# NEW YORK NONPROFITS

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## going...going...gone... the facts on Fraud & Embezzlement

*According to the Association of Certified Fraud Examiner's Report to the Nations on Occupational Fraud & Abuse, worldwide estimates of fraud losses show that more than three and a half trillion dollars is embezzled annually and median losses for nonprofits are around $100,000 per occurrence. Nonprofits were not insulated from the economic downturn of the past five years and as a result have experienced cutbacks in contributions, government funding and other revenue sources, often leading to positions being eliminated or consolidated among employees, often with little or no compensation increases. The fraud triangle model explains that for fraud to occur, three components typically exist: opportunity, motivation and rationalization.*

Certified public accountants Kevin Foley and Matthew O'Dell with Condon O'Meara McGinty & Donnelly LLP recently led an NPCC workshop discussing how to detect signs of duplicity and the controls that should be put into place to help prevent employees from committing these acts.

The majority of executive directors are not professionally trained in financial matters. They are inundated with a million things to do and too often bookkeeping affairs are not their top priority, so they place their trust in the bookkeeping staff. However, financial management is one area where an executive should not delegate all of the responsibility to one person.

Financial malfeasance can range from simple schemes such as reusing petty cash receipts to complicated ones where funds are transferred from an organization's account into a personal account. Perpetrators of fraud and embezzlement usually fall into one of several general categories: the disgruntled employee who rationalizes his actions by stating, "They're not treating me right ... I'm underpaid and underappreciated," to an employee with a personal problem, such as a gambling or drug addiction, a messy divorce, or an employee with a psychological problem. Those who steal can range from an employee with power and trust who answers to no one to an employee at an organization that has poor or few internal controls. Embezzlement cases usually start out small and snowball until out of control. In many instances an employee does not intend to steal in the beginning, but discovers how easy it is to get away with and then can't stop.

Fraud is usually discovered by tips or by accident. Often it is someone in the organization who notices the irregularities. Unfortunately, hindsight is a great detector of fraud and embezzlement. Malfeasance is usually not uncovered during a regular financial statement audit. An audit designed specifically to detect fraud and embezzlement would be very expensive. However, the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA) issued risk assessment standards that clarifies the auditor's role in detecting fraud during an audit and is designed to make auditors more aware of the possibilities. The AICPA classifies fraud and embezzlement as either misstatements in financial reporting or misappropriation of assets.

There are several warning signs that things might be amiss and should be investigated immediately. —Poor or sloppy recordkeeping, including bank reconciliations not done in a timely fashion; financial statements that don't make sense; large numbers of journal entries (without adequate explanation) in the general ledger. —Work not done in a timely manner or at all. —Missing or incomplete bank statements. —The staff is not ready for the annual audit, especially when repeatedly delaying. —Tax penalty notices are ignored or discarded altogether. (Incidents have been uncovered where tax notices were stuffed in a drawer and ignored. Remember that in certain instances the board could be held liable for these penalties.) —The staff blames the computer for problems. —Checks are missing from the bank statement. —An employee whose life style suddenly appears to be more extravagant than that which his salary could support.

Foley notes that according to the Association of Certified Fraud Examiners, around 40% of instances of fraud are found through tips and that 50% of these tips come from employees. The IRS Form 990 now asks whether the organization has a whistleblower policy, and studies show that those organizations with whistleblower hotlines are 13% more likely to receive a tip about fraud.

Probably the most precarious situation that an organization can place itself in—and one that almost invites dishonesty —is where one person has control over all financial matters.

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**Controls to Protect Against Fraud**

The following items are ways to reduce the possibility of fraud or embezzlement being committed.

*Internal Controls.* Foley and O'Dell noted that the primary way to protect your organization against fraud or embezzlement is through internal controls. Almost every nonprofit can do something to improve its bookkeeping systems, even small-staffed organizations. If your organization does not have a system of internal controls, establish one. Create an accounting manual that lists responsibilities, procedures, etc., and have an accountant review for areas that need strengthening.

*Segregate duties.* Do not allow one person to be in control of all aspects of financial matters. For example, require a different person to physically mail the checks than the person who writes them. Foley cited a case of a bookkeeper who surreptitiously wrote the checks in erasable ink. After they were signed and returned to her to mail, she would change the names on selected checks and deposit them to her account.

Review the monthly bank statements, journal entries, payroll registers, and credit card statements.

Require the bookkeeper to take an annual vacation, during which time the executive director should review the financial records to ensure that all is in order and that previously reviewed records haven't been altered.

*Purchase employee dishonesty insurance.* An insurance carrier will usually offer this as an add-on to a general liability insurance policy and it's usually not expensive. In addition, most underwriters will review an organization's procedures and provide suggestions and may require that action be taken in order to be underwritten on operations needing strengthening.

*Background Checks.* Conduct background checks on prospective new employees who will have access to financial records and instruments.

*Accountants.* When hiring an accounting firm to conduct your annual audit, be sure that they are well versed in nonprofit accounting practices. Not all CPAs are nonprofit savvy. Periodically (some recommend every five years) use a different auditor from your accounting firm, as familiarity breeds contempt.

*Payroll Services.* An outside service (like Paychex or ADP) will assume the liabilities for payroll withholding taxes if you elect to use that component of their service. A payroll company will provide a paper trail that can be easily verified by others. On occasion, the executive director or a board officer must check the payroll ledgers to be sure that the bookkeeper transmitting payroll isn't issuing an extra check to himself or a phantom employee. This is especially important when using direct deposit and when you have multiple locations.

*Petty cash.* Keep petty cash banks to a minimum and monitor regularly. Most auditors prefer to see as little activity as possible. Foley further urged people to consider eliminating cash altogether and never allow ATM cash cards for employees.

*Checks and wire transfers.* Do not rely on a bank in the area of signature verification. As almost every business manager can attest, checks that should have required two signatures will usually clear the bank with only one signature. Furthermore, signatures are usually not verified, and most banks will be upfront about their inability to do so.

*Check signing.* The best method of control is to have an officer sign every check. Most organizations don't opt for this severe level of accountability, and will have the executive director sign checks, provided that he or she are not the individual physically writing the checks. Organizations should not allow individuals to sign checks if they also write and record the checks.

Never allow signed, blank checks to be held in the office. For example, don't leave a few signed checks with the bookkeeper when the executive director goes on vacation.

Certain banks offer check clearing services which are commonly being referred to as "positive pay": an electronic file of every check written within a given time period is submitted to the bank, so that if someone presents a check for payment that is not on the list, it will be denied and you will be contacted.

Beware of fake emails that look like they're from a bank. Inform your staff to never open or click thru these emails.

Consider doing all banking-related transactions on a computer that no one else accesses and is dedicated solely to that financial purpose.

Use debit or ACH (automatic clearing house) blockers so that if someone tries to transfer money out of your account either through a debit card or a clearinghouse, the bank notifies you.

Wire transfers should have a control book or some type of written account that will provide a paper trail. The executive director should phone the transfer in when the bookkeeper requests a transfer of funds. An extreme method of control would be to require that transfers have written authorization and not be done by phone; however, most organizations will not want to commit to this kind of delay and extra use of time.

*External control.* The treasurer of the board or another officer must review the bank reconciliations at least twice a year, unannounced. He or she should receive an unopened bank statement and conduct an analysis to verify that the cancelled checks in the envelope match the check numbers on the statement, and also verify that the endorsements on the back of the checks match those of the payees. It would defeat the purpose of this control to run this test on a scheduled basis, so make it a surprise.

To help prevent fraud and embezzlement, it takes active management in all aspects of the organization. The board has a fiduciary responsibility to make sure that management has the proper internal controls in place so that all transactions are properly recorded. Basic bookkeeping functions should be performed on a timely basis with no exceptions. Wherever possible, at least one person should be reviewing the work of employees in sensitive areas. Checks and balances make fraud and embezzlement less likely to occur.

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NPCC has a sample whistleblower policy available at www.npccny.org/compliance_checklist.htm as well as other items related to accountability and transparency.

The New York State Office of the Attorney General has a guide, *Internal Controls and Financial Accountability for Not-for-Profit Boards,* at www.charitiesnys.com/guides_advice_new.jsp.

ACFE's *2012 Report to the Nations on Occupational Fraud & Abuse* is at www.acfe.com/rttn.aspx.