

FRAUD – It Can Happen to You!

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Occupational Fraud

- The use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets

Fraud – 2004 ACFE Study

- \$660 Billion/Year
 - Up from \$600 billion estimate in 2002; \$400 billion estimate in 1996
- 6% of Annual Revenue Lost to Fraud
- 12.2% of Cases Studied Involved Nonprofit Organizations (average loss was \$100,000)
- Small Entities Are Most Vulnerable

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Most Common Schemes:

	NPOs	Overall
● Billing Schemes	46.6%	33.5%
● Check Tampering	44.8%	20.1%
● Skimming	24.1%	24.4%
● Corruption	20.7%	30.1%
● Cash Larceny	17.2%	20.7%
● Payroll	17.2%	12.6%
● Expense Reimb.	13.8%	14.2%
● Non-Cash Misapprop.	8.6%	20.5%

● Source: 2004 ACFE Report to the Nation

Billing Schemes

- Personal Purchases
- Fictitious Goods or Services
- Inflated Prices
- Fictitious Vendor
- Duplicate Payments
- Refund Schemes
- Financial Assistance Schemes

Check Tampering

- Forgery of Signatures
 - Most common method
- Altering Amounts or Payees
 - Check-washing, erasing, etc.
- Duplicate Checks
 - Create phony checks
- Need to Conceal Through Bank Reconciliation

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Skimming

- “Off-Book” Fraud
- Stolen Prior to Entry on Books
- Checks are Just as Vulnerable as Cash
 - Establish phony account in name of organization
- Contributions are Most Vulnerable
 - No exchange (outflow of resources)
- Other Revenue Streams Also
 - Dues, off-site events, seminars, late fees

Corruption

- Bribery
 - Employee receives payment for influence over a business transaction
- Kickback Schemes
 - Undisclosed payments by vendors to employees, often involving fictitious billings or overpricing on invoices, bid-rigging, etc
- Conflicts of Interest
 - Employee, officer has undisclosed personal interest in a transaction

Payroll Schemes

- Ghost Employees
- Over-stating Hours Worked
- Over-stating Pay Rates
- Withholding Schemes

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Expense Reporting Schemes

- Duplicate Payments
 - Same employee re-submits
 - Multiple employee submit same expenditure (i.e. meal, entertainment)
- Personal Expenditures
 - Included with valid expenditures
- Airfare Schemes
 - Ticket-swapping
 - Trips not taken

Fraud – Who Commits It ??

- Employees
- Officers and Directors
- Service Organizations
- Contractors and Vendors
- Subrecipients
- Program Participants
- Volunteers
- Competitors

Perpetrators

- Gender: 53% male, 47% female
- Tenure: The greater the tenure, the greater the loss
- Age: 17% are over 50, 32% age 41-50, 34% between 31-40, 17% less than 30
- Education: median loss increases w/educ.
 - Postgraduate degree = \$325,000
 - Bachelor degree = \$150,000
 - High school or less = \$50,000

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Another Way of Looking at Fraud
Three Classifications

- Fraud committed against a NPO
- Fraud committed by a NPO
- Fraud committed through a NPO

Frauds Committed By Nonprofits

- Financial Reporting Fraud
 - Overstating program expenses (understating fundraising and administrative expenses)
 - Charging unallowable costs
 - Inflating contributions reported
- Fundraising Fraud
 - Misleading statements to donors
 - Noncompliance with restrictions
- Program Fraud
 - Misrepresenting program accomplishments
 - Noncompliance with regulations

Frauds Committed Through Nonprofits

- Committed by an insider
- Against an external party
- Utilizing information entrusted to the individual by the NPO
- Example: Identity theft perpetrated by an employee, using confidential data of a donor, member, etc.

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Goals of Fraud Protection

1. **Prevent** as much as possible
2. Utilize **detective** controls to catch what cannot be prevented
3. **Insure** against acts that are not prevented or detected
4. **Accept** a certain, minimal level of risk
5. Continually **update** our understanding of fraud risks and manage those risks
6. Utilize **EVERYONE** in an ongoing system of fraud deterrence

Fraud Prevention & Detection

1. Financial Controls
 - a. Preventive controls
 - b. Detective controls
2. Non-Financial Systems
3. Management Oversight and Behavior

Organization-Wide Model of Fraud Defense

- All Three Components Are Inter-Relate
- Involves Everyone in the Org. – Top to Bottom
- Cross-Cuts all Functions
- Addresses Each of the Factors Present in all Frauds:
 - Motive
 - Opportunity
 - Rationalization
 - Concealment

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Financial Controls

- Preventive
 - Designed to prevent fraud from being committed
 - Distinguish preventive policies from preventive controls
- Detective
 - Example: bank reconciliation
 - Average fraud scheme lasts 18 months before detection (2002 ACFE study)
 - 13% lasted 5 years before detection!

Internal Control Weaknesses

- Deficiencies in Design
- Deficiencies in Application
- Circumvention/Over-ride

Financial Controls

- Maintain in Written Form
 - Update and review periodically
- Elements Applicable to All Cycles
 - Segregation of duties
 - Mandatory vacations/rotation of duties
 - Data access controls
 - Timely reconciliations
 - Use of analytical techniques
 - Awareness of warning signals

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Segregation of Duties

- Goal: Make it Impossible to **Commit** and **Conceal** a Fraud
- **Example 1:** Separate functions involved in handling funds from those involved with recording
- **Example 2:** Have bank reconciliation performed by someone not involved in writing or recording checks

Key Controls – Cash Receipts

- Immediate Restrictive Endorsements
- Dual Control or Lockbox System
- Preparation of Permanent Record
- Timely Deposits
- Matching Permanent Record With Deposits
- Matching Deposits with A/R Postings

Detective Controls for Revenue

- Comparing Recorded Revenue With Budgets and Prior Years (trend analysis)
- Reasonableness Testing of Specific Accounts
 - Use of independent data to calculate expected revenue, then compare to actual
- Periodic Reviews of Customer Activity Reports (and/or customer statements)
- Monitor Aging of Receivables
- Review all A/R Credits, Write-offs
- Review Non-Cash JE's to Cash Accounts

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Key Controls – Check Preparation

- Secure Storage of Check Stock
- Pre-Numbered Checks (reconciled)
- No Pre-Signed Checks
- Two Signatures
- Use Checks Difficult to Alter
- Appropriate Voiding of Checks
- Use of “Positive Pay” System
- No Returning of Checks to Requester (Put All Checks in the Mail)

Key Purchasing Controls

- Purchase Order System
- Procurement Authorization Policies
 - Tiered levels of authorization
 - Including RFP processes
- Contract Review
- Conflict of Interest Policies
- Controls Over Establishment of Vendors in A/P Master Files
- Use of Separate Accounts to Track Refunds

Payment Approval

- Require Original Invoices (no copies or statements accepted)
- Match With Receiving Reports
- Match With Purchase Order
- Review of Invoice
 - Mathematical accuracy
 - Description of goods or services
 - Quantities and prices
 - Vendor information
- Documented Approval
- Cancellation of Invoice

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Bank Reconciliation

- Review Statement for Duplicate Checks or Un-Numbered Checks
- Investigate Gaps in Check Numbers
- Review Statement for Other Debits
- Examine Returned Checks
 - Signs of alteration or forged signatures
 - Review endorsements for consistency
- Compare Payees With Check Register or Disbursements Journal
- Verify Lists of Voided Checks

Key Payroll Controls

- Documentation
 - Pay rates and adjustments
 - Withholdings and deductions
- Timekeeping Policies
 - Preparation by employee only
 - Authorization of hours worked by supervisor
- Access Controls Over Payroll Database
- Segregate H.R. Duties (Master File Updates) from P/R Processing (Input of Time, etc)
- Match Checks/Stubs With Employees/Roster
- Master File and Data Analysis

Key Expense Report Controls

- Timely Submission of Reports
- Limit Travel Advances
- Mathematical Accuracy
- Match Authorized Dates of Travel With Supporting Documentation
 - Watch for extra nights of lodging, etc.
- Original Supporting Documentation
 - Vendor invoices (hotels, etc.), not just credit card receipts
 - Proof that air travel was used, not just booked
- Documentation of Business Purpose, etc. per IRS Requirements
- Compare all Information on Receipts
- Cross-check With Other Employees, Prior Reports

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Internal Controls Were Responsible for the Initial Detection of Fraud in Only 18.4% of Cases Studied
(Source: 2004 ACFE Report)

Methods of Detection:

	NPOs	Overall
● Tips	48.1%	39.6%
● By Accident	25.0%	21.3%
● Internal Controls	15.4%	18.4%
● External Audit	13.5%	10.9%
● Internal Audit	11.5%	23.8%
● Notified by Police	1.9%	0.9%
● Source: 2004 ACFE Report to the Nation		

What Does This Tell Us?

1. Internal Controls Generally Need to be Strengthened, **AND**
2. Systems Other Than Traditional Internal Controls Play Integral Roles in Fraud Prevention and Detection

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Non-Financial Systems

- Several Non-Financial Systems Play Roles in Controlling Fraud
- Among the Most Important:
 - Human Resources Systems
 - Physical Security
 - Information Technology Systems
 - Communications Systems
 - Insurance Protection

Human Resources Systems

- Hiring Policies and Practices
- New Employee Orientation
- Codes of Ethics (see next slide)
- Performance Evaluation Systems
- Compensation Adjustment Practices
- Grievance Policies
- Counseling of Troubled Employees
- Exit Interviews

Codes of Ethics

- Two Approaches to Drafting
 - Detailed – identifying specific acts
 - Broad – conduct in general terms
- If Broad, Cross-Reference Other Written Policies, Such as Personnel Manual, etc.
- Have Employees Sign, Acknowledging They Understand it and Agree to Comply With it
- Training and Periodic Re-certification

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Policy on Suspected Misconduct

- Functions in Conjunction With Code of Ethics
- Identifies How to Report Suspected Activities
- Incorporates SOX Whistleblower Protection Provisions
- States Employer's Rights
 - Including right to inspect and search employee files, lockers, desks, etc. that are provided as an employee convenience by the employer
- Explains Disciplinary Actions That May Result, Including Termination

Physical Security (p. 249)

- Who has access?
- During what times?
- Using what method of restricting access?
- Updated how frequently?

Controls

- Restrict Access to Data
 - Limit and screen personnel with access
 - Keep under lock and key (and never leave out while away from work station)
 - Restrict use of photocopier (most common method of stealing this information)
- Document and Data Destruction Policies

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I.T. Systems

- Data Controls
 - Access
 - Transmission
 - Input
- Software Controls
- Protection of Hardware

Communications

- Organization Chart
 - Clear understanding of lines of communication
- Access to Audit Committee
 - Or equivalent board-level representatives
- Hotlines
 - Anonymous reporting of suspected fraud and abuse by employees
- External
 - Crisis management

Compliance With SOX 2002

- Enhanced Whistleblower Protection Provisions
- Criminal Act to, With Intent to Retaliate, Take Action Harmful to a Person, Including Interference With Employment, for Providing to Law Enforcement Officer any Truthful Information Relating to Possible Commission of a Federal Offense
- Fines and Imprisonment up to 10 years
- Establish Written Policies That Conform to SOX and Communicate Throughout Company, But Extend Policies Beyond "Law Enforcement" and "Federal Offenses," to Include any Allegations of Fraud, Abuse, or Other Policy Violations

Insurance Protection

- Bonding Provides Protection
 - Review your coverage carefully
 - 65% of frauds result in recovery of less than 75% of loss
 - 39% of frauds result in recovery of less than 25% of loss
 - Do not under-estimate your risks in applying for and renewing coverage

Bonding Coverage

- Perpetrator Must be an Employee of Insured (Check Policy for Whether Volunteers are Covered)
- Many Policies Require That Loss be Reported to Law Enforcement
- Dishonest Act Must Occur and be Discovered During Bond Period
- Policy May or May Not Cover Fidelity Claims Expenses (Costs of Investigation)

Bonding Coverage Denied If

- Loss not Reported Timely
- Reasonable Precautions not Taken
- Misleading or Incomplete Information Provided in Application
- Failure to Provide Updated Information About Risks/Operations
- Failure to Follow Policies That Organization Claims are in Place

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Day-to-Day Management

- Understanding Fraud Responsibilities and Risks
- Setting an Example – Follow all Policies
 - "Tone at the top"
 - Communicate seriousness of fraud control
- All Supervisors and Managers Have Responsibilities
 - Awareness of red flags
- Enforcement of Policies
 - And reward ethical behavior
- Responding to Fraud
- Open-Door Policies – Receive Communications Regarding Allegations of Wrongdoing
- Corrective Actions

Board of Directors

- Oversight Responsibilities
- Establishment of Committees
 - Separate Audit Committee
- Committee Charters
 - Outline Responsibilities and Authority
 - Committees Deal With Issues in Detail, Bringing Summaries and Recommendations to the Full Board

Audit Functions

- External Audit
- Internal Audit
- Special Audits and Investigations, Including Allegations of Fraud and Abuse

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External Audit

- Limited - Provides “Reasonable Assurance” That Financial Statements are Free of “Material” Misstatement
- New Audit Standard SAS No. 99 Clarifies and Attempts to Provide Guidance to Auditors, But Does Not Change the Ultimate Level of Assurance You Get From an Audit

Internal Audit Function

- Provides for More Detailed Analysis in Areas or Greatest Risk
- Can be Part-Time or Outsourced
- Need or Degree of Use Varies Based on Complexity & Risks of Organization
- Important Detective Control
- Median Loss From Fraud (2002 ACFE Report):
 - With Internal Audit Function = \$87,500
 - Without = \$153,000

Financial Oversight

- Budgeting
 - Establishing budgets
 - Variance analysis
- Financial Analysis
 - Analysis of financial statements
 - Trend analysis
 - Ratio analysis
 - Benchmarking

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Variance Analysis

- Timely – Throughout the Year
- Involve All Who Are Accountable
- Substantiate Explanations
- Require Plans for Corrective Action Involving Variances and Projected Variances
- Consider When Establishing Next Year's Budget

Financial Reporting

- Frequency of Reporting
- Level of Reporting
 - Statement of financial position
 - Statement of activities
 - Individual program financials
 - Functional expense reporting
 - Cash flows
 - Budget to actual
- Supported by Timely Reconciliations
- Timeliness of Reporting
- Accrual vs. Cash Basis

For More on Fraud Protection. See:

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A Guide to Prevention and Detection*

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Services Offered by Gerry Zack

- Internal Control Evaluations
- Anti-Fraud Consulting
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- Internal Auditing
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- Forensic Accounting
- Fraud Investigation
