

PREVENTING FRAUD IN NONPROFIT ORGANIZATIONS

- Understand the areas where nonprofits are most at risk
- Establish internal controls to avoid embezzlement
- Analyze weaknesses in controls and document recommended improvements
- Create a fraud action plan if victimized

EDWARD J. McMILLAN, CPA, CAE

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Edward J. McMillan, CPA, CAE, is an experienced fraud examiner and teaches fraud prevention courses to organizations such as the American Institute of CPAs, the Maryland Association of CPAs, other state societies of CPAs, the U.S. Chamber of Commerce, and the American Bar Association, among others. Ed also speaks regularly on the subject of fraud prevention at business conventions of all types and can be reached at (410)893-2308 or contacted via email at emcmillan@sprintmail.com.

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The American Chamber of Commerce Executives

*Fraud and Embezzlement in Small Business:
How It Happens, How You Can Prevent It*

Association of Certified Fraud Examiners

Glossary

Preface

Unfortunately, embezzlement and fraud are a reality that all organizations are confronted with.

This manual is designed to help auditing CPAs, internal auditors, fraud investigators, and management understand how to thoroughly evaluate the system of internal controls, expose weaknesses that could lead to fraud, and take corrective action to reduce the possibility of victimization.

Obviously this book cannot guarantee that fraud or embezzlement will be eliminated. However, if the suggestions offered in this manual are implemented, this risk will be reduced substantially.

Disclaimer

The contents of this book should not be construed as legal advice, and in that respect the publisher and author assume no liability or responsibility accordingly. Before implementation, the internal controls, policies, and forms suggested in this book should be reviewed by a competent attorney to ensure compliance with federal, state, and local laws.

Implementing the internal controls, forms, and processes in this book will by no means guarantee that an organization will be protected from fraud. While this book may help to decrease the *possibility* of embezzlement, it is imperative to remain diligent in business practices.

Remember, desperate people resort to desperate action, and where there is a will, there is a way.

About the Companion Website

The sample policies and procedures found in Section Six of this book are also available in MS-Word format on a Web site designed to accompany this book:

www.wiley.com/go/mcmillan_nonprofit_fraud

They can be copied and customized to fit the specific needs of your organization.

Editor's Note: The author has also written a similar book (Wiley 2006) on the subject of fraud prevention policies and procedures designed for the business community entitled:

Policies and Procedures to Prevent Fraud and Embezzlement: Guidance, Internal Controls, and Investigation

SECTION 1

Not-For-Profit Organizations: Four Consistent Areas of High Risk Embezzlement: Who Does It and When

Not-For-Profit Specific Issues

WHEN AUDITING CPAs audit an organization, they are required to have a good understanding of the nature of their client's business to enable them to evaluate risk factors that could lead to embezzlement and to suggest corrective action accordingly. Obviously, business environments vary according to the nature of the business, because the risks banks face are substantially different from the risks an automobile dealership faces.

Although auditing CPAs, internal auditors, and management should continually strive to reduce embezzlement risks of the not-for-profit organization as a whole, history has shown that a typical nonprofit has extremely high fraud risk in four specific areas, those being:

1. Checks *mailed* to the organization's offices from members, advertisers, and the like
2. Printing expenses
3. Postage expenses
4. Personnel-related expenses including wages, payroll taxes, and employee fringe benefits

This book will address these areas in greater detail in later chapters, but because of the high likelihood that a knowledgeable person could take advantage of weak internal controls in these four areas, it is important to understand why these areas are so susceptible to fraud and why basic corrective action must be taken.

Checks Mailed to the Organization:

Issue: Not-for-profit organizations in general are unique in that they are *widely known by their acronyms* by both their members and the public! For example, the American Medical Association is referred to as AMA, the National Rifle Association is called NRA, and so forth. The vast majority of nonprofits are known by their acronyms.

Risk: When members, advertisers, and the like remit payments to nonprofits, often the remittance check will be made payable simply to the organization's acronym rather than the full name of the entity.

What could an individual with access to checks do to perpetrate a fraud? Simply open an account in another bank using a clever variation of the legitimate organization's name, with the same acronym. For example, someone at the American Crayon Association (ACA), could open an account for the nonexistent Apple Collectors Association (another ACA) at another bank and easily divert checks payable to ACA to the second account.

Suggestion: 1. Utilize the bank's Lockbox Service whereby members and contributors are provided with remittance envelopes, and checks are mailed directly to and deposited by the organization's bank rather than mailed to the organization. This service effectively eliminates the risk associated with diverting checks made payable to an acronym because employees never come into contact with these checks.

Important—see "Lockbox" in Section 3 of this manual for an in-depth discussion of this service.

2. On invoices, dues billings, and the like, request checks be made to the full legal name of the organization rather than its acronym.

Printing Expenses:

Issue: In most not-for-profit organizations, the primary product is the printed word (magazines, newsletters, books, brochures, etc.) and printing expense is typically a substantial portion of the overall budget, and in that respect, susceptible to fraud.

Risk: Because printing is such a major portion of the budget, the organization must be vigilant in monitoring internal controls over printing, to avoid ghost printing vendors and collusion between printers and key staff.

Suggestion: Ensure the organization has thorough and continually updated Approved Vendor Files. These files should include detailed information such as legal entity name, remittance address, street address, contact name, federal identification number, emergency numbers, and so on. This information is vital to auditing CPAs and internal auditors when reviewing records.

Important—see “Ghosts on the Payroll and Ghost Vendors” in Section 4 of this manual for more in-depth discussion.

Postage Expenses:

Issue: As with printing expenses, not-for-profit organizations typically have a substantial budget for postage (and freight), because they would probably have, at a minimum:

- First class mail
- Business reply mail
- Bulk mail
- Media mail
- Second class mail
- Postal permits

Additionally, nonprofits often also do business with:

- Mail and fulfillment houses
- Commercial couriers such as UPS, FedEx, and the like

Once again, because of the high volume of mail that a typical not-for-profit experiences, the organization must be vigilant in ensuring that postage funds are not diverted.

It is a simple matter for knowledgeable persons to “sell” organization postage to another party, divert postage for their own use, prepare checks to nonexistent mail houses, open up accounts using clever variations of commercial couriers’ acronyms or names, and so forth.

Suggestion: It is imperative that postage expense be monitored very closely and routinely by auditing CPAs, internal auditors, key staff, and others.

Important—see the “Postage Issues” and “Ghosts on the Payroll and Ghost Vendors” in Section 4 of this manual for in-depth discussions and recommendations.

Personnel Expenses:

Issue: Risks associated with personnel-related expenses are obviously not unique to nonprofits, and all businesses have a high risk in this area. Why? Typically upper management rarely is aware of the detail

associated with processing payroll, calculating Social Security and Medicare, calculating federal and state income tax withholding, and other areas related to payroll.

When management is unaware of the detail associated with processing payroll, they are highly susceptible to payroll fraud.

- Suggestion:**
1. Always ensure that *two* employees are involved with processing payroll, and both employees sign the payroll detail attesting accuracy.
 2. Consider direct deposit of employee pay. Direct deposit requires bank account numbers, creating an audit trail.
 3. Have either the auditing CPA or internal auditor pay a surprise visit to the organization to check the accuracy of payroll, ensure there are no ghost employees, and so forth.

Important—refer to ghost employee and other personnel-related information in this handbook for greater in-depth discussion and recommendations.

Summary

Although there are obviously other areas of risk such as travel expenses and the like, it is clear that the four areas noted in this chapter are of paramount importance when evaluating the risk associated with a typical not-for-profit. Published operating ratio reports for nonprofits consistently report that if a nonprofit is victimized, there is a high likelihood that one of these areas is involved.

The Perpetrators: Who They Are, Why They Do It, and How They Are Caught

In the real world of embezzlement, the perpetrators rarely fit the stereotypical image of someone capable of concocting and carrying out fraud schemes. Rather, they are almost always someone *above suspicion!* The stories of internal theft being carried out by the innocent-appearing young man who sings in the choir or the older woman whom you can count on to remember everyone's birthday are actually the norm. Embezzlers are of any age, sex, race, religion, and income bracket.

Why? Despite the appearance of honesty, you can never be sure of what is going on in someone's personal life, and desperate people are capable of taking desperate action. For example, it is probable that you have no idea that a fellow employee may:

- > Have a gambling issue
- > Have an alcohol problem

- Have a substance abuse situation
- Be experiencing financial difficulties
- Have expensive medical bills
- Or—enjoy living life on the edge!

There are, however, a few profiles that warrant the attention of management:

Who They Are, Why They Do It

The Disgruntled Employee Employees who have been passed over for promotion, demoted, reprimanded, or been the subject of disciplinary action often feel they have a justifiable grievance against the organization. People in this situation often feel they have nothing to lose if they are caught in wrongdoing. Additionally, they often rationalize their actions and feel they are justifiably righting a perceived wrong, and they convince themselves they have done nothing wrong.

The Stressed-Out Employee People experiencing a personal crisis such as a divorce, serious illness, or death in the family often become desperate. It is worth repeating that desperate people often take desperate actions.

Employees Living above Their Means Employees living an extravagant lifestyle well above their income level are always suspicious. Money needed to fund this lifestyle had to come from somewhere!

The Employee Who Never Takes a Vacation It is unnatural and unhealthy for people never to take time off. Unfortunately, the reason for this behavior is often that they can't risk having someone else sit at their desk, look at their mail, or answer their telephone because they are hiding something.

Employees Who Are Unnaturally Compulsive about Their Job Responsibilities As in the case of the employee who never takes a vacation, employees who refuse to share their work with anyone, hide their work, or take work home could also be covering something.

Employees Experiencing Financial Difficulties People who can't meet their debts and are stretched too thin financially are always of concern. When this situation comes up, consider helping the individual by providing personal financial counseling.

Unfortunately, people sometimes find themselves in dire circumstances. Often this occurs through no fault of their own. There may be health issues, financial difficulties, layoffs, or elderly parents needing assistance. Always remember that desperate people will take desperate action.

Note: Occasionally check where people cash their paychecks. A bank or credit union is the typical place. If an employee owes money, you may see an endorsement