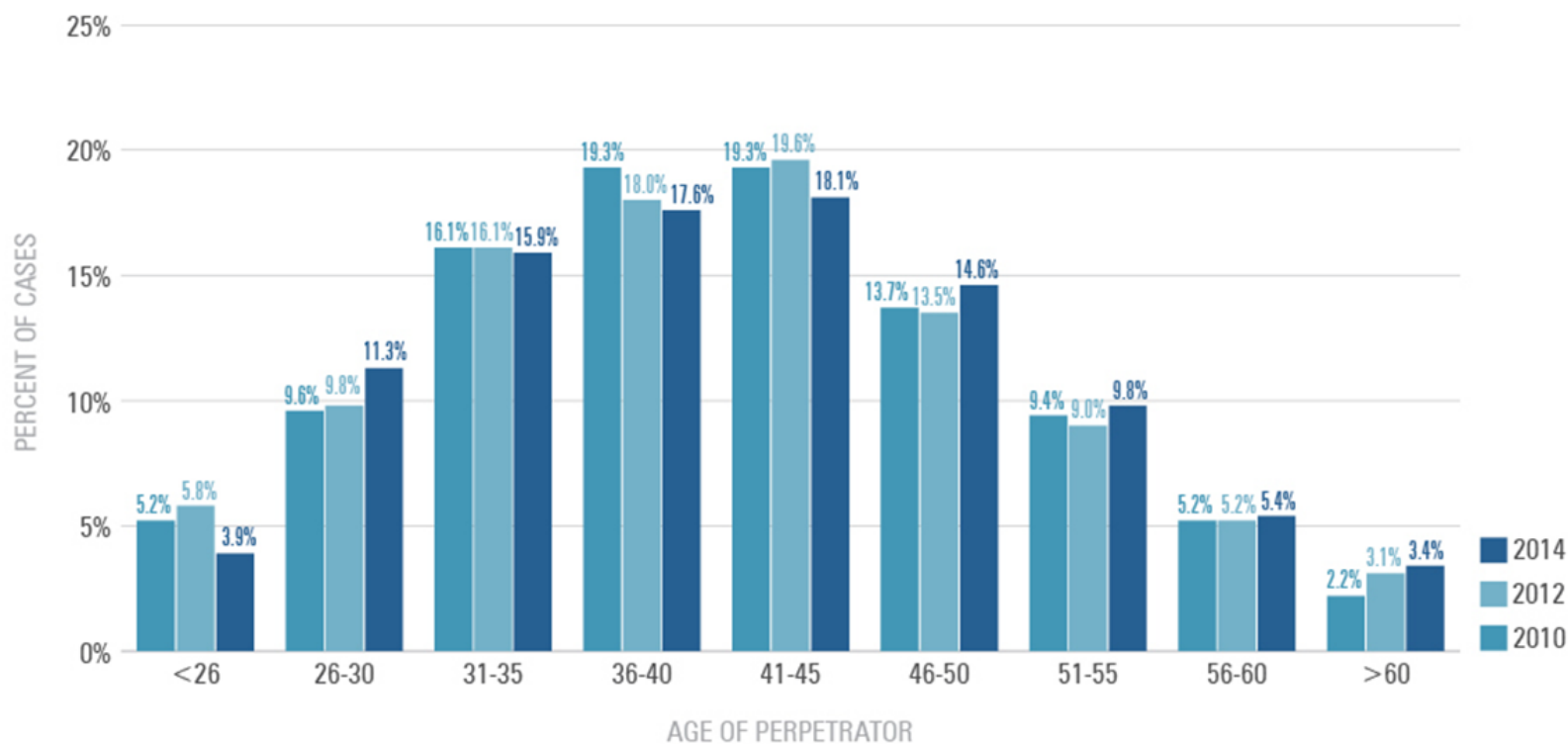
Who commits Fraud?

Who commits Fraud?

- People outside the organization
- People in positions of responsibility with the ability to override controls
- Often trusted and respected employees
- People with an understanding of the system and processes
 - “Inside Jobs” are easier

Who commits Fraud?

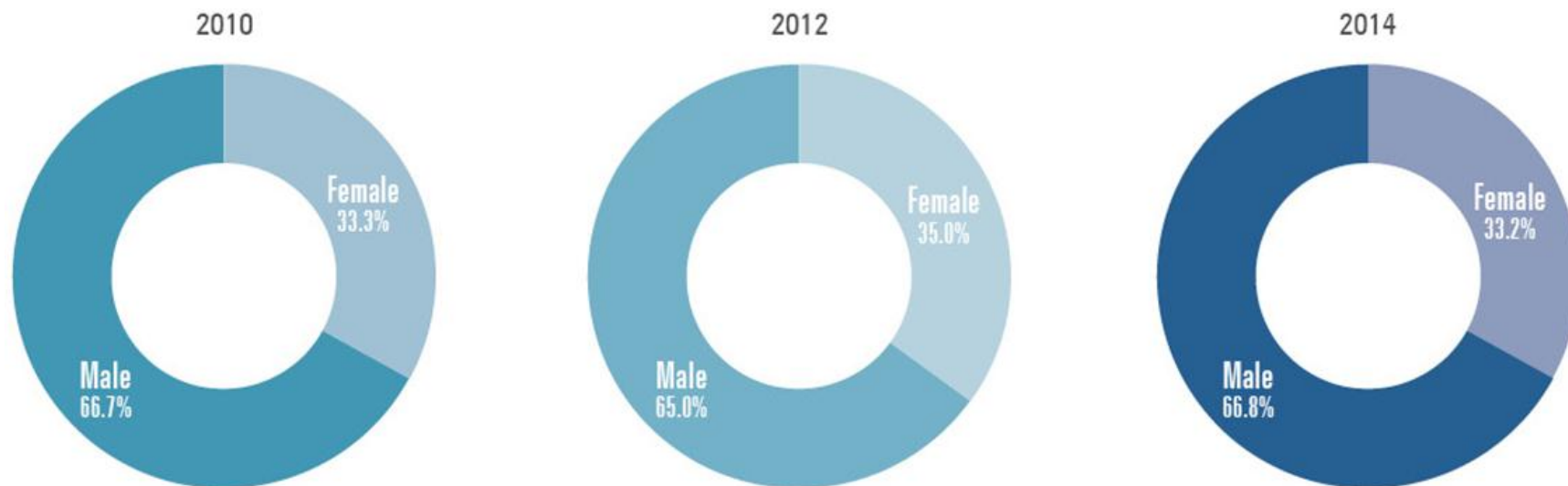
Age of Perpetrator - Frequency



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Who commits Fraud?

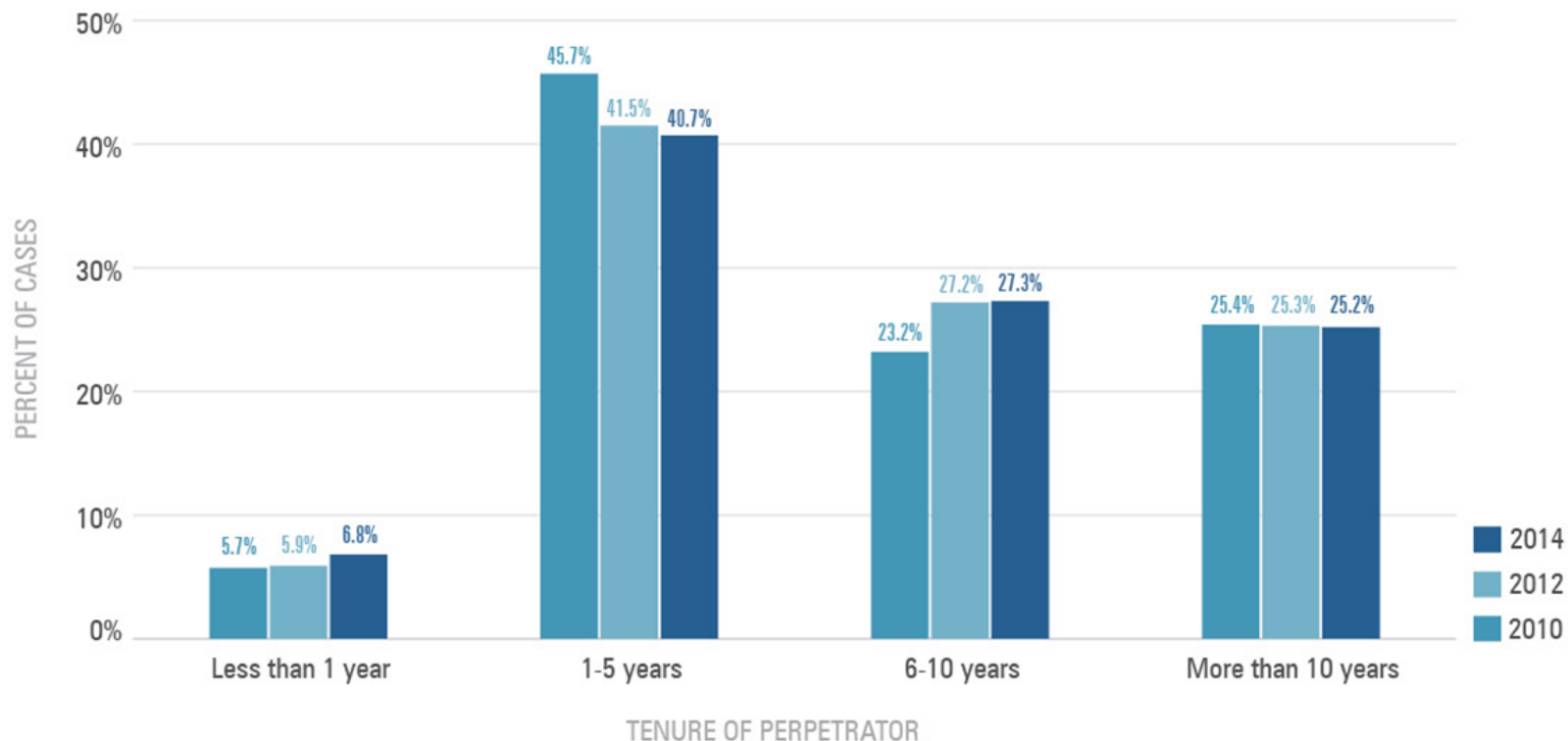
Gender of Perpetrator - Frequency



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Who commits Fraud?

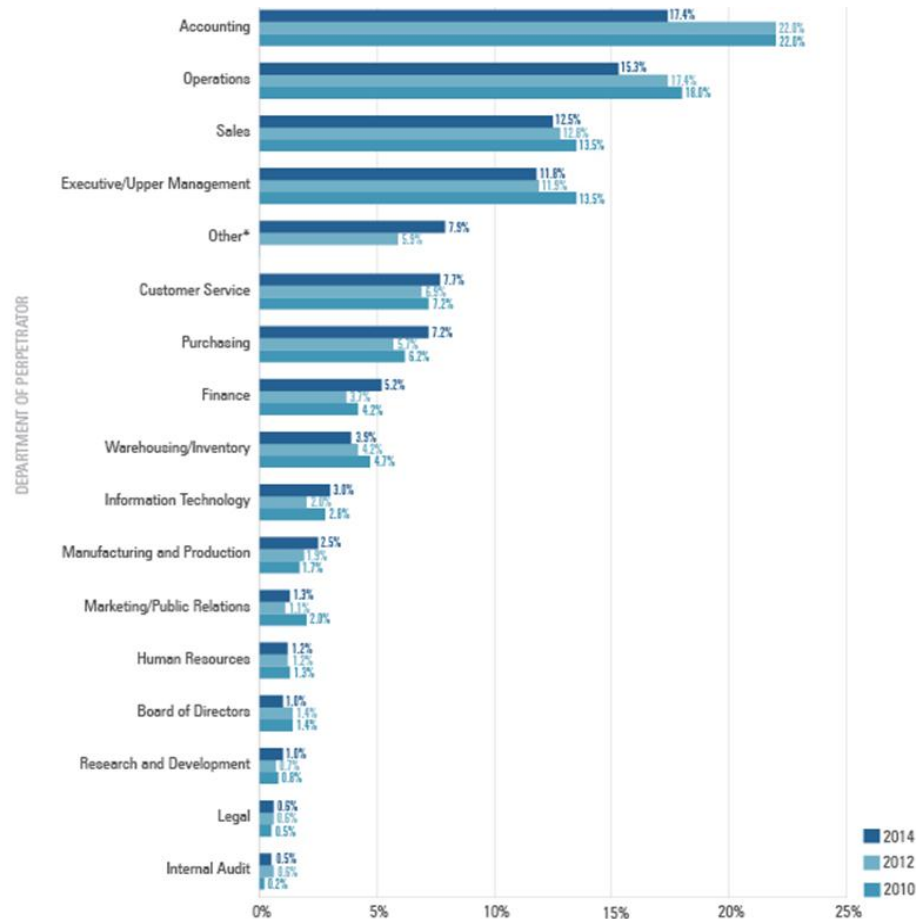
Tenure of Perpetrator - Frequency



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Who commits Fraud?

Department of Perpetuator - Frequency



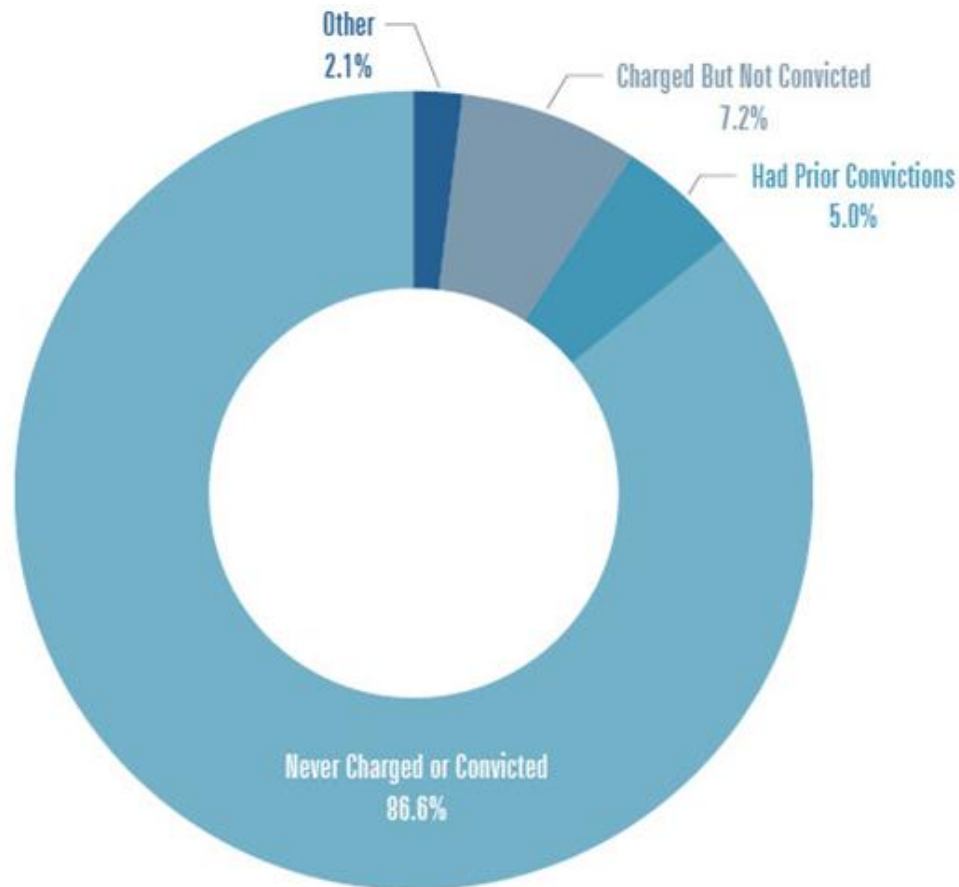
*"Other" category was not included in the 2010 Report.

PERCENT OF CASES

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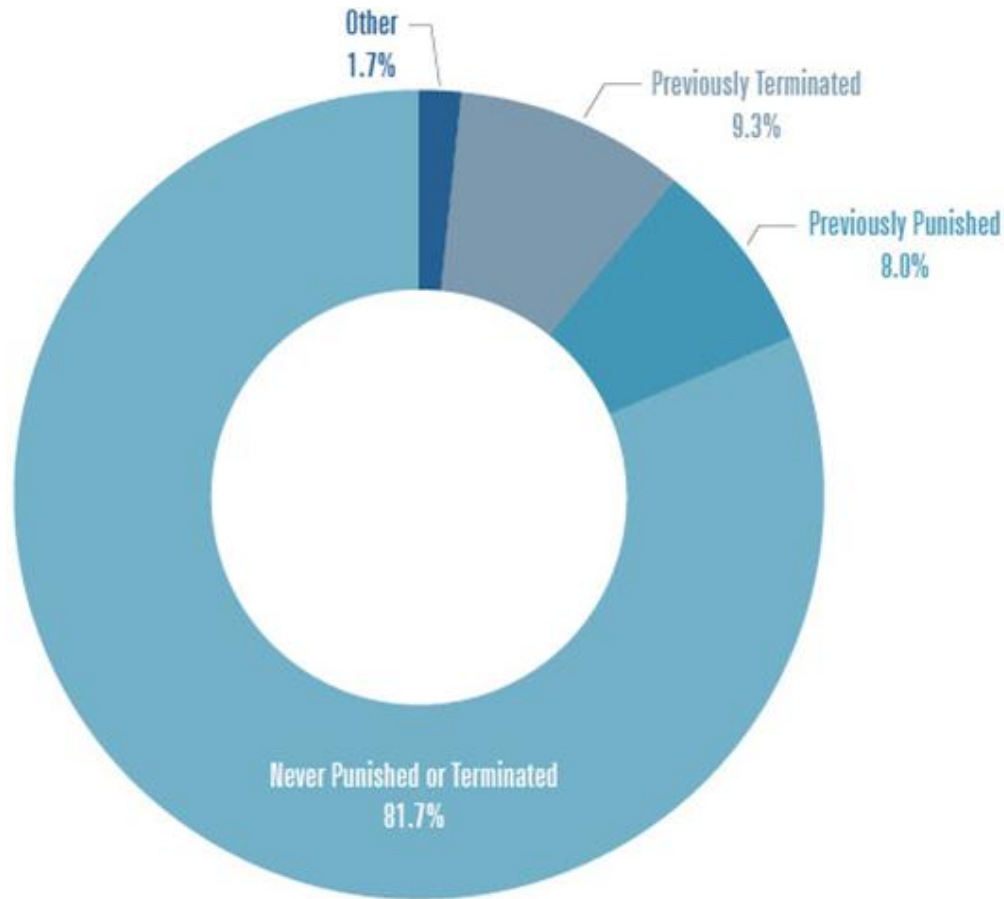
Who commits Fraud?

Criminal Background of Perpetrator



Who commits Fraud?

Employment Background of Perpetrator



Who commits Fraud?

Example: Florida State University's Seminole Boosters

Earlier this month Sanford Lovingood, the longtime comptroller for the Seminole Boosters, admitted that he stole between \$500,000 and \$700,000 from the FSU athletic booster club.

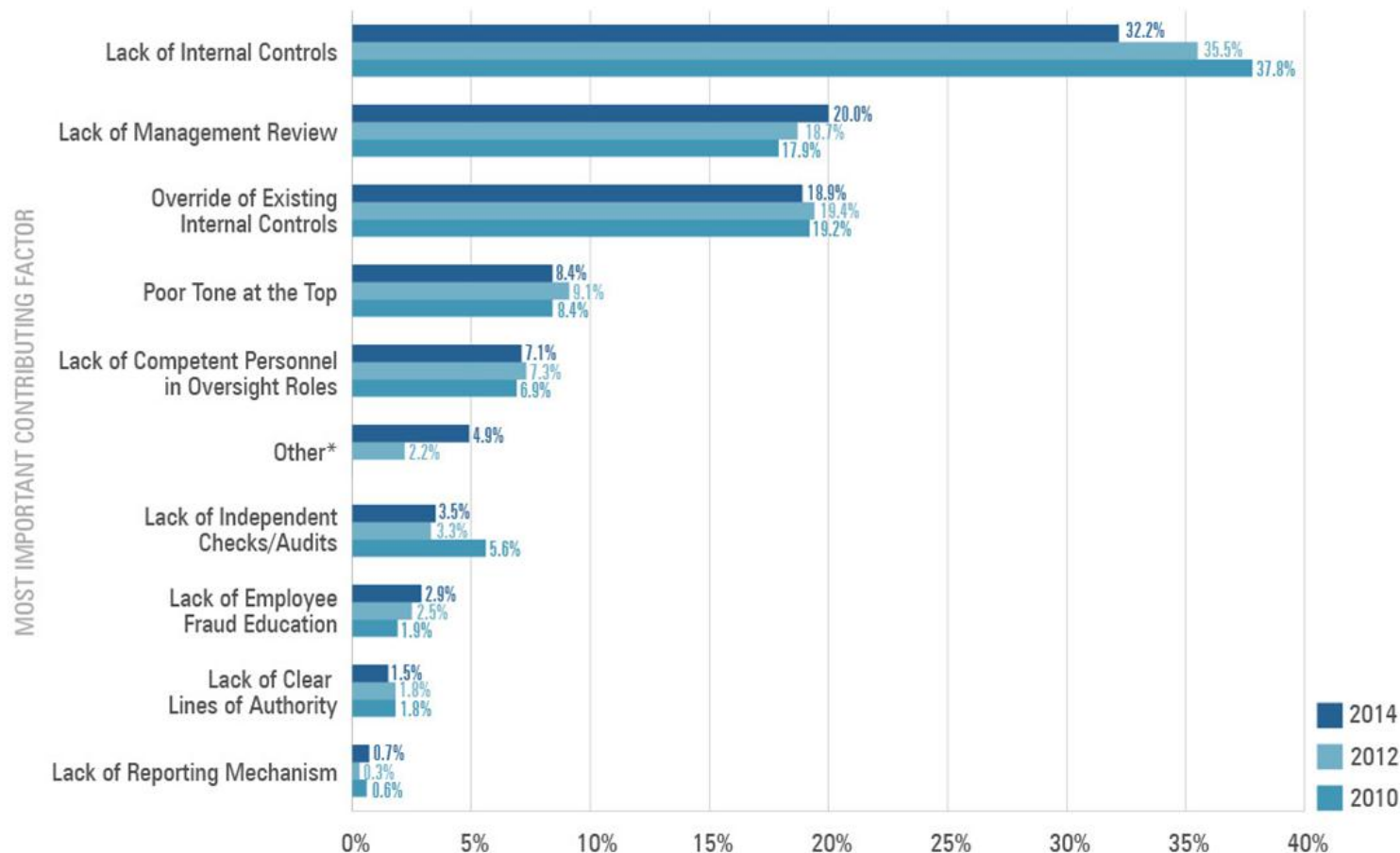
- Mr. Lovingood wrote checks from an investment account to a development company, where he was listed as an officer
- The fraud was discovered when another officer of the development company contacted the booster club and informed them of the theft
- Mr. Lovingood told investigators that he planned to repay the money by willing property that he owned back to the Boosters upon his death

What You Need To Know As A Non-profit Organization

What can you do at an organizational level?

What can you do at an organizational level?

Primary Internal Control Weaknesses Observed



*"Other" category was not included in the 2010 Report.

What can you do at an organizational level?

Financial and Non-Financial Systems and Controls

Management should implement both financial and non-financial systems and controls to detect and prevent fraud.

The financial controls that management can implement include:

- Reconcile accounts – reconcile bank accounts as well as fundraising assets such as raffle tickets and cash receipts
- Perform ratio analysis – compare number of donors with contributions, compare number of employees with payroll expense.
- Review all general ledger adjustments
- Institute job rotation and mandatory vacations
- Conduct surprise audits

What can you do at an organizational level?

Financial and Non-Financial Systems and Controls (continued)

The organization should consider using the following non-financial controls, among others:

- Pre-screen potential employees
- Communicate often with current employees so you will know when they are feeling pressured
- Communicate the consequences of committing fraud
- Set a good example by following the rules
- Provide an anonymous fraud hotline for employees
- Conduct anti-fraud training for managers and employees
- Implement an anti-fraud policy

What can you do at an organizational level?

Hi-Risk Operational Process Areas

Some of the processes that may exist in your organization and should warrant additional controls and scrutiny because of the relative risk for fraud include:

- Expense Reimbursement
- Accounts Payable
- Payroll
- Bank Accounts
- Use of Grant Money
- Procurement
- Asset Management
- Fleet Management
- Fuel Cards

What can you do at an organizational level?

Setting the Tone at the Top

- Management, including directors and officers, needs to “set the tone at the top” for ethical behavior in an organization
- Management must show employees through its words and actions that dishonest or unethical behavior will not be tolerated, even if the result of the action benefits the organization
- Additionally, it should be evident that all employees will be treated equally, regardless of their position

What can you do at an organizational level?

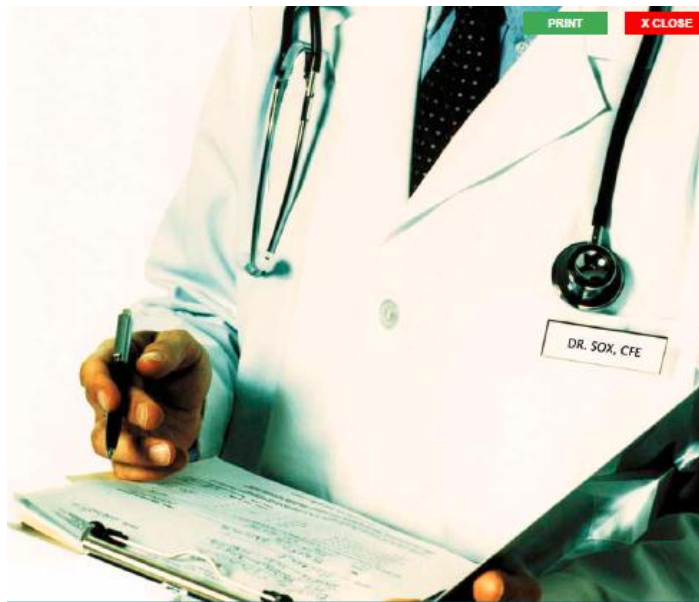
Assessing Fraud Risks and Responses

Organizations should be proactive in reducing fraud opportunities by:

- Identifying and measuring fraud risks
- Taking steps to mitigate identified risks
- Implementing and monitoring appropriate preventative and detective internal controls and other deterrent measures

What can you do at an organizational level?

ACFE – Fraud Prevention Check-Up



ACFE FRAUD PREVENTION **CHECK-UP**



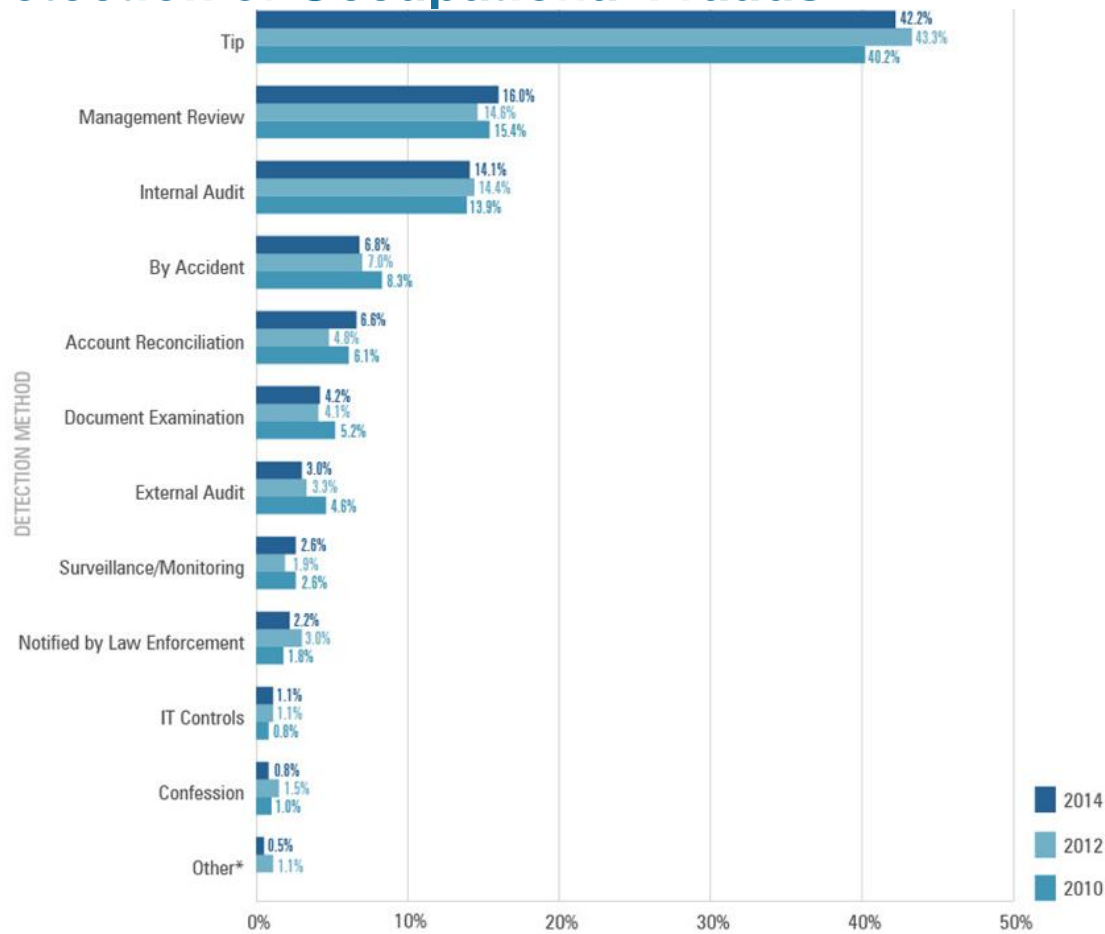
Together, Reducing
Fraud Worldwide

A self-assessment checklist is offered by the ACFE to help organizations evaluate how they address the risks that could lead to fraud.

The Fraud Prevention Check-Up is available on the ACFE website, or if you email us, we will send it to you.

What can you do at an organizational level?

Initial Detection of Occupational Frauds



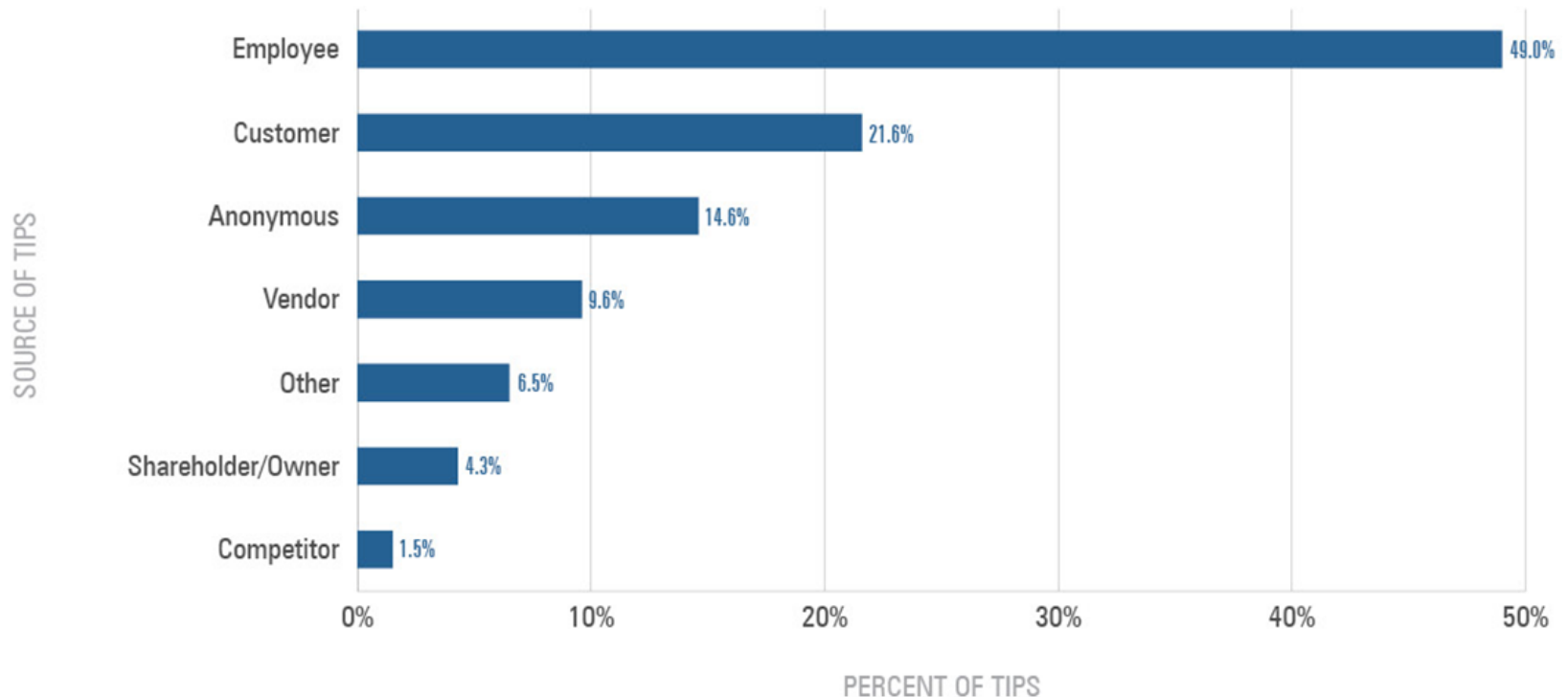
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PERCENT OF CASES

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What can you do at an organizational level?

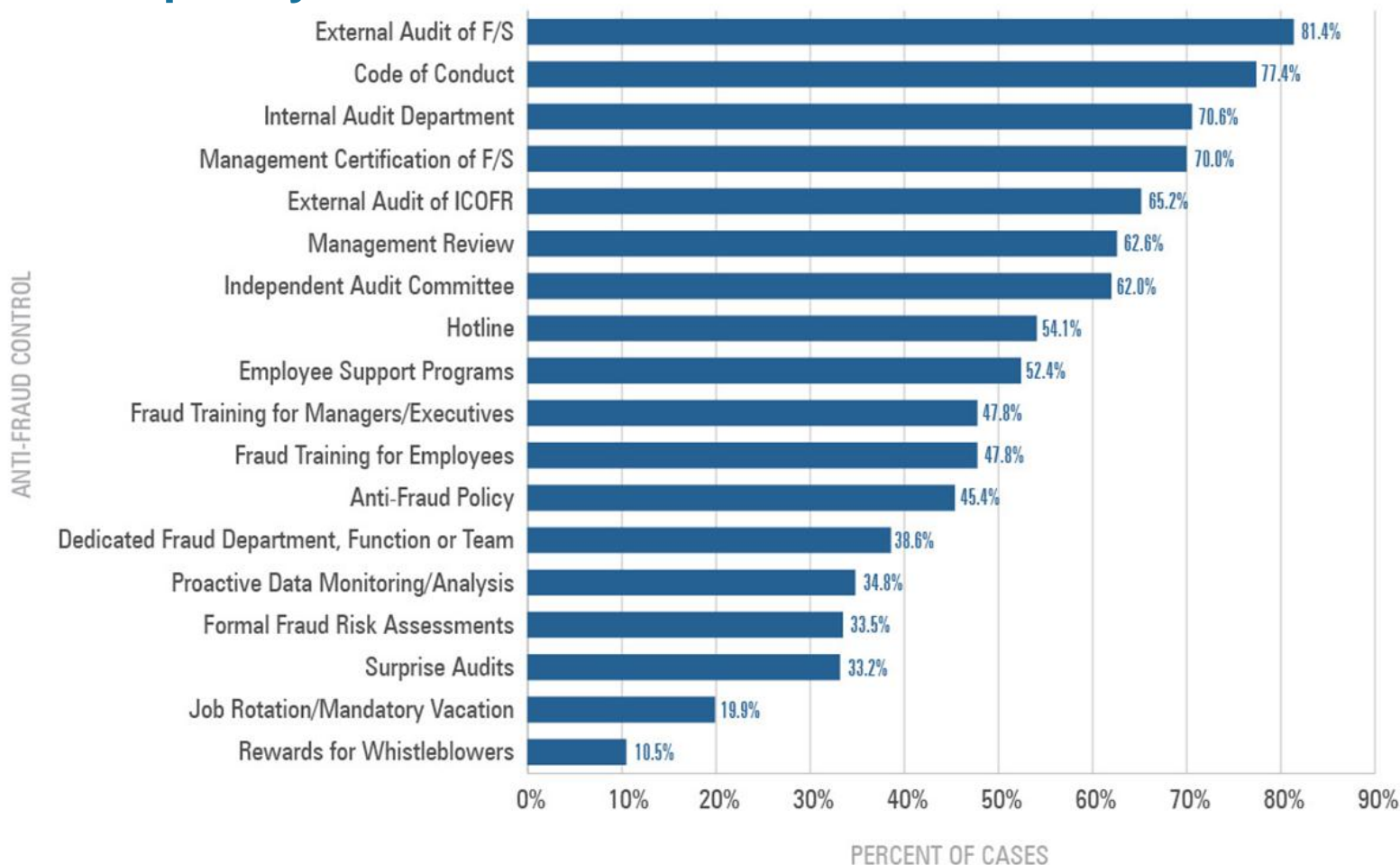
Source of Tips



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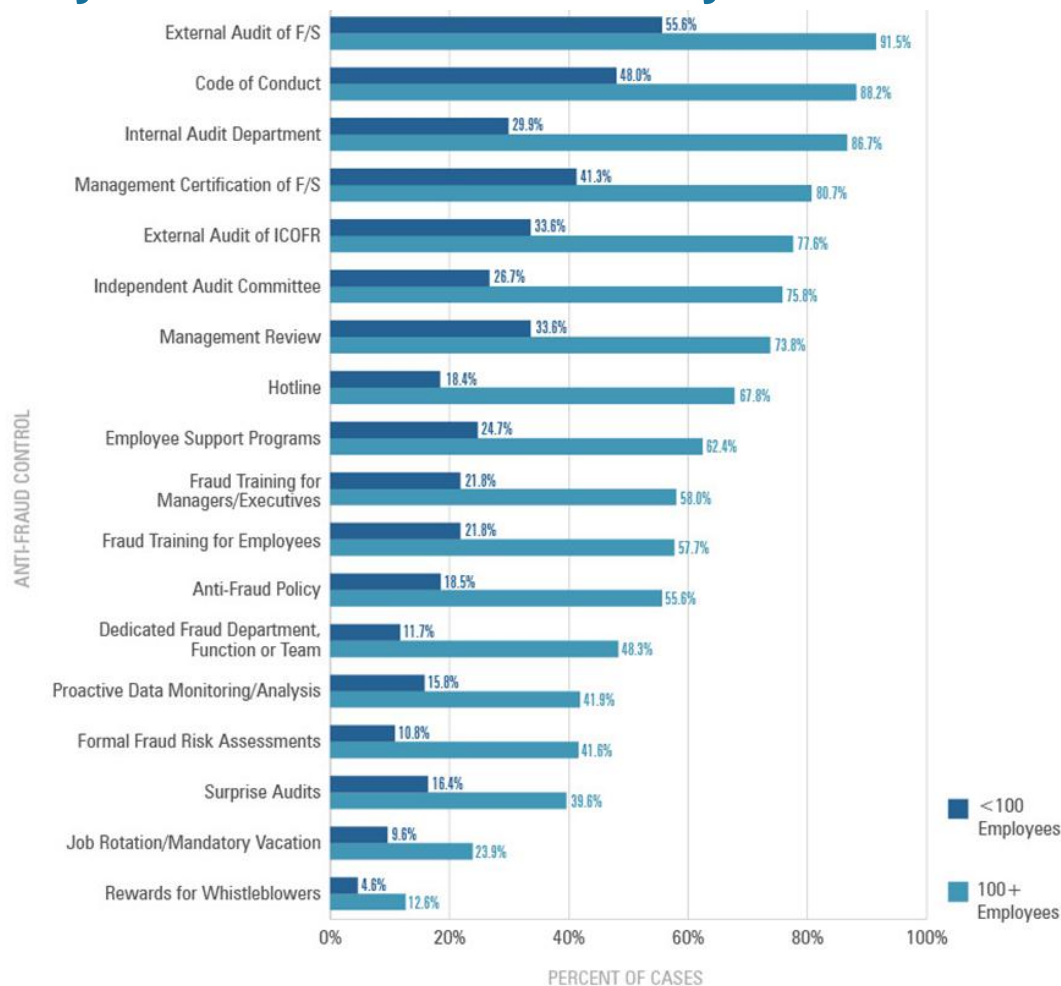
What can you do at an organizational level?

Frequency of Anti-Fraud Controls



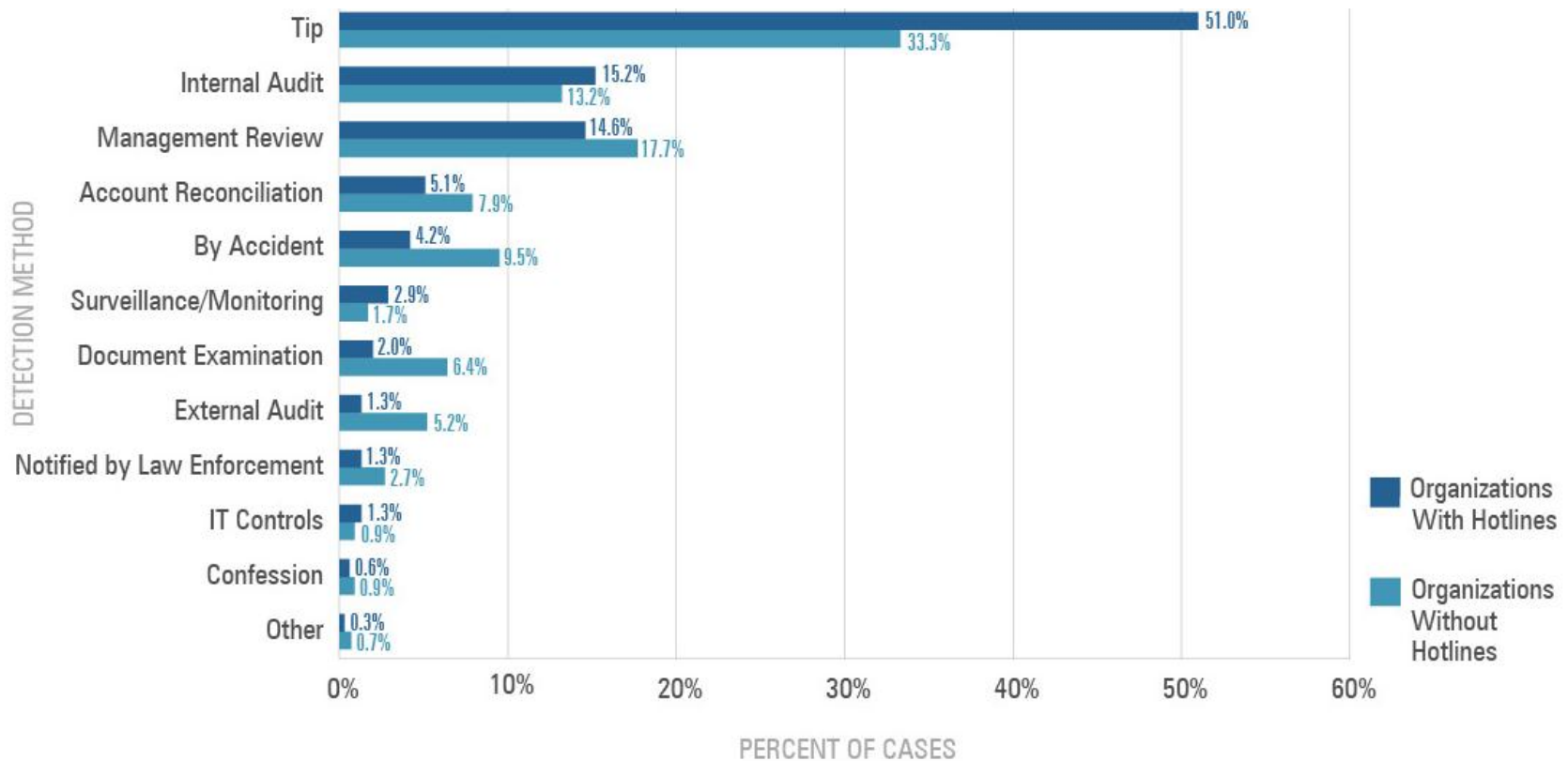
What can you do at an organizational level?

Frequency of Anti-Fraud Controls by Size of Victim Organization



What can you do at an organizational level?

Impact of Fraud Hotlines



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What can you do at an organizational level?

Example: James B. Sanderlin Neighborhood Family Center

In March of this year, Kimberly Sue Ross was sentenced to six years in prison for embezzling \$200,000 from the James B. Sanderlin Neighborhood Family Center, which provides services to low income families in St. Petersburg, FL.

- Ms. Ross worked at the center as a program manager responsible for handling the budget, paying the bills and supervising administration
- She wrote 232 fraudulent checks totaling \$200,337 in four years
- Ms. Ross monitored the account balances, wrote checks sequentially with the same dollar amount and even wrote checks directly payable to Progress Energy for her electric bill

What You Need To Know As A Nonprofit Organization

- **Wrap-Up**



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