



**<RETHINK>** *Fraud*

## Fraud Considerations in Nonprofit Organizations

*Presented by Aronson LLC Nonprofit Services Group*

 [www.aronsonllc.com/blogs/nonprofit](http://www.aronsonllc.com/blogs/nonprofit)

# Why are Nonprofits so Susceptible to Fraud?



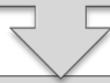
Fraud in the News



Fraud Overview



Antifraud Programs & Controls



Taking Action

# Why are Nonprofits so Susceptible to Fraud?

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- Organizations are built on public trust.
- It takes years to build a good reputation.
- FRAUD DESTROYS PUBLIC TRUST IN SECONDS!!

# The Numbers Are Staggering

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- **Association of Certified Fraud Examiner's 2014 Report to the Nations:**
  - The typical organization loses 5% of its revenues to fraud each year.
  - Asset misappropriation schemes made up 85% of reported cases.
  - Reported frauds last approximately 18 months before detection.
  - Some 77% of frauds were committed by individuals in one of the following six departments: accounting, operations, sales, executive/upper management, customer service, purchasing.
  - Owners/executives committed fraud with median losses at \$500,000 while managers' fraud median losses were \$130,000.
  - The median loss caused by occupational fraud was \$145,000.
  - The median loss for nonprofits was \$108,000.
  - Approximately 87% of fraudsters are first-time offenders.
  - Approximately 52% of fraudsters were between the ages of 31 and 45.
- **U.S. Chamber of Commerce:**
  - Annual loss from employee fraud schemes estimated at \$20B to \$40B.

# Occupational Fraud Statistics

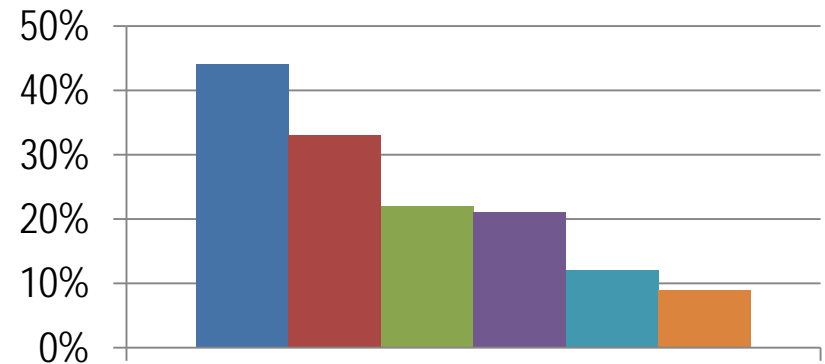
- **Instances of fraud by organization size**

- 100 EEs or less: 29%
- 100-999 EEs: 23%
- 1,000 to 9,999 EEs: 28%
- 10,000+ EEs: 20%

- **Median fraud loss by organization size**

- 100 EEs or less: \$154K
- 100-999 EEs: \$128K
- 1,000 to 9,999 EEs: \$100K
- 10,000+ EEs: \$160K

## Red Flags (Asset Misappropriation)



- Living beyond means
- Financial difficulties
- Unusually close to vendor/customer
- Unwillingness to share duties
- Addiction problems
- Past employment-related problems

Source: ACFE 2014 Global Fraud Study

# Occupational Fraud Statistics

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- **Tenure of perpetrator:**
  - < 1 year: 7%
  - 1 to 5 years: 41%
  - 6 to 10 years: 27%
  - > 10 years: 25%
- **Median fraud loss by tenure of perpetrator:**
  - < 1 year: \$51K
  - 1 to 5 years: \$100K
  - 6 to 10 years: \$200K
  - > 10 years: \$220K
- **Initial detection:**
  - Tip: 42%
  - Management Review: 16%
  - Internal Audit: 14%
  - By accident: 7%
  - External Audit: 3%
  - Confession: 1%
- **Median time to detection:**
  - 18 months

Source: ACFE 2014 Global Fraud Study

# Religious, Charitable, or Social Services

Scheme	Frequency of Scheme
Check Tampering	35.0%
Billing	32.5%
Expense Reimbursement	32.5%
Corruption	30.0%
Payroll	20.0%
Non-cash	15.0%
Skimming	12.5%
Cash on Hand	12.5%
Financial Statement Fraud	7.5%
Cash Larceny	7.5%
Register Disbursements	2.5%

Source: ACFE 2012 Global Fraud Study

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# Ponzi Schemes

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- An investment fraud that involves the payment of purported returns to existing investors from funds contributed by new investors.
- Organizers often solicit new investors by promising to invest funds in opportunities claimed to generate high returns with little or no risk.
- The fraudsters focus on attracting new money to make promised payments to earlier-stage investors.

# Ponzi Schemes in the News

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- Coquina Investments sued TD Bank over alleged material misrepresentation that caused them to invest \$37.7 million in a \$1.4 billion Ponzi scheme perpetrated by Scott Rothstein, attorney.
- TD Bank's appeal of the \$67 million verdict has been rejected by a federal appeals court judge.
- Rothstein pleaded guilty and was sentenced to 50 years.
- Rothstein's Ponzi scheme convinced investors to buy into interests in legal settlements.
- Rothstein allegedly used proceeds from the scam to fund his philanthropic and political contributions as well as an extravagant lifestyle.
- The Rothstein scheme is considered the 4<sup>th</sup> largest known financial fraud.

Source: [http://www.bizjournals.com/southflorida/blog/picking\\_up\\_the\\_pieces/](http://www.bizjournals.com/southflorida/blog/picking_up_the_pieces/)

# Diverted Contributions

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- Contributions intended for certain programs are directed elsewhere.
- Charity might be a front for a fraud scheme.
- Incoming contributions could be pocketed.
- Unapproved bank accounts could be opened.
- Deposits could be made to personally controlled bank accounts.

# Diverted Contributions in the News

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- John Donald Cody was sentenced to 28 years in prison for a \$100 million charity scam.
- A bogus charity was established to assist American military veterans called U.S. Navy Veterans Association.
- The perpetrator was said to have modeled his life after the true story behind the Hollywood movie, "Catch Me If You Can."
- Where the funds went has not been determined, but there has been little evidence of them being used to support veterans.

Source: <http://abcnews.go.com/Blotter/navy-vet-scammer-bobby-thompson-28-years/story?id=21232519>

# Misrepresented Fund Drives

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- Deceptive fundraising:
  - Portion of proceeds to be used in an organization's charitable programs.
  - The charitable contribution deduction to which a supporter is entitled.
- Compliance with donor-imposed restrictions pertaining to the use of a gift.

# Misrepresented Fund Drives Example

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- The New York Attorney General's Office recently announced a \$24.6 million settlement, the largest settlement for alleged deceptive fundraising in U.S. history.
- 90% of funds raised for the Disabled Veterans National Foundation went to pay direct mail vendors.
- DVNF will have to appoint a committee to re-examine its business model.
- They also used fictitious stories of wounded veterans to solicit contributions.
- The parties to the settlement have neither admitted nor denied the charges.

Source: <http://www.thenonproffitimes.com/news-articles/big-fines-might-little-impact/>

# Phantom Vendors

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- Employee establishes a fictitious vendor.
- False invoices are then submitted for payment.
- Invoice may not exist to support payment.

# Phantom Vendor Schemes in the News

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- Ephonia Green was sentenced to 46 months in prison for embezzling \$5.1 million from a DC nonprofit.
- The thefts occurred over 8 years starting in 2005.
- The scheme involved creating nearly 200 phony invoices with names of fictitious companies that closely resembled actual vendors the organization was doing business with.
- Green approved the invoices for payment.
- The scheme was caught when the bank noticed a discrepancy.

Source: [http://www.washingtonpost.com/local/crime/sentencing-set-for-woman-who-stole-51-million-from-district--based-nonprofit/2014/07/24/67ca78de-12b5-11e4-98ee-daea85133bc9\\_story.html](http://www.washingtonpost.com/local/crime/sentencing-set-for-woman-who-stole-51-million-from-district--based-nonprofit/2014/07/24/67ca78de-12b5-11e4-98ee-daea85133bc9_story.html)



# Other Disbursement Schemes

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- Billing schemes
- Payroll schemes
- Expense reimbursement schemes
- Check tampering
- Bribery
- Kickbacks from vendors
- Fraud in the bidding process
- Refund schemes
- Financial assistance schemes
- Electronic funds transfer schemes

# Disbursement Example

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- Ex-D.C. council member, Harry Thomas Jr., disbursed \$300,000 in city funds through a now-defunct youth sports charity.
- Thomas used the money for personal expenses.
- Mr. Thomas was sentenced to 38-months in prison.
- One of Thomas's staff is facing 20 years in prison for funneling grants intended for at-risk D.C. kids to Thomas's charity.

Source: <http://www.washingtoncitypaper.com/blogs/looselips/2014/07/28/harry-thomas-jr-aide-im-not-htj/>

# Collusion

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- Collusion is defined as secret cooperation between people to do something illegal or underhanded.

# Collusion Example

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- Three south Florida men were charged with conspiracy to commit mail and wire fraud:
  - Cross was Superintendent of Calder Race Course.
  - Campos and Cantrell were employed by companies that sold chemicals used to maintain the race course grounds.
- Cross allegedly ordered chemicals from Campos and Cantrell, who then filled the order and had it delivered to the race course. When the supplies arrived, Cross would allegedly sign for the false delivery.
- About 80% of the chemicals billed to Calder by Campos were never delivered and none of the chemicals billed by Cantrell were ever delivered.

Source: [http://articles.sun-sentinel.com/2012-02-02/news/fl-calder-race-arrests-20120202\\_1\\_kickback-scheme-three-men-calder](http://articles.sun-sentinel.com/2012-02-02/news/fl-calder-race-arrests-20120202_1_kickback-scheme-three-men-calder)

# Excessive Compensation

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- Excessive compensation is compensation that is well over the "market rate."
- "Market rate" is determined by researching what someone in a similar position would earn at an organization that is of the same size and has a similar mission or field of activity.
- The IRS has no standard formula, such as percentage of total revenues or expenses, for determining reasonable compensation.

# Excessive Compensation Example

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- A veterans' charity, Help Hospitalized Veterans, was accused of paying officers "excessive" salaries and making "imprudent" loans.
- The charity was also accused of using donors' funds to buy a country club membership and a suburban Washington condominium, and unlawfully diverting money to start another nonprofit.
- The charity president at the time was paid nearly \$390,000 in 2010, according to HHV's public tax disclosure forms.
- Its former president was paid more than \$2.3 million from 2002 and 2009.
- The charity agreed to pay a \$2.5 million fine.
- Board members are banned from serving as an executive for any charity.

Source: <http://www.cnn.com/2013/09/06/us/california-charity-fine/>

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# What is Fraud?

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## Black's Law 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.

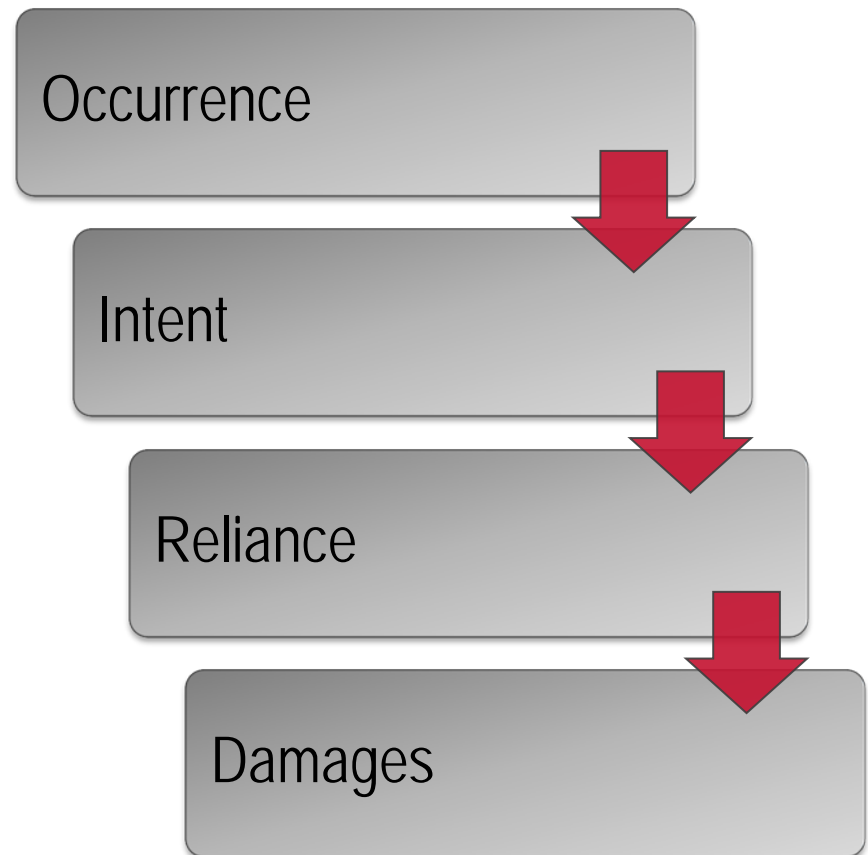
## Auditing Standards

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.

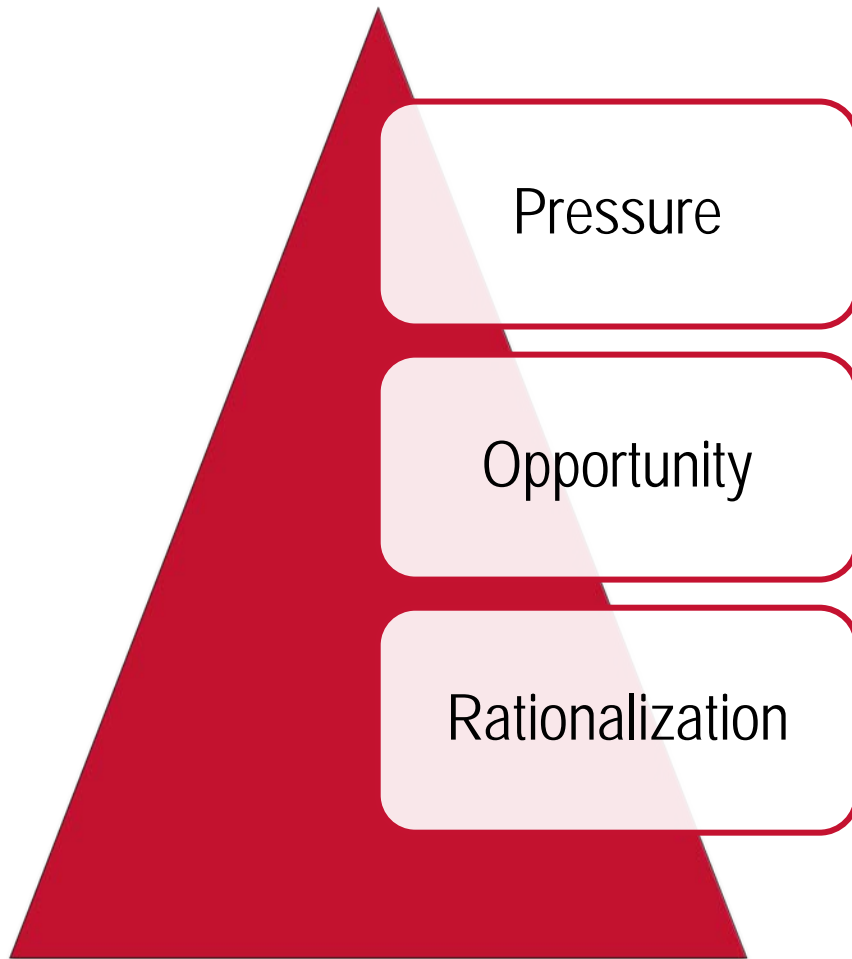


# Elements of Fraud

- False representation / willful omission about a material fact.
- Perpetrator intended to mislead the victim.
- Victim relied on the misrepresentation.
- Victim suffered damages as a result of the misrepresentation.



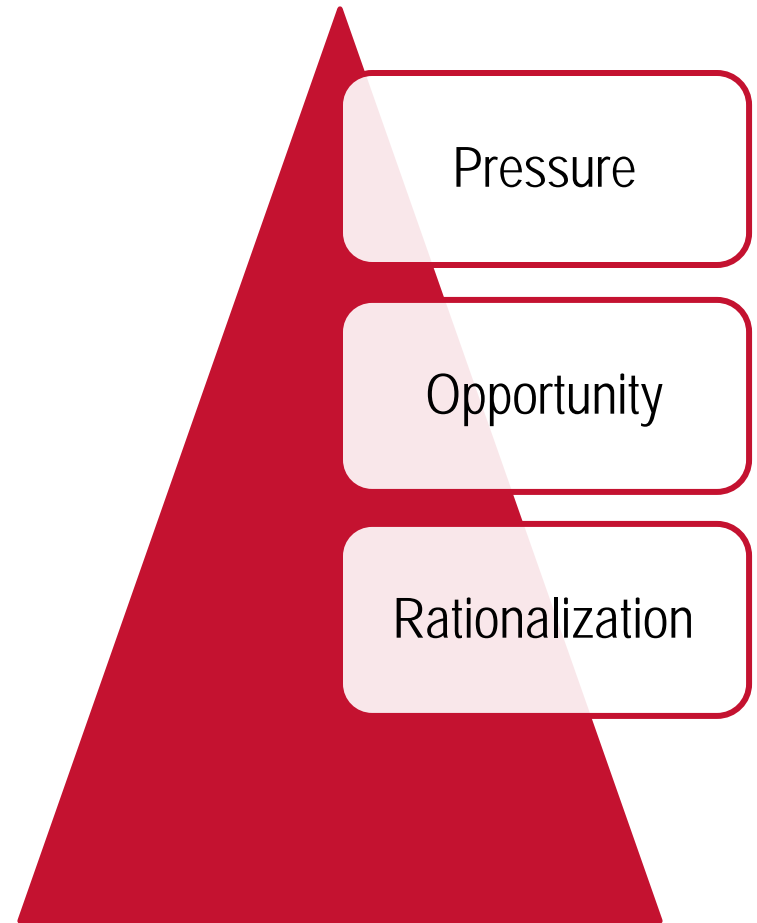
# The Fraud Triangle



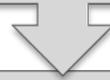
- **Pressure**
  - Personal debt
  - High medical bills
  - Supporting a habit
- **Opportunity**
  - Inadequate segregation of duties
  - Rapid turnover/lack of oversight
  - Absence of mandatory vacations
  - Constant “crisis mode”
- **Rationalization**
  - “I’m not hurting anybody”
  - “This company owes me”
  - “I’ll pay it back”

# Fraud Risk Factors

- Employee with mounting debts.
- Management tolerance for prior employee misdeeds.
- Adverse relationship between organization and employee.
- Minimal segregation of duties.
- Lack of formal authorization/ approval process for disbursements.
- Employee in key control function that doesn't take vacation.



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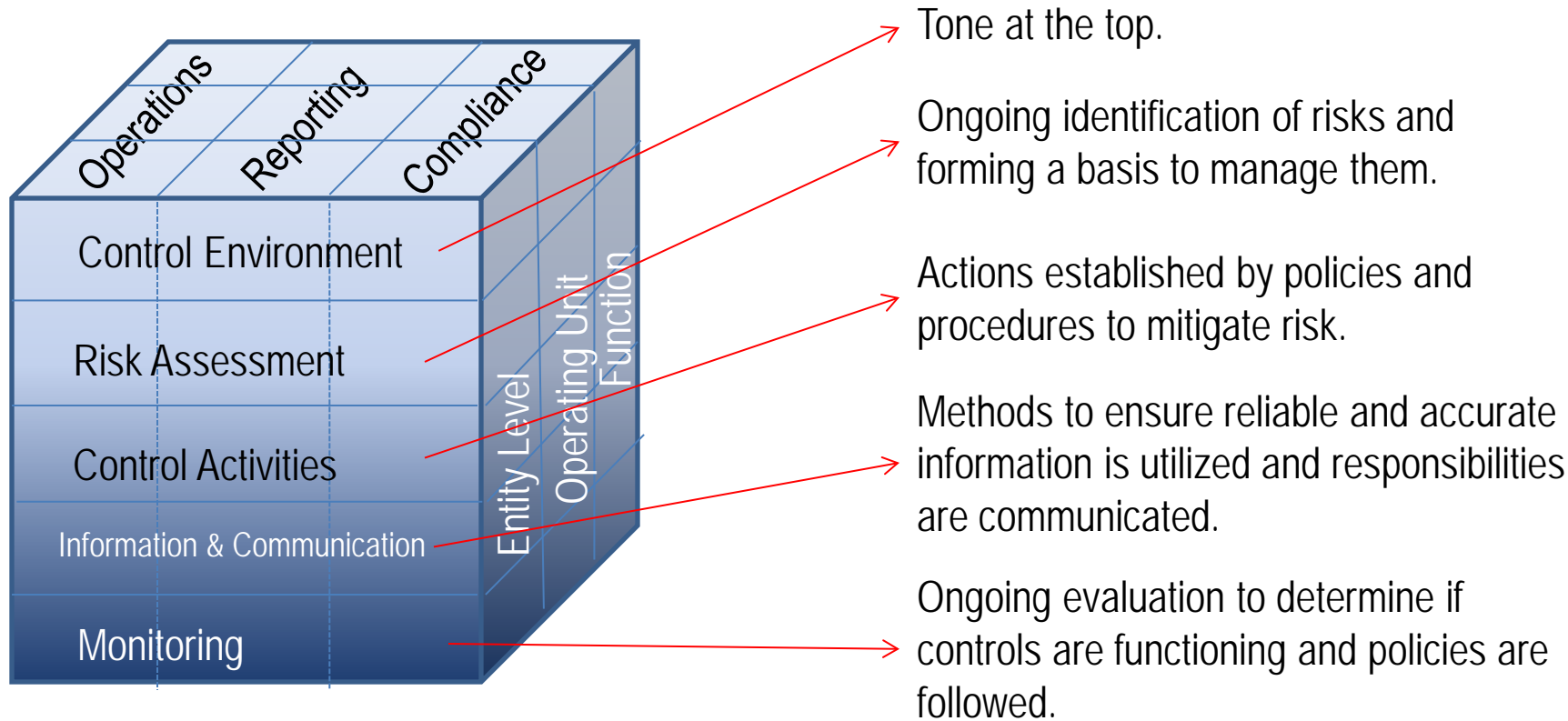


**Antifraud Programs & Controls**



Taking Action

# COSO Framework



# The Fight Against Fraud

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## Prevention

- Pre-employment screening
- Segregation of duties
- Ethics / antifraud training
- Tone at the top

## Deterrence

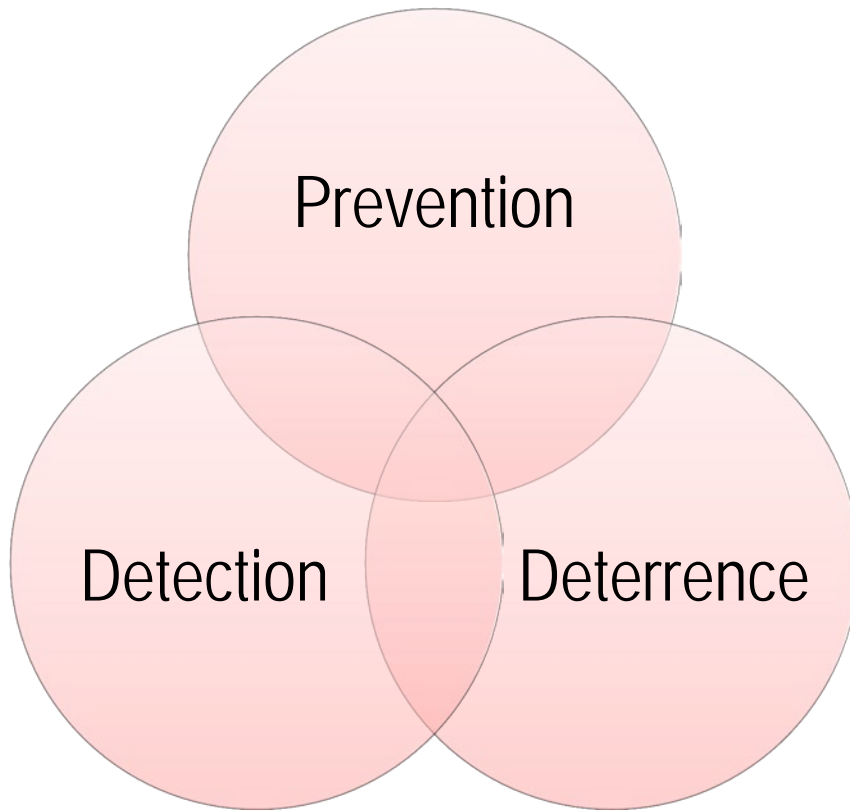
- Timely corrective action
- Fraud training / education
- Visibility of auditors

## Detection

- Financial statement trend analysis
- Fraud hotline
- Mandatory vacations / job rotation

# Effective Controls

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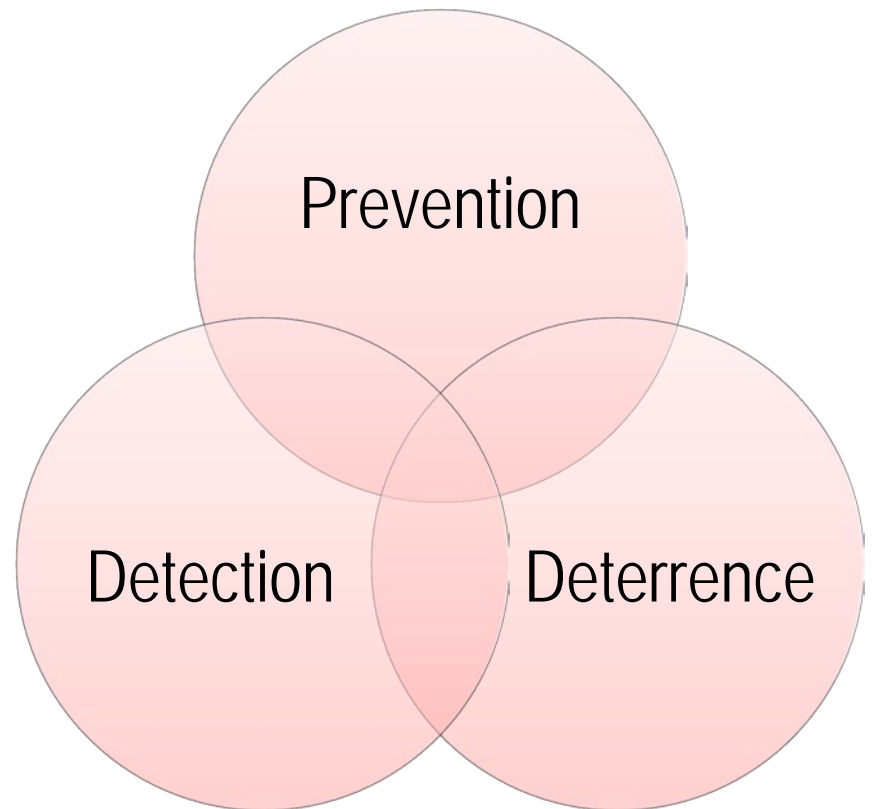


- **Monthly** financial statement preparation and review.
- Budget to actual comparisons
- **Monthly** reconciling of accounts.
- Fraud hotline.
- Employee counseling services.
- Surprise (internal) audits.
- Fraud training.
- Perform periodic inventories.

# Effective Controls

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- Employee background checks.
- Code of conduct.
- Employee bonds.
- Review computer security.
- Job rotation, mandatory vacations.
- Cross-train your workforce.
- Segregation of duties.
- Prosecuting fraud perpetrators.





# Fraud Hotlines

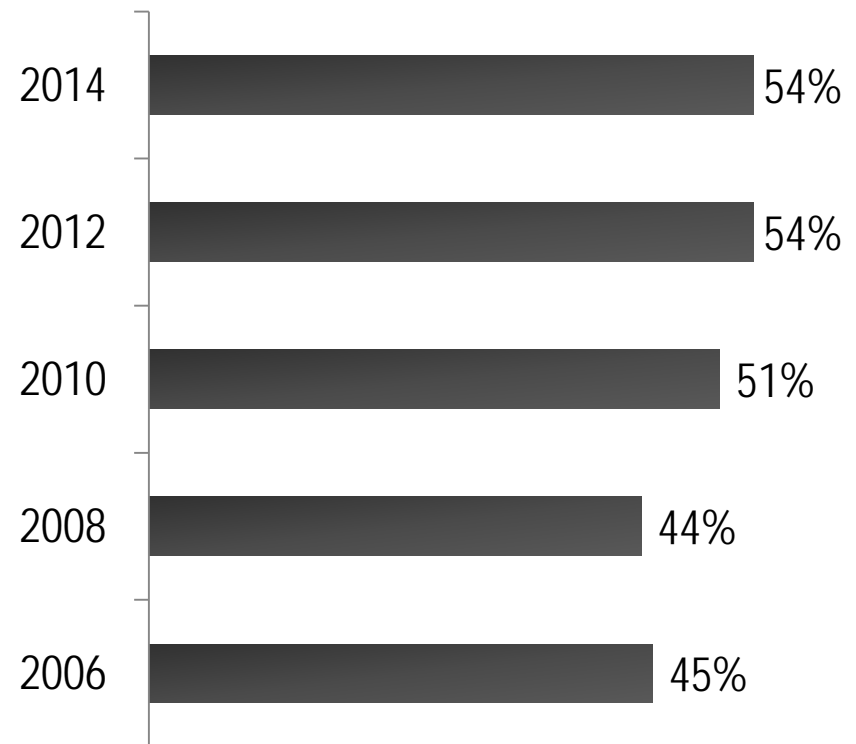
 Hotlines provide a reporting channel for complaints from employees and/or outsiders

- Confidential
- Anonymous

 Tips are the #1 fraud-detection method

 Many organizations (especially small nonprofits) do not have a fraud hotline

% of Victim Organizations that Had a Fraud Hotline



Source: ACFE 2012 Global Fraud Study

# Code of Conduct

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- Conflicts of interest.
- Confidentiality.
- Relationships with vendors.
- Gifts and entertainment.
- Unethical behavior.
- Use of organization's assets.
- How to report fraud or unethical behavior.

# Segregation of Duties in Small Nonprofits

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## Human Resources

- Is there a mandatory vacation policy in effect?
- Is the organization's hiring function kept separate from payroll processing?

## Cash Receipts

- Is the fundraising function separate from the cash receipts process?
- Is incoming mail opened and logged by someone other than the person responsible for making bank deposits?

## Cash Disbursements

- Does the person who signs the checks also perform bank reconciliations?
- Do checks over a certain threshold require multiple signatures?
- Who approves new vendors?

## Financial Management

- Are financial statements prepared monthly and reviewed by the controller or CFO?
- Are A/R and A/P reports reconciled to the G/L on a monthly basis?

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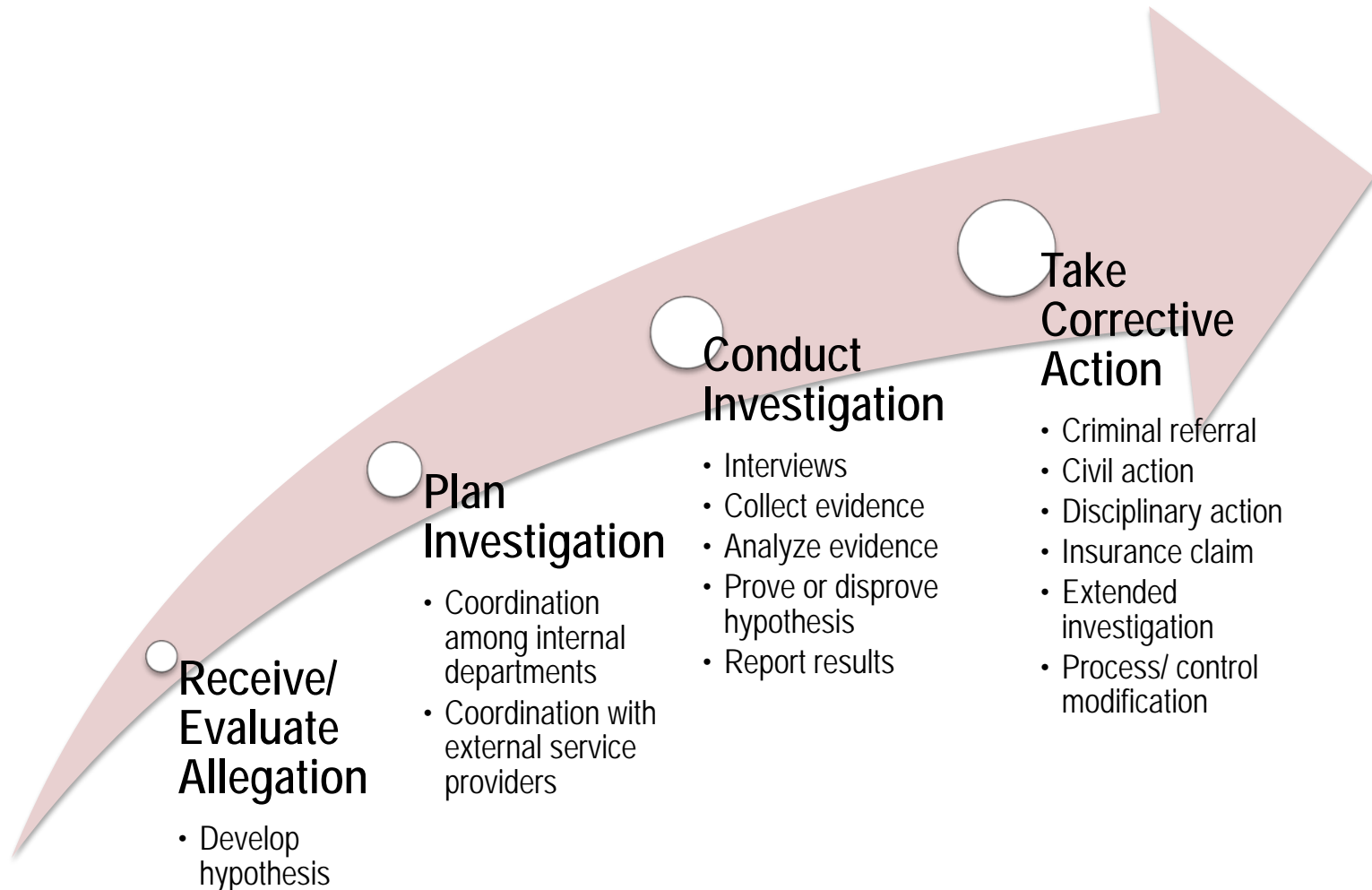
**Taking Action**

# Fraud Risk Assessment

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- Understand the controls that are in place.
- What controls should be added?
  - Prioritize based on level of risk
  - Subject to cost-benefit analysis
- Are there ineffective controls in place that should be removed?
- Risk assessment should consider both fraud **prevention** controls and fraud **detection** controls.
- Not all fraud can be prevented.
- Trying to prevent **all** fraud generally is not cost-effective.

# Fraud Investigations



# What Can YOU Do?

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- Call Fraud Hotline if available.
- Lodge a complaint with the Better Business Bureau.
- Contact the Internal Revenue Service with your suspicions. Go to the IRS website at [www.irs.gov](http://www.irs.gov) and fill out their Form 3949-A.
- File a complaint with the Association of Certified Fraud Examiners chapter nearest you. You can find that chapter by going to [www.acfe.com](http://www.acfe.com).
- Report fraud suspicions to the U.S. Postal Inspection Service. If a nonprofit organization has been sending out letters requesting contributions that have not been used as promised, this may constitute mail fraud.

# Thank You for Attending!

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## Contact Us



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