Preventing and detecting fraud at not-for-profits

Environment, policies, and controls can help organizations steer clear of problems.

By Maria L. Murphy, CPA

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Organizations in all industries must deal with the potential for fraud to occur, and design controls to prevent and detect it. Some not-for-profits have a unique environment that can contribute to fraud. Common characteristics such as an outlook of trust, significant control by a limited number of people (founder, executive director, CEO), limited human and financial resources, reliance on volunteers, higher turnover, and weaker internal controls can contribute to the likelihood of fraud.

Fortunately, not-for-profits can use many strategies and controls to prevent fraud. These methods start with the creation of an environment that makes it clear to everyone that fraud will not be tolerated and that appropriate action will be taken if it occurs. This control environment can be created when management and boards set the tone, identify specific risks, and create effective policies and procedures to ensure that the organization can achieve its mission to prevent fraud, and detect fraud if it should occur.

**TONE AT THE TOP**

Executives and boards, including the audit committee where there is one, should set the anti-fraud tone. This tone can be established with a set of core values, a mission statement, or a general message about how everyone is expected to act. If management and the board demonstrate through their actions a commitment to do the right thing, and make it clear to their organizations that they have high expectations that their employees and volunteers will do the same, people see it and are more likely to understand what is expected of them. On the other hand, if the CEO, CFO, chief legal counsel, and/or board demonstrate through their actions that they are not really committed to ethical behavior or core values, employees and volunteers are likely to follow their lead.

Hillary Coley, CPA, CGMA, the CFO and chief administrative officer for fisheries conservation organization Trout Unlimited, said sharing tone at the top and an anti-fraud environment is especially important in the not-for-profit sector.

“When management shares their commitment, it helps the organization’s leaders and volunteers to understand that fraud can happen to them,” she said. “This is a foreign concept for many not-for-profits because this is an organization they love, and they don’t understand how anyone could steal from them. They believe that people are good at heart, but things happen in life that make people rationalize doing things they wouldn’t normally do.”

Having a committee structure within the board is important, even for smaller not-for-profits, said Donald Murphy, CPA, CGMA, the CEO and managing associate of The Wesley Peachtree Group, CPAs, a full-service firm based in metropolitan Atlanta that has a strong focus on higher education, faith-based organizations, and other not-for-profits.

“It is a challenge for not-for-profits to attract qualified board members with credentials specific to their industries, and creating separate committees like finance and audit with board members with the appropriate qualifications can make the board more effective,” he said.

Boards can maintain an appropriate focus with periodic retreats and ongoing education in not-for-profit business and governance matters, including fraud.

Not-for-profits can understand where they are vulnerable by undertaking a critical assessment of fraud risks specific to their circumstances. These include the risks of material misstatement to the entity’s financial statements and enterprise-wide risks based on the not-for-profit’s sector. The extent of the risk-assessment process will vary based on the organization’s size and the nature of its activities. Once the risks are identified and documented, management and the board can discuss the risks on an ongoing basis, with input from external auditors. The board’s responsibilities for oversight include ensuring that management is performing the appropriate analysis and oversight.

**POLICIES AND PROCEDURES**

Not-for-profits should have clear, written policies and procedures, including specific anti-fraud policies. These should start with policies that enable compliance with the Sarbanes-Oxley Act of 2002 (SOX), P.L. 107-204.

Although many SOX provisions apply only to public companies, two provisions that apply to not-for-profits require attention in organizations’ policies to prevent fraud. First, SOX provisions make it a crime to destroy or falsify documents or records in an attempt to impede investigation or administration by federal departments or agencies. Second, a SOX whistleblower provision makes it a crime to retaliate against a person for providing law enforcement with information about a federal offense.

Not-for-profits can work with legal counsel to develop appropriate policies for document retention and whistleblower protection. The document retention policy will identify responsibilities related to the storage...

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and destruction of records. The whistleblower protection policy will create a mechanism for employees or volunteers to report a violation of policy or law without fear of retaliation. Not-for-profits should ensure that directors, employees, and board members understand the policies and how to report concerns.

Offering a telephone fraud hotline is a best practice that provides a mechanism for employees to anonymously report concerns, as tips over the years have consistently proved to be a top method for detecting fraud. In The 2014 AICPA Survey on International Trends in Forensic and Valuation Services, respondents reported that the two most common methods for detecting fraud that had occurred were internal inquiry or tipoff (39%) and whistleblowers (36%).

It is better to have the hotline calls received and managed by someone outside the organization, and that third party should report areas of concern to someone other than management, such as to internal audit or a member of the board or audit committee, if possible. Hotline services can be purchased without incurring substantial cost. All fraud or unethical behavior should be shared with the full board of directors. Calls could also be reported to someone in legal or human resources, but wherever they are received, it is critical for the not-for-profit to have a protocol for how to respond to hotline calls within the organization.

Not all calls should be responded to in the same manner, and the organization should not rely on just one person to do the right thing. Employees should be educated about effective use of the hotline, and it should not be allowed to turn into an employee gripe line.

Other policies also can reduce the risk of fraud, including policies that put the right people in the organization. To ensure that the right people are hired, background checks should be performed on management and finance employees before they are hired, with periodic updates, to assess whether they are persons of integrity. Laurie De Armond, CPA, an assurance partner at BDO who is a co-leader of the firm’s Nonprofit and Education Industry Group, said this is not done enough in the not-for-profit sector. Credit checks, education checks, reference checks, and criminal history checks can reveal issues that can be risk indicators for future fraud.

In addition to using good hiring practices, not-for-profits should provide adequate training for employees to help them be effective in their jobs. This is an area of concern for not-for-profits, where budgets may not provide for training for employees other than the corporate controller. Good supervision and fair promotion and compensation practices also can deter and prevent fraud. Meanwhile, budgets should be scrutinized to prevent unreasonable expectations that can put pressure on finance employees to create fraudulent financial results.

Employee handbooks that contain information about an organization’s code of conduct, along with its policies and how violations will be addressed, should be given to all employees when they are hired, with periodic updates and ongoing communication and training. Murphy suggested that employees should understand policies about conflicts of interest and should be required to complete periodic surveys. If an employee resigns or is terminated, it is important to ensure that access to the facilities and systems is protected so that the organization is not vulnerable.

Coley recommended that in the not-for-profit world,
human resources departments should have a policy that “allows humans to be human at work.” This includes a support structure and a willingness to help and listen, while still protecting the organization. Disgruntled employees or low morale can create a higher risk of fraud, because unproductive behavior and higher turnover can contribute to ineffective internal controls and because employees may be more likely to commit fraud to get even with their employer or for their own financial reward.

Employees, volunteers, and boards can be a not-for-profit’s best sentries against fraud, and they should be educated to perform this role. De Armond encourages organizations to make their people aware of “red flags,” which can indicate fraud or an increased risk of fraud. These red flags should be shared with the finance team and with anyone who receives or handles personal data, to ensure that it is protected. Murphy suggested that everyone, especially supervisors, should be aware of fellow employees and how people present themselves. For example, employees who never take a vacation or are living well above their salary levels may be exhibiting behavior that merits further investigation.

“After something happens, people will say, ‘I always thought that was strange,’ ” De Armond said.

**COMMON NOT-FOR-PROFIT FRAUD ISSUES**

Not-for-profits face the risk of fraud in many areas, including risk associated with donations. Here are some common fraud issues that not-for-profits may encounter:

- Stolen donations, embezzled funds, and misappropriated revenues.
- Misclassified restricted donations.
- Incorrect allocation of costs between programs.
- Related-party transactions.
- Abuse of credit card privileges for personal use.
- Improper expense reporting and reimbursements.
- Inappropriate vendor arrangements, lack of competitive bids, and kickbacks.
- Bribery, forgery, and other illegal acts.
- Management-level override of controls.
- Lack of segregation of duties.
- Improper financial reporting.

**CONTROLS**

It is important for all organizations to have an effective internal control environment, with both preventive and detective controls over fraud. Fraud prevention controls reduce the opportunity for fraud to occur and deter individuals from committing fraud because it is likely to be detected and punished. Fraud detection controls discover the fraud if it does occur and address its remediation. In smaller not-for-profits with fewer financial and human resources, creating effective controls can be more challenging. All controls are subject to the integrity of the people in the organization.

“A good financial control policy should include general fraud practices,” Coley said. “It should be collaborative and educational.”

Accounting controls can help to ensure that executives and board members do not abuse their authority and fail to follow policies. Appropriate controls can prevent fraud from going unchecked, but even if controls are in place, people can circumvent them. Common examples of circumventing controls that can lead to the potential for fraud include:

- Submitting multiple expense reports for smaller amounts to eliminate the required higher approval level.
- Submitting multiple low-dollar requisitions to circumvent the required bid-and-approval process.
- Making multiple lower-value journal entries to avoid the required supervisory review.
- Using a corporate credit card to make purchases without preapproval.

When collusion occurs in the organization, fraud prevention and detection may become more difficult.

“Accounting controls and policies can often be perceived as an obstacle to accomplishing the not-for-profit’s mission, by putting up roadblocks to what others want to do, rather than a foundation for success,” De Armond said. “But a strong organization can set everyone up for success by helping them to achieve their objectives.”

One of the most fundamental controls that is critically important to preventing and detecting fraud is segregation of duties. This control ensures that no one person has complete control over an entire transaction. A basic control in this area includes independent review of work by a supervisor. In addition, there should be a separation of duties in the following general areas:

- Vendor approval and setup from payment processing.
- Cash receipts and deposits from cash recording and bank reconciliations.
- Employee master file record additions from payroll processing.
“Many not-for-profits have segregation-of-duties issues, separating custodial versus recordkeeping duties,” Murphy said. “So if there are not enough employees to have this segregation, you may have to engage an outside accountant, or directly involve members of the finance or audit committee in review of transactions, bank statements, or check registers, to add checks and balances.”

Outside accountants can review employees’ work, compile monthly financial reports, and review processes, controls, and reconciliations. Employee staff from departments other than finance may be able to assist. However, it is also important to have controls over the outsourced work, because it is possible for fraud to occur at that entity as well.

Centralized recordkeeping also can help prevent fraud. When changes occur in personnel responsible for financial reporting and recordkeeping, control over records can be an issue. Remote working arrangements and the involvement of many volunteers can increase this risk. Good controls include keeping fiscal records in a safe and central location, managing changes in personnel with access to records, and giving controlled access to records to more than one person.

Not-for-profits that receive grants should have additional controls over compliance with regulations and grant terms, proper documentation, and reporting. Adequate systems and accounting controls over the quality of data are essential. Fraud in this area could include embellishing program reports and reporting required actions that were not performed. Failure to comply in these areas can lead to public scrutiny, government sanctions, harm to reputation, and potential repayment of funds and lack of future funding. Internal auditors or outside CPAs can be employed to assess these controls periodically.

Detective controls, meanwhile, can uncover fraud if it is occurring. The following detective controls can be easily implemented:

- Account reconciliations performed on a regular basis.
- Supervisors’ review of the work of their subordinates.
- Bank alerts and reporting features.
- Monthly board review of reports and variance analyses.
- Analytical review procedures by internal audit or finance staff that can be similar to the procedures performed by external auditors. A budget versus actual variance analysis can be a good way to detect changes that may be indicators of fraud.
- Data analytics and computer-assisted audit techniques that can detect anomalies in databases overall. These technological tools can help bring items to the surface that can then be investigated further to determine whether errors or fraud occurred. Examples include matching employee address files to vendor files, looking at the frequency of voided checks, and highlighting unusual journal entries. Internal audit can perform data analytics, or outside CPA firms can assist. Software packages can be purchased, and the cost and ease of use will vary depending on the level of sophistication.

**SKILL SETS ARE CRITICAL**

Having the appropriate skills in place is a must for not-for-profits as they aim to prevent and detect fraud. Not-for-profits should look critically at the skill sets they require from their boards, executive officers, and employees, based on the sector in which the not-for-profit operates. Similarly, they should select the outside CPAs they use as consultants and auditors because they are a good fit based on their industry experience and quality of their work, not just based on low fees because of budgetary concerns. SOX resulted in more-stringent requirements for CPAs in this area, Coley said. Before SOX, auditors were able to prepare and review financial information for not-for-profits. Now, financial statement preparation and auditing must be performed by separate entities.

It is helpful for management to meet with accountants and auditors before they begin their work, to discuss areas of concern so that there is a focused effort. If auditors recommend internal control improvements, it is critical that the board and management fulfill their fiduciary responsibility and make a concerted effort to implement changes to prevent repeat findings in future years. While it is not the auditors’ primary responsibility to detect and prevent fraud, using them as a resource to assess the overall risk environment and strengthen internal controls is a way for not-for-profits of all sizes to reduce and, hopefully, prevent their risk of fraud.

While it’s virtually impossible to guarantee that fraud will never occur at an organization, not-for-profits can significantly improve their odds of preventing and detecting fraud if they create the right environment and implement strong controls and sound policies. These anti-fraud measures are just as essential in a not-for-profit environment as the passion that employees and volunteers bring to their charitable mission, which can suffer devastating consequences if and when fraud occurs.

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