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Fraud Considerations for Nonprofits

Is Your Nonprofit Ripe for Fraud?

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SC CPA's Spring Splash Accounting Conference
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North Charleston Marriott

Agenda

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- Understanding what fraud is and why businesses are a target of fraud
- Explaining the vulnerabilities of nonprofits
- Appreciating the profile of a fraudster
- Awareness of fraud prevention measures
- Identifying what to do when you suspect a fraud has occurred

The Business of Nonprofits

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- **For-profit world**
  - Make money for its owners; bottom line net profit
- **Non-profit world**
  - In the business of doing good
  - Carry out programs designed to accomplish a mission; inherently non-financial
  - True financial measure, ratio of program expenses to total expenses (or to total income)

Fraud and Business

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- Takes money or property, or uses them in an Illicit manner, intent to gain a benefit from it
- Decisions and actions by individuals
- Trust in employees is necessary; also raises the risk of fraud

Fraud Risks

- Operational
- Financial
- Human – it’s a people problem and not always a solo act

Intent and Fraud

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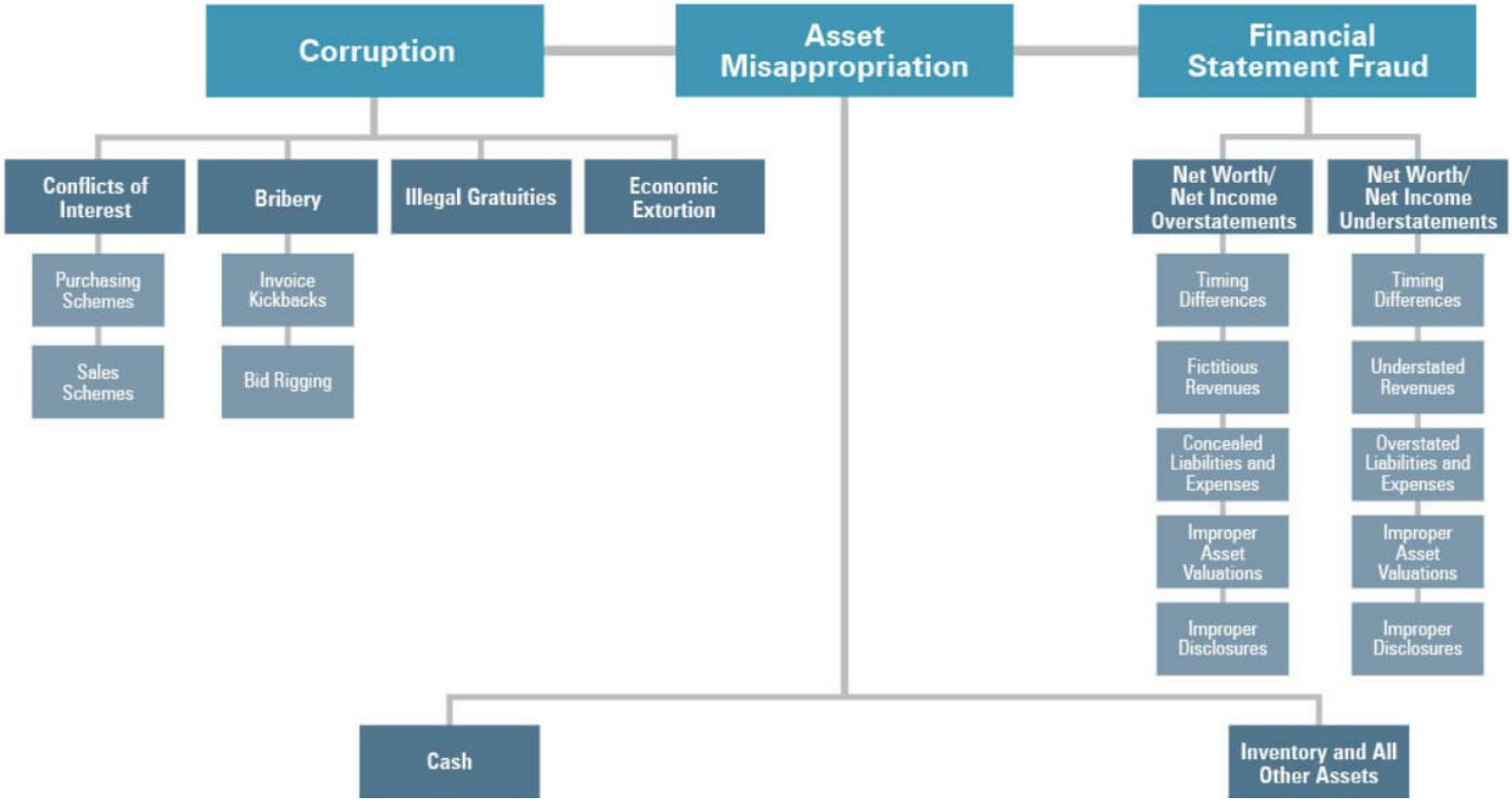
- **People, not organizations are behind financial reporting fraud**
- **Question of intent comes into play**
  - Determine if intent to defraud is present
  - Turning a blind eye can be even more damaging than actual deception
- **Nonprofits are also the victims of fraud**

The Fraud Tree - Occupational Fraud and Classifications



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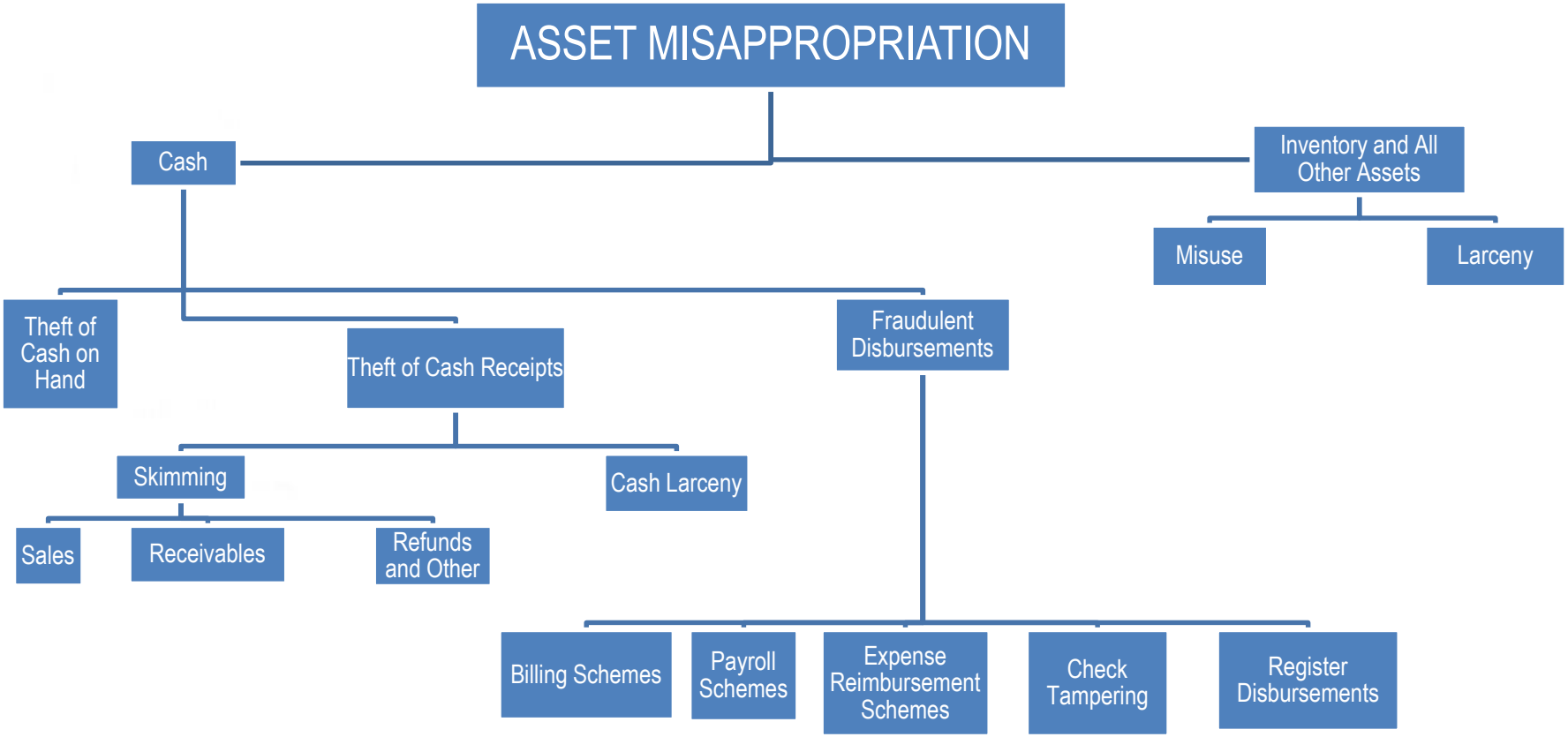
Asset Misappropriation



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The Fraud Triangle – The Why

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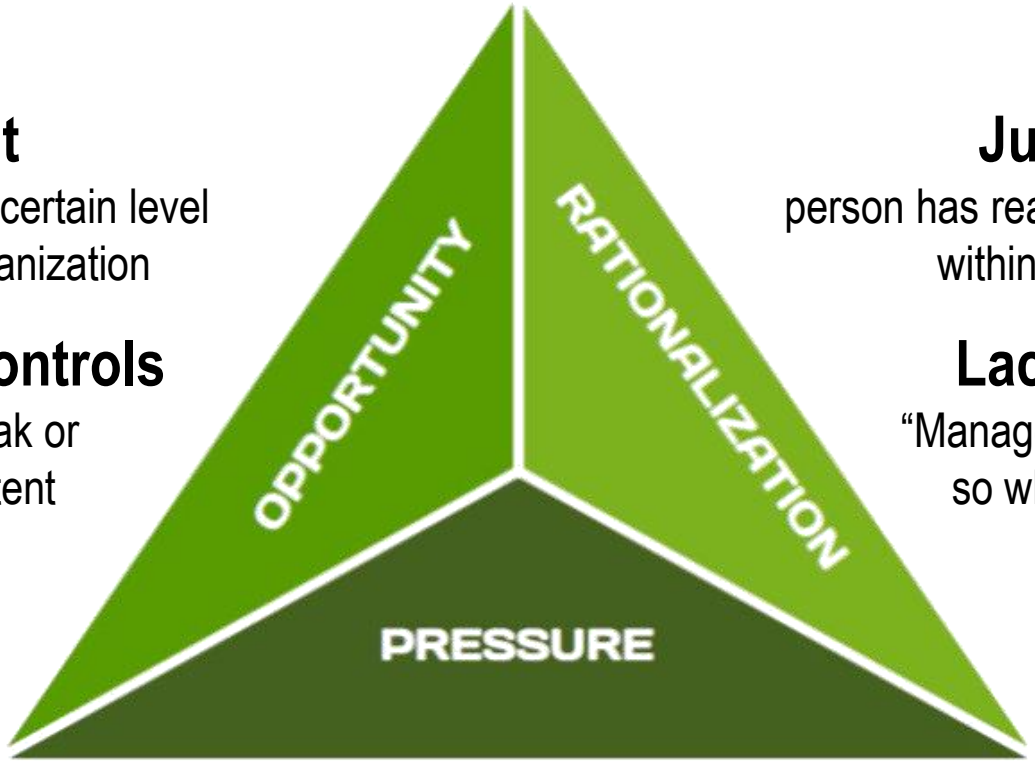
Trust
person has reached a certain level within the organization

Internal Controls
either weak or nonexistent



Justification
person has reached a certain level within the organization

Lack of Ethics
“Management isn’t honest, so why should I be?"

Financial major bills, high level of debt, or simple greed.

Work-related feeling overworked and underpaid

Personal gambling or other addiction

Internal Control

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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:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Procedures for Monitoring Internal Controls

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- **Examples of procedures for monitoring internal controls include:**
  - General organization level controls
    - Preparation of budget and financial statements
    - Budget to actual variance explanations
  - Information technology general controls
    - Controls for accessing, inputting and changing electronic data
    - Preserving electronic records, ensuring data compatibility and record retention policy
    - Securing competitive bids from vendors and approving contracts

Internal Control Monitoring (Cont)

- Segregation of duties
  - Checks and balances to hinder embezzlement
  - No single individual should be responsible
    - For writing and signing checks or vouchers
    - Receiving, recording, securing and depositing cash and other receipts
- Whistleblower
  - Establish confidential and anonymous mechanism to encourage employees to report inappropriate financial management
    - Procedure to handling employee complaints with no retaliation is permitted

Internal Control Monitoring (Cont)

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- Revenue
  - Properly record grants and contributions and monitor/comply with any restrictions
- Purchasing and Accounts Payable
  - No single individual request, authorize, verify and record expenditures
- Providing for regular oversight by an audit committee or, there is no audit committee, by the executive committee or by the board

Internal Control Monitoring (Cont)

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- Ensuring that timely and appropriate financial reports are distributed to all directors and officers and are reviewed by them, as well as organizational leadership
- Preparing for annual audit process in timely manner
- Developing a prudent investment strategy and providing proper oversight of the investment assets
- Complying with governmental and other reporting requirements
- Complying with obligations to members, employees and public, including their right to copy of organization's annual financial report

Opportunity to Rationalization

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TEMPTATION → GUILT → ENTITLEMENT

Nonprofit - Incentives and Fraud

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- Incentives to commit financial reporting fraud
  - Funding sources establish minimum program expense ratios as one criteria for awarding grants
  - Media ranks and compares nonprofits based on program expense ratios
  - Charity “watchdog” groups in the U.S. established minimum program expense ratio as one of the standards to evaluate charities

Nonprofit - Fraud Motivation

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- May or may not be a direct benefit
  - Gain a promotion
  - Increase in salary
  - Bonus if reported program expense ratio achieves established threshold
  - Pat on the back for job well done
  - Assurance of job security
  - Personal financial gain

Nonprofit - 5 Methods for Fraud

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1. Netting the results of special funding events and activities
2. Exaggerating the values of non-cash gifts received and made
3. Improperly reporting contributions raised on behalf of nonprofits
4. Misapplying the accounting rules – “joint” activities for programmatic and fundraising objectives
5. Misclassification of funding or management expenses as program expenses

Profile of a Fraudster

KPMG Profile of a Fraudster 2016

Nonprofit World (60 Cases)

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- **Religious, Charitable, or Social Services Industry**

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Nonprofits and Losses

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Owners or Execs. and Fraud

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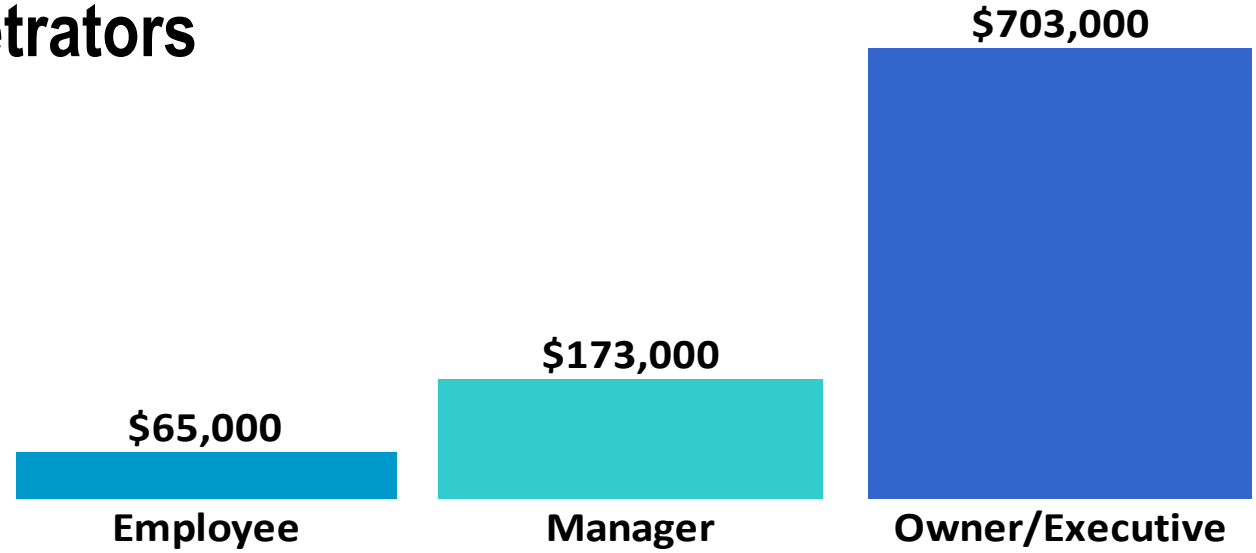
When Owners or Executives Committed Fraud, the Median Damage Was More Thank 10X Worse Than When Employees Were The Perpetrators



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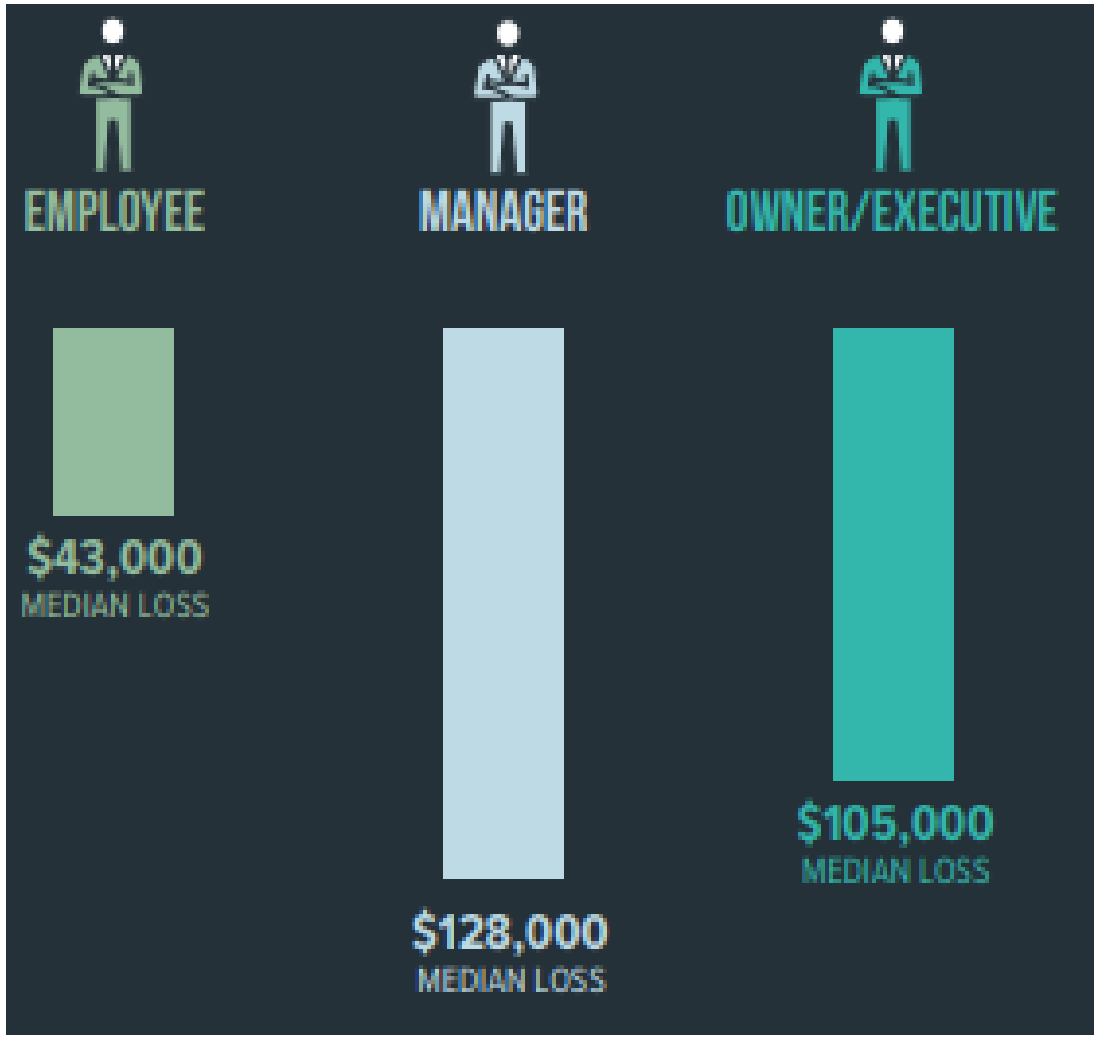
Nonprofits – Authority and Fraud



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Non-Profit CEO Arrested

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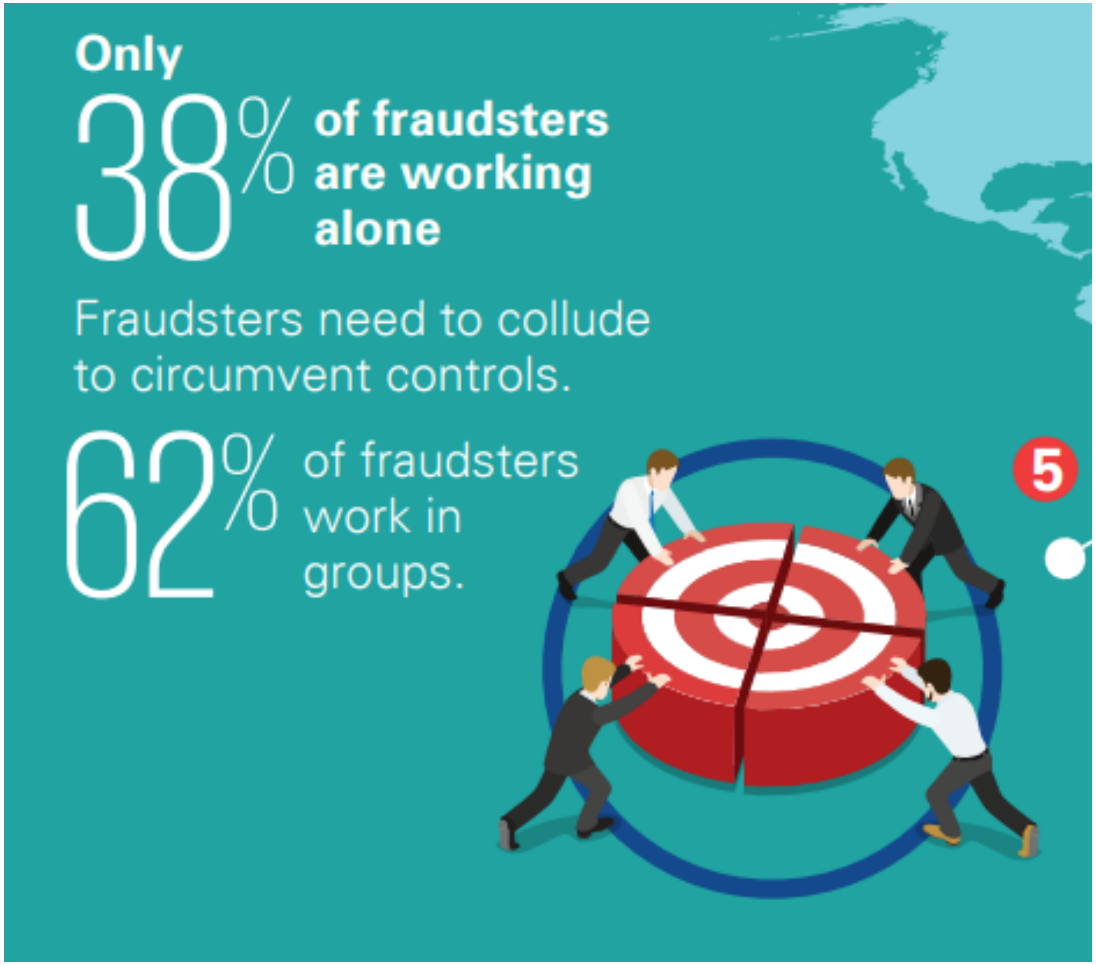
https://www.youtube.com/watch?v=bO4uRsyiO7Y

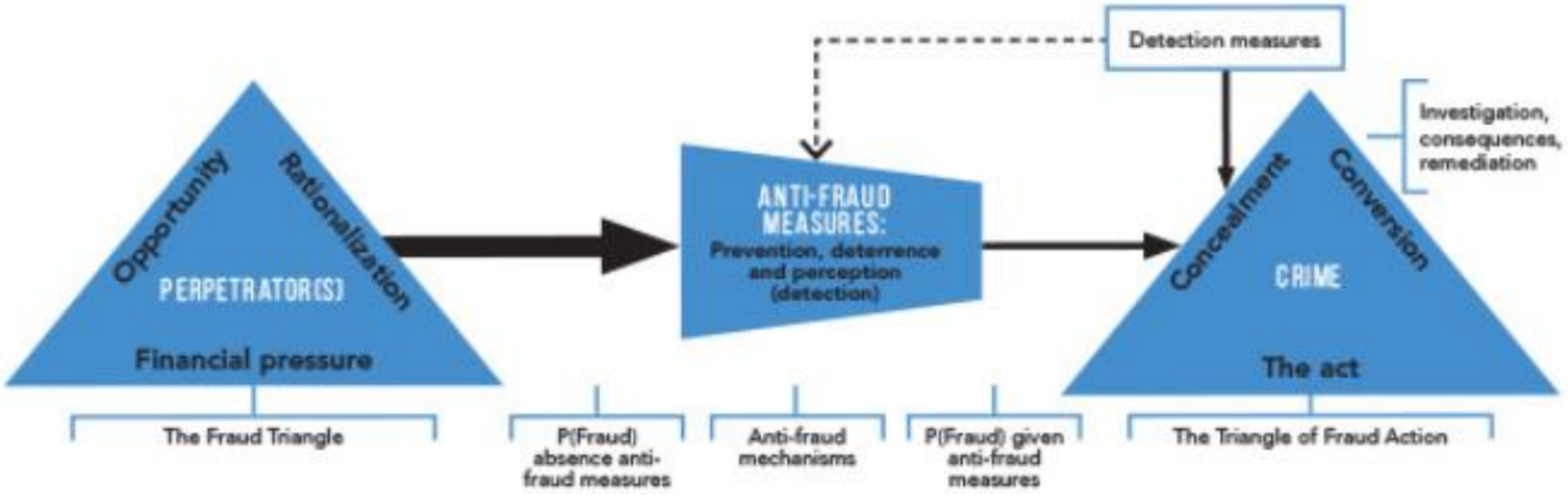
Working Alone v. Working Together



KPMG Profile of a Fraudster 2016

The Fraud Triangle – The How

Meta-Model of Fraud



Note: Anti-fraud controls in place: fraud losses 12% to 56% lower; and frauds detected 33% to 58% more quickly

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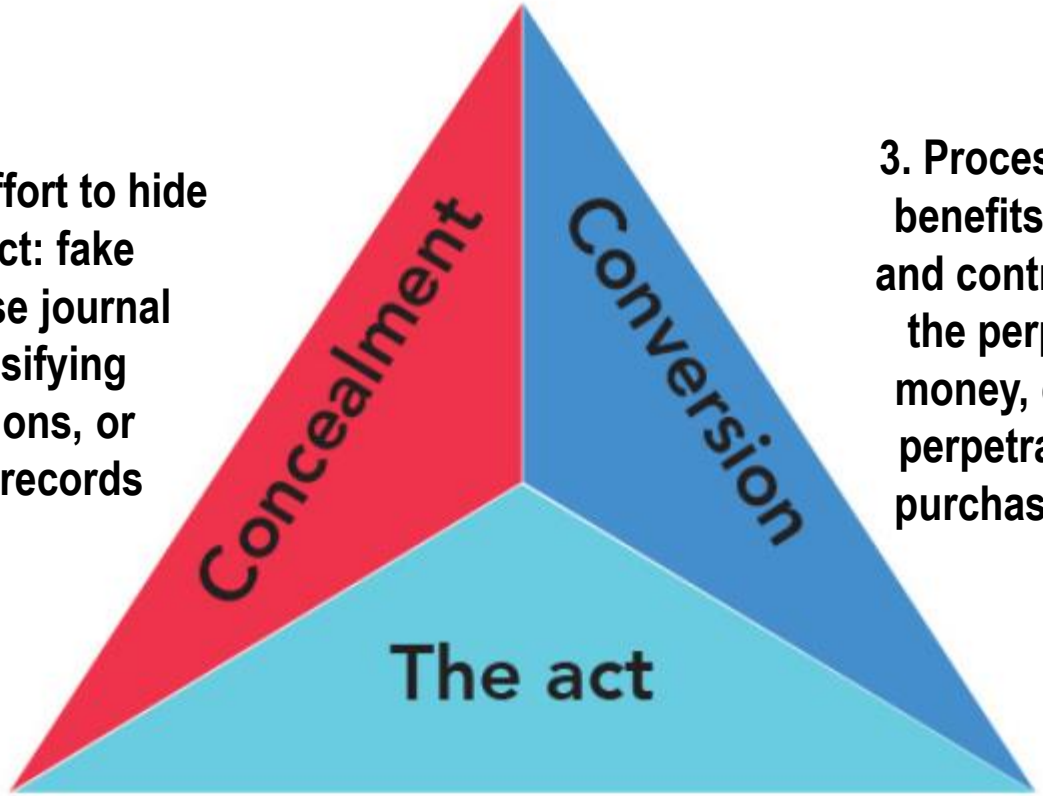
The 'Meta-model of fraud', Fraud Magazine vol. 33, no. 4, July/August 2018

Triangle of Fraud Action

2. Deliberate effort to hide the fraud act: fake invoices, false journal entries, falsifying reconciliations, or destroying records

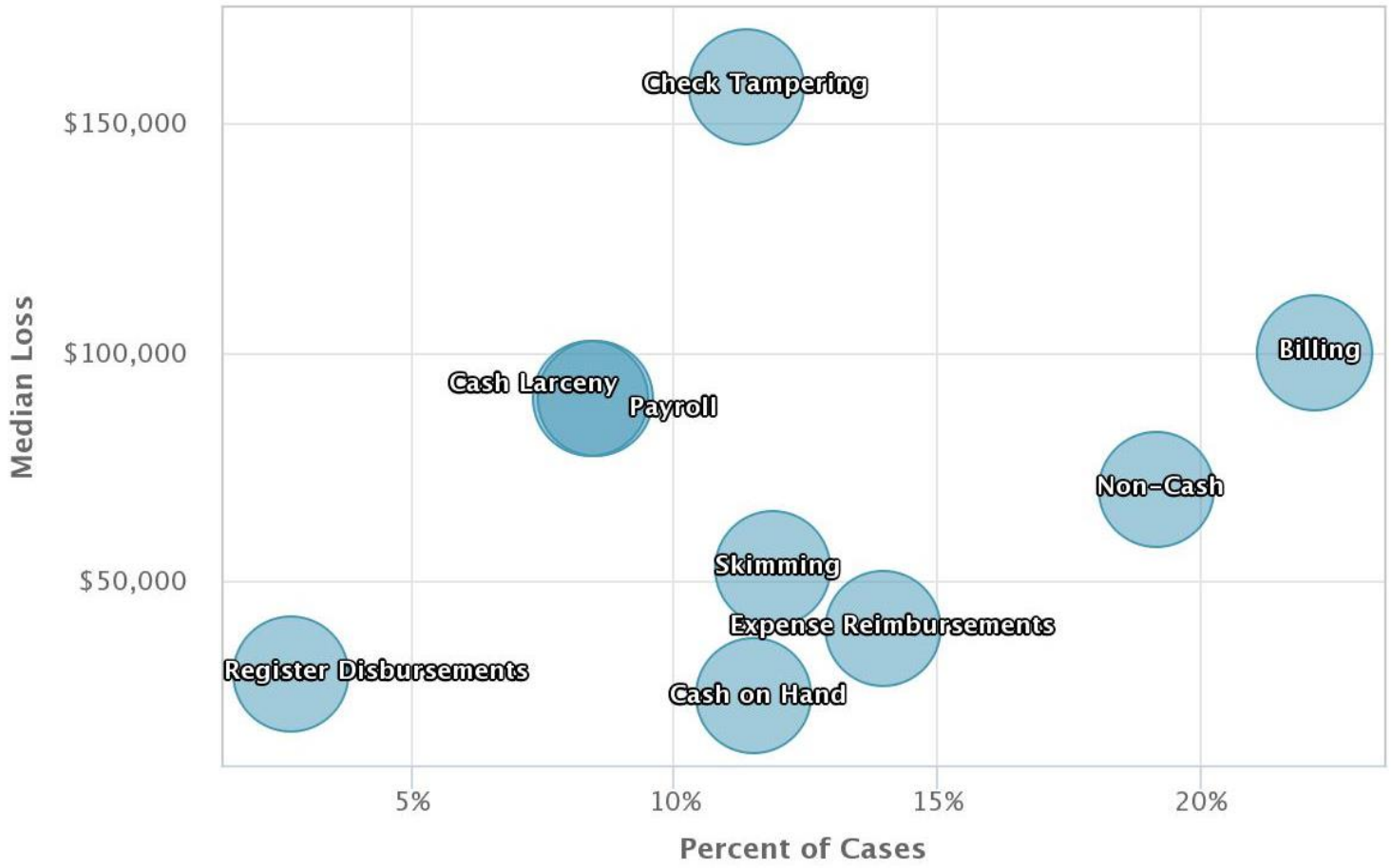


3. Process of transferring the benefits of asset ownership and control from the victim to the perpetrator: laundered money, cash deposited into perpetrator bank accounts; purchased personal cars or homes

1. Execution and methodology; asset misappropriation, corruption, financial statement fraud

The 'Meta-model of fraud', Fraud Magazine vol. 33, no. 4, July/August 2018

Frequency and Medial Loss of Asset Misappropriation Sub-Schemes



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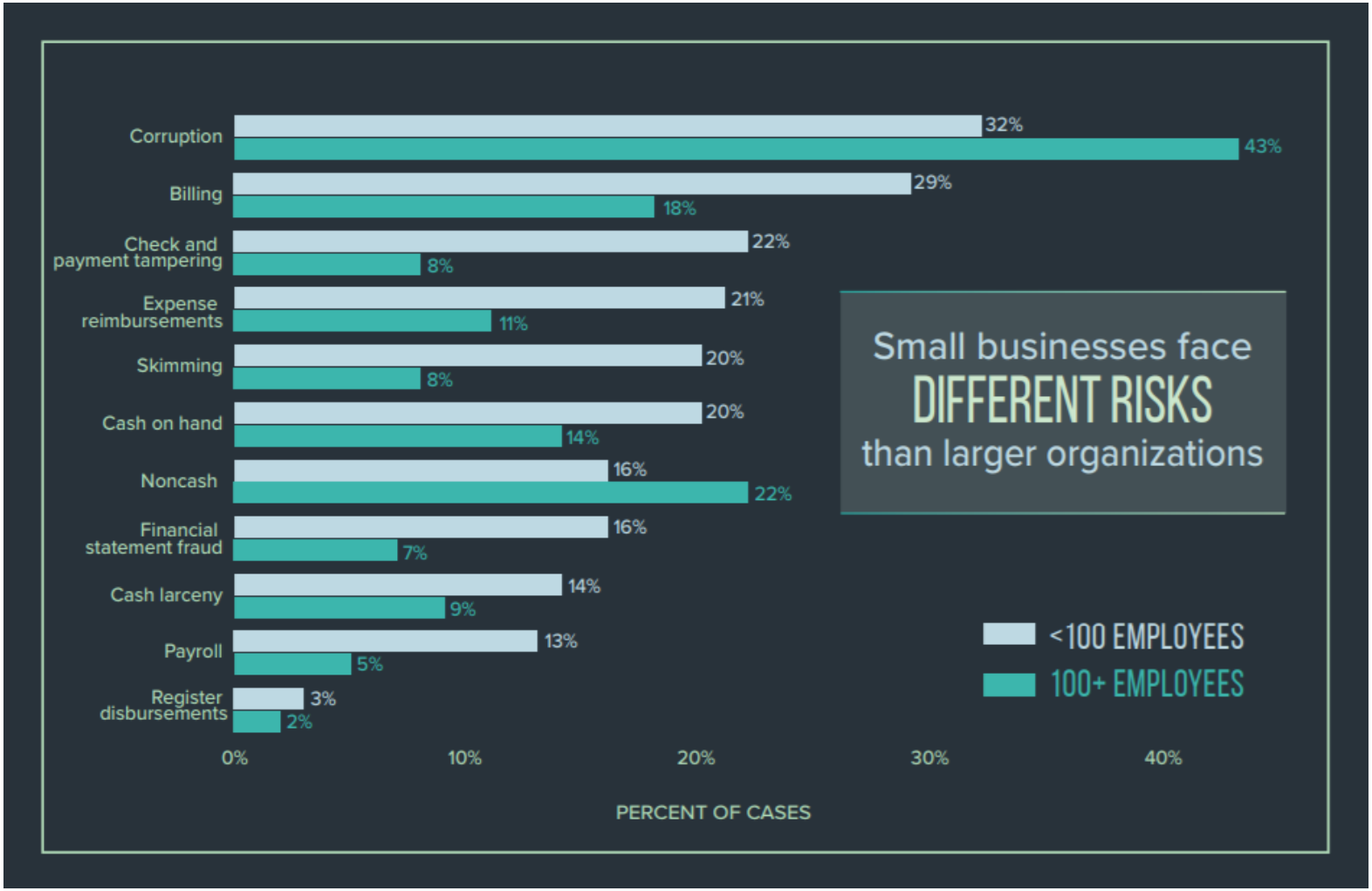
Types of Fraud Schemes



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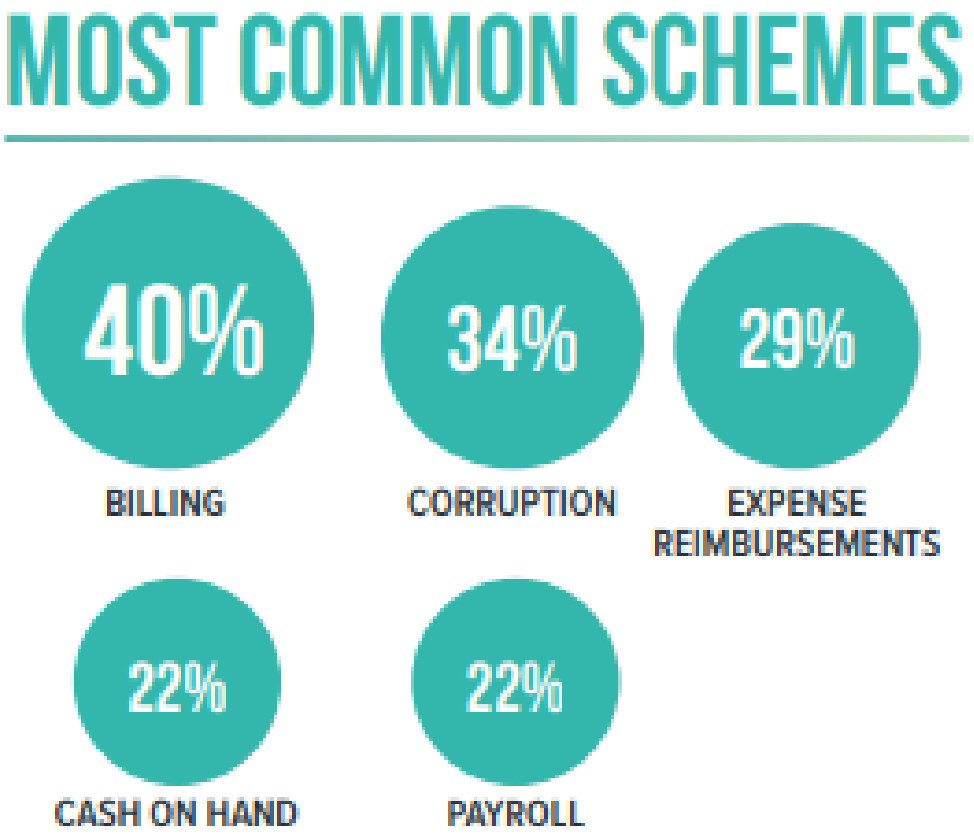
Nonprofits – Most Common Fraud Schemes



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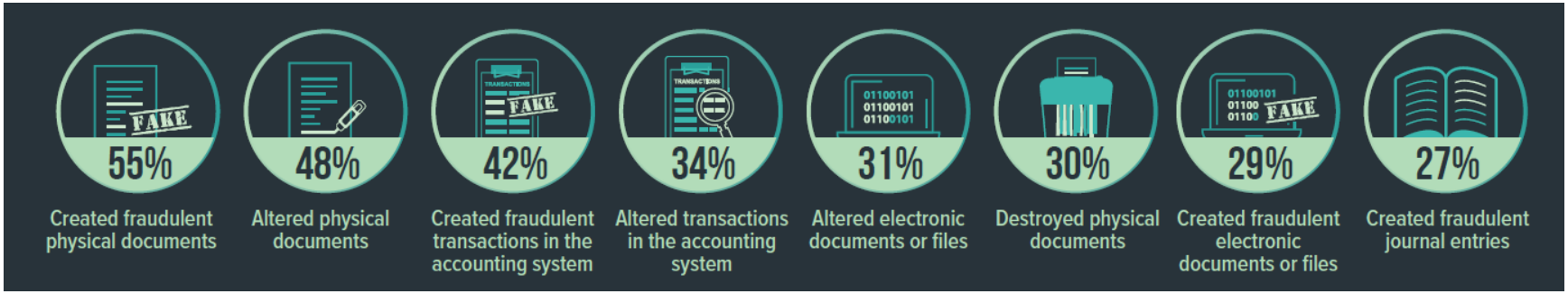
Concealment Methods



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Wounded Warriors

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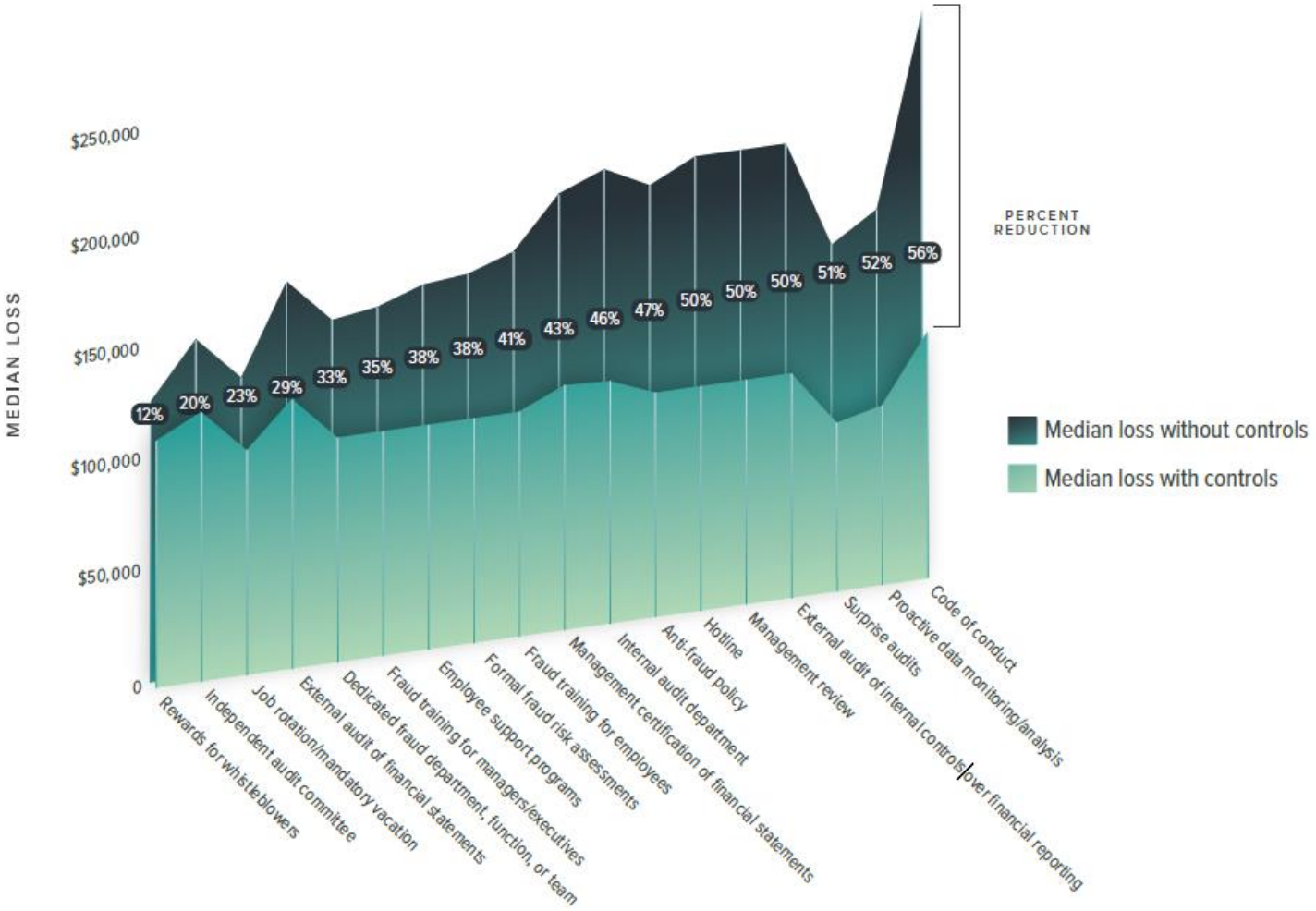
https://www.youtube.com/watch?v=mhbSC-xKQ5s

Strong Internal Controls Make a Difference

KPMG Profile of a Fraudster 2016

Internal Control Weaknesses that Contributed to Fraud



Nonprofits - Vulnerability

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- Small organization; wearing of too many hats
- Leaders passionate, no background in finance
- High employee turnover (low pay)
- Limited or ineffective controls in place
- Training is a luxury
- Volunteers privy to confidential information
- Volunteer Board; limited time, no financial oversight expertise

Nonprofit - Most Common Fraud Prevention Controls

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68%	EXTERNAL AUDIT OF FINANCIAL STATEMENTS
65%	CODE OF CONDUCT
51%	MANAGEMENT CERTIFICATION OF FINANCIAL STATEMENTS
49%	MANAGEMENT REVIEW
47%	EXTERNAL AUDIT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING
40%	HOTLINE
38%	INDEPENDENT AUDIT COMMITTEE
38%	INTERNAL AUDIT DEPARTMENT
35%	EMPLOYEE SUPPORT PROGRAMS
31%	FRAUD TRAINING FOR EMPLOYEES
30%	ANTI-FRAUD POLICY
29%	FRAUD TRAINING FOR MANAGERS/EXECUTIVES
21%	SURPRISE AUDITS
21%	PROACTIVE DATA MONITORING/ANALYSIS
19%	DEDICATED FRAUD DEPARTMENT, FUNCTION, OR TEAM
18%	FORMAL FRAUD RISK ASSESSMENTS
9%	JOB ROTATION/MANDATORY VACATION
4%	REWARDS FOR WHISTLEBLOWERS

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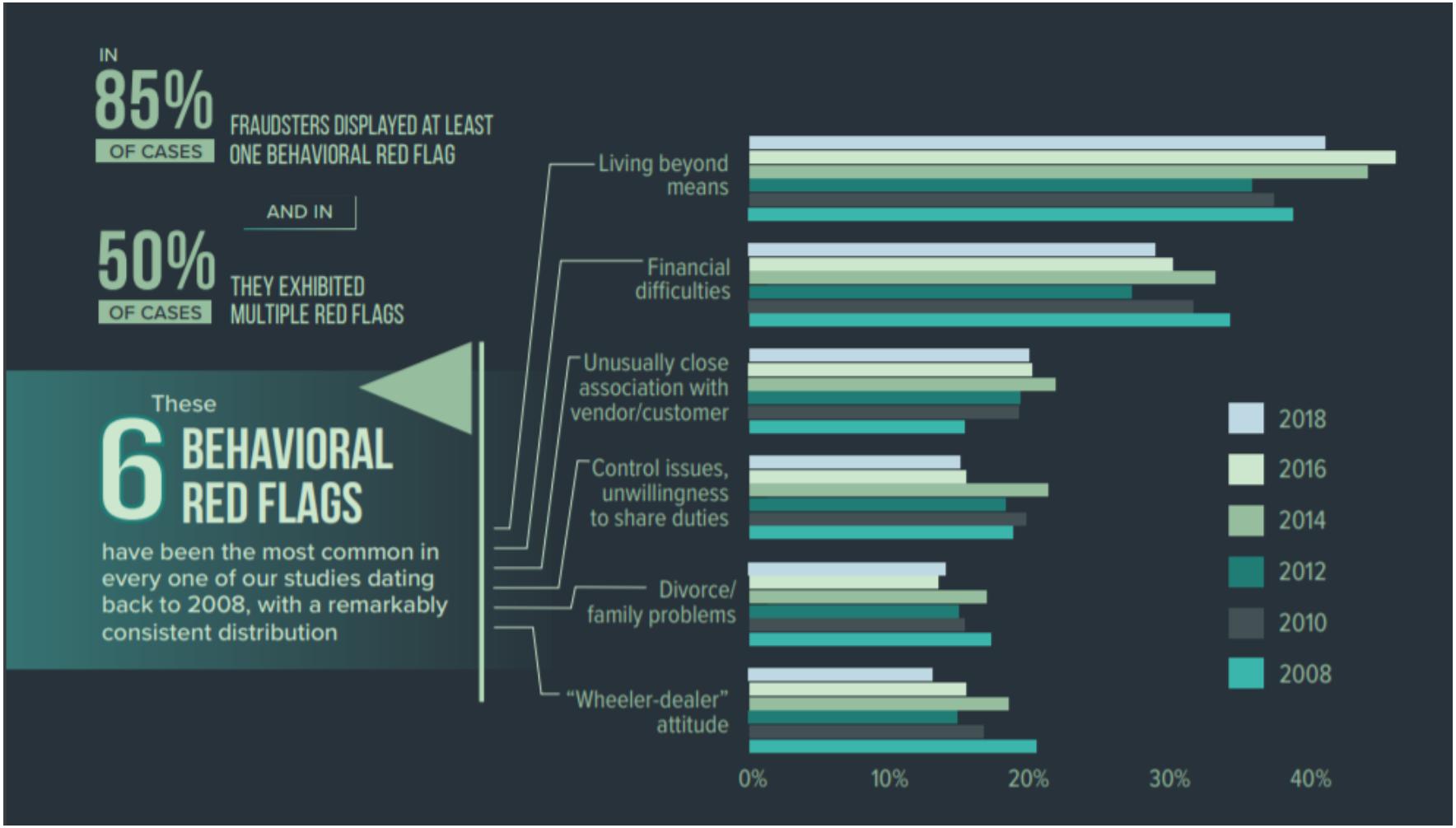
Red Flags of Fraud



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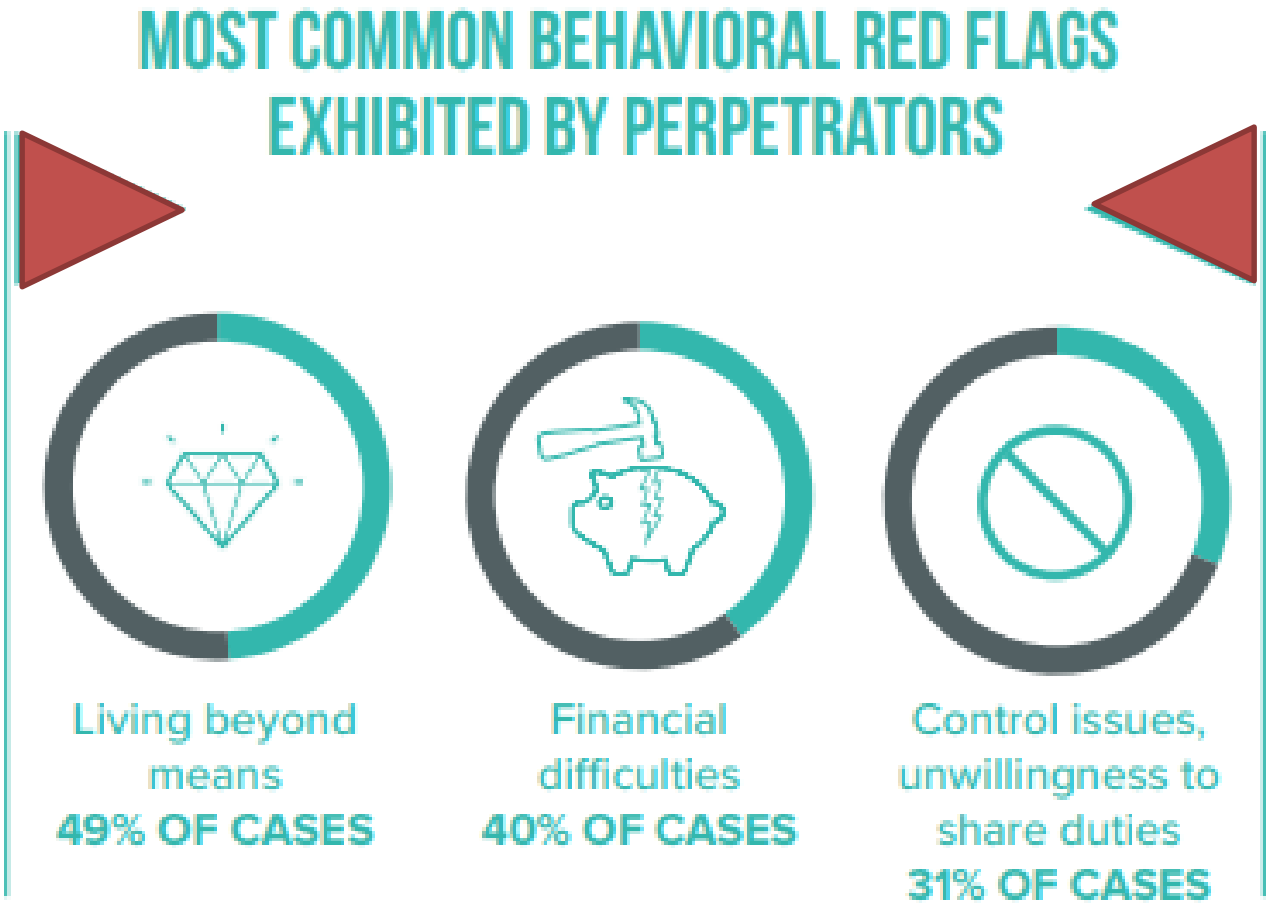
Nonprofits – Top 3 Red Flags



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Reporting Fraud – Tips and Hotlines

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Telephone hotline

42%

Email

26%

Web-based/ online form

23%

NOT ALL TIPS COME THROUGH HOTLINES

When a reporting mechanism is not used, whistleblowers are most likely to report to:

DIRECT SUPERVISOR **32%**

EXECUTIVE **15%**

FRAUD INVESTIGATION TEAM **13%**

COWORKER **12%**

INTERNAL AUDIT **10%**

CORRUPTION IS PARTICULARLY LIKELY TO BE DETECTED BY TIP

Corruption	Asset Misappropriation	Financial Statement Fraud
50% DETECTED BY TIP	38% DETECTED BY TIP	38% DETECTED BY TIP

Fraud losses were **50%** SMALLER at organizations **with hotlines** than **those without**

Organizations **without hotlines** were more than **TWICE AS LIKELY** to detect fraud by accident or by external audit

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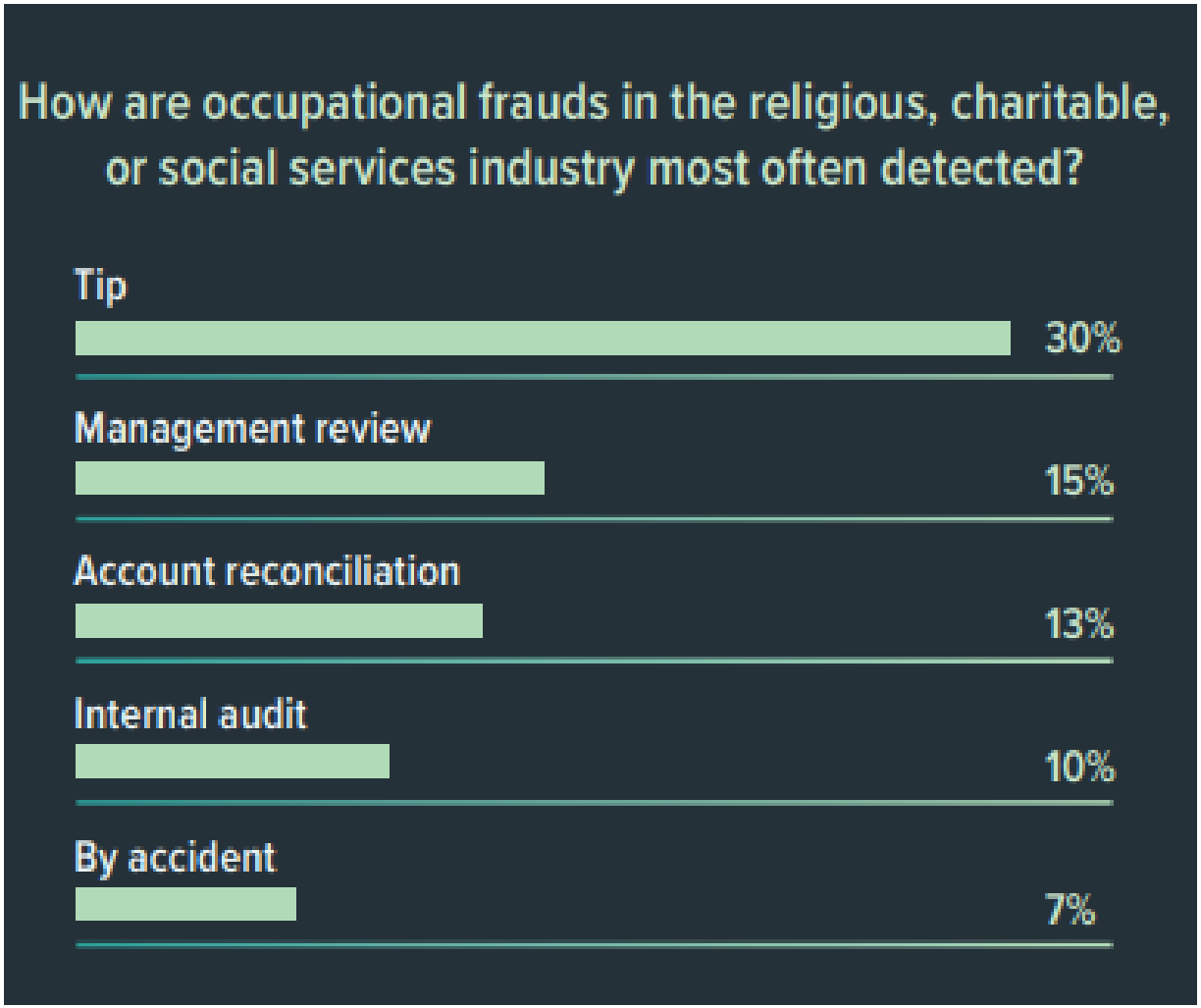
Nonprofits – Fraud Detection



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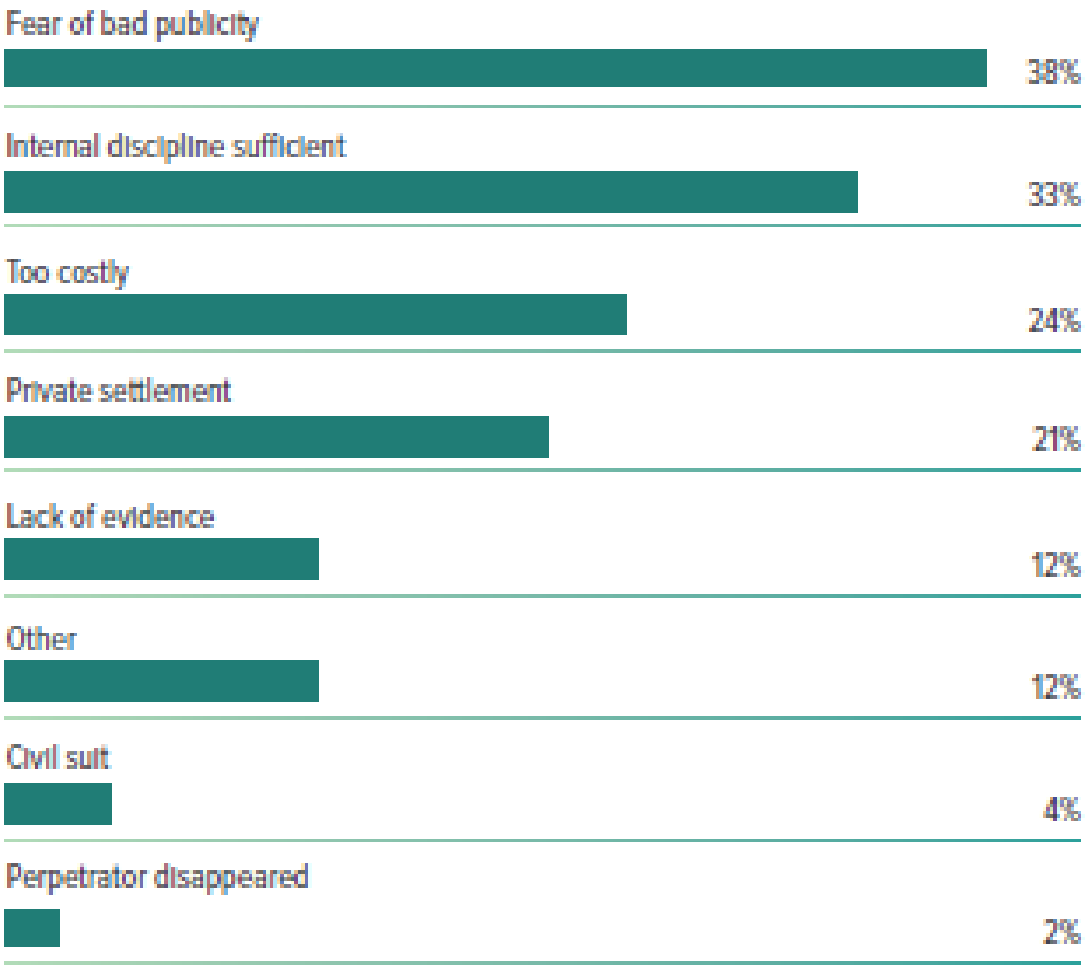
Why Cases Not Referred to Law Enforcement



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Ways to Help Prevent Fraud

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- Recognize pressures
- Reduce the opportunity
- Set an ethical tone at the top
- Encourage whistleblowers
- Develop an effective internal audit department
- Focus on long-term goals
- Ethics training for employees and executives

Suspect Fraud - 10 Things to Do

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1. Don’t panic
2. Do something
3. Be discreet
4. Save all paperwork related to crime
5. Lock down relevant data/systems
6. Consistent messaging to employees
7. Protect your reputation – internal, external
8. Set an example
9. Seek help from professionals
10. Make positive changes

Questions

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