

How to Prevent, Deter, and Uncover Fraud

Recent studies shine a light on ways to keep fraud from your door.

By Frank Grippo and Noah Barsky, PhD

Many organizations depend on their auditors to ferret out fraud. But the purpose of an audit isn't to look for fraud. Rather, it's to see if financial statements have been presented fairly. As Table 1 shows, an external audit is low on the list of ways fraud is usually uncovered.¹

Table 1. How Fraud Is Usually Detected

Detection Method	Initial Detection of Occupational Fraud
Tip	40.2%
Management Review	15.4%
Internal Audit	13.9%
By Accident	8.3%
Account Reconciliation	6.1%
Document Reconciliation	5.2%
External Audit	4.6%
Surveillance/Monitoring	2.6%
Notified by Police	1.8%
Confession	1.0%
Information Technology Controls	0.8%

Although discovering fraud isn't their main objective, auditors do keep an eye out for warning signs of financial misconduct, such as the following:

- A culture of arrogance. Fraudulent financial reporting grows out of a culture of greed, entitlement, and excessive risk-taking.
- Accounting policies that are too aggressive or rely on the judgment of management.
- Ineffective boards or audit committees. Warning signs include irregular meetings and members with little financial experience.
- Unbalanced control over financial reporting. Control by one person or a small group of individuals contributes to the risk of fraud.
- Benchmarks that conflict with similar types of nonprofits.
- Turnover. Often a sign of problems is a pattern of terminations or resignations of key people.

- Constant financial success. It's unlikely that a nonprofit would experience continual financial success with no financial "droughts." This could be a sign that managers are manipulating numbers.
- Lack of input from employees. Managers may be so concentrated on fraudulent activity that they completely ignore comments from employees.²

A survey by the Association of Certified Fraud Examiners traced many frauds to a lack of good internal controls. Table 2 summarizes the control problems that led to fraud in the organizations studied.

Table 2: How Control Problems Contribute to Fraud

Control Weaknesses	Applicable Percentage
Lack of Internal Controls	37.8%
Override of Existing Internal Controls	19.2%
Lack of Management Review	17.9%
Poor Tone at the Top	8.4%
Lack of Competent Personnel in Oversight Roles	6.9%
Lack of Independent Checks/Audits	5.6%
Lack of Employee Fraud Education	1.9%
Lack of Clear Lines of Authority	1.9%
Lack of Reporting Mechanism	0.6%

The same survey noted common behaviors of employees who perpetrate fraud, as shown in Table 3. One of the best ways to uncover fraud is to be alert for these red flags.

The purpose of an audit isn't to look for fraud.

It's also important to understand the most common types of fraud in nonprofit organizations so you can keep a watchful eye. These are:

- Accounts payable billing schemes. An employee submits invoices for payment by fictitious vendors or for fictitious goods or services, personal purchases, or inflated amounts.

Nonprofit World • Volume 30, Number 1, January/February 2012. Published by the Society for Nonprofit Organizations
P.O. Box 510354, Livonia, Michigan 48151
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- After assessing risk, strengthen problem areas. Make necessary changes to your policies and procedures. Reinforce your value system with further communication and training. Monitor vulnerable areas closely.
- Cultivate sound internal controls and proper accountability. Require employees to rotate jobs and take regular vacations. Segregate people's duties. Authorize all transactions. Conduct regular performance reviews.
- Hire with care, taking time to verify information and perform criminal, credit, and reference checks.

When employees feel positive about their employer, there is less fraud.

3. Create an Oversight Process.

You can't prevent fraud unless you have an oversight process in place. Ways to assure effective oversight include the following:

- Be sure you have an audit committee.
- Provide ongoing anti-fraud training for all personnel. Ensure that they understand what constitutes fraud and are familiar with the organization's fraud policies.
- Be proactive in looking for fraud throughout the organization—for example, by conducting surprise audits and other nonscheduled fraud checks. Doing so will send a message that you're serious about minimizing fraud.
- Give employees easy access to support programs, including assistance with mental, legal, drug, and health problems.
- Encourage people to speak freely about issues that concern them. Conduct anonymous surveys to assess staff morale.

Require employees to rotate jobs and take regular vacations.

- Make sure employees know where to seek advice if faced with an ethical dilemma and where to report fraud.
- Set an example for the rest of the organization by performing regular self-assessments to be sure you're behaving in an honest, ethical way.

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Footnotes

¹All tables are from a survey by the Association of Certified Fraud Examiners, summarized in the "Report to the Nation on Occupational Fraud and Abuse," Austin, Texas.

²The American Institute of Certified Public Accountants (AICPA), in its *Audit Risk Alert*, identified these warning signs.

³These three elements are taken from a practice aid, "Management Anti-fraud Programs and Controls," included as an exhibit to Statement on Auditing Standards (SAS) No. 99 *Consideration of Fraud in a Financial Statement Audit*.

Seeking a Fraud-Free Organization

Use these resources (www.snpo.org/members) to continue building an environment free of fraud:

- **New Internal Control Guidance: What You Need to Know Now** (Vol. 28, No. 1)
- **Protecting your Organization against Financial Misuse** (Vol. 17, No. 4)
- **Nonprofits without Audit Committees Risk Disaster** (Vol. 22, No. 2)
- **Six Ways to Reduce Risk & Comply with the Law** (Vol. 25, No. 6)
- **The Ethics Audit: A Tool Whose Time Has Come** (Vol. 13, No. 6)
- **Building a Great Organization from Within** (Vol. 24, No. 5)

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