Common-Sense Approaches to FRAUD

AWARENESS & PREVENTION & DETECTION

Don't think that **FRAUD** occurs only in other organizations. It's better to be prepared.

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SURVEYING HEADLINES AND news stories, one is struck by the prevalence of fraud in today's environment. Statistics show that the upward trend will continue. Fraud—deliberate deceit, planned and executed with the intent to deprive another of property rights—is estimated to cost billions of dollars each year.

The issue of fraudulent activity has become more evident in nonprofit organizations because of the increased public perception that some are not properly handling their finances. Lax accounting policies, poor internal controls, and autocratic directors have been the major contributors to fraud in these organizations and have resulted in millions of dollars of abuse. In this article, we'll explain what these cases have in common—and how to be sure your organization doesn't end up the same way.

A Few Examples from the Nonprofit Fraud File

Several recent nonprofit frauds have captured everyone's attention, and their stories have been openly discussed in the media. The following details relate to these more prominent nonprofit frauds.

American Parkinson Disease Association (APDA): For 10 years, the executive director embezzled an average of $100,000 a year. He had raised millions for the charity and had an impressive list of fundraisers that included Muhammad Ali.

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A not-so temporary bank account, used 10 years previously for a fundraising walkathon, had been left open. The director had deposited several checks from donors into that account for his personal use. He was the only one who knew the account existed. After feeling guilty about his actions, he was caught when he told a staff member about the bank account.

Why did he commit fraud? He stole because he felt he

- was underpaid (his salary was approximately $110,000 per year, while other directors of similar nonprofits had annual salaries of about $200,000)
- was overworked (he spent countless hours raising funds)
- needed to maintain a high standard of living, given his stature as director.

New Era: New Era Philanthropy was a pyramid scheme that guaranteed that nonprofit organizations could double their investments in as early as six months. As in any such scheme, early participants were paid off with the proceeds of those who joined the venture later.

The scam cost investors and creditors approximately $200 million. Interestingly, New Era had contributed $15,000 to the campaign of an accountant for a state assembly. The accountant happened to be New Era's independent auditor and had earlier given New Era a clean bill of financial health just before it filed for bankruptcy.

United Way: The former chief of United Way was convicted and sentenced to seven years for having spent over $600,000 to pay for romantic getaways with his teenage girlfriend. At the time he was caught, he was 77 years old.

UNICEF:The Kenya office of UNICEF in 1993-94 lost $10 million to fraud and mismanagement that approximated 25% of its yearly budget. One million dollars was stolen and $9 million was wasted. Several employees padded expense accounts, falsified medical claims, and channeled money to phony organizations. The fraud was the worst scandal for UNICEF since its beginnings in 1946.

The Fraud Triangle

Three elements are present in every fraud:
1. perceived pressures
2. rationalization
3. perceived opportunity

Everyone experiences pressures, and everyone rationalizes. Thus, everyone is a walking-around two-thirds fraud triangle. Combining the right level of pressure and rationalization with the perceived opportunity is what allows a person to commit fraud.

The simplest way to abolish fraud, then, is to eliminate opportunity. It's not possible to do so completely, however. Therefore, an organization should follow several steps to lessen the chance of fraud. These include the following:
1. Pre-screen potential employees.
2. Talk often with current employees so you'll know when they're feeling pressured.
3. Tell employees the consequences of committing fraud.
4. Be sure management sets a good example by following the rules.
5. Establish a sound internal control system.

A System of Internal Control

It is vitally important to have a strong system of internal control. Recent studies confirm the following key facts:
- The top *detector* of fraud is *good* internal control.
- The top *cause* of fraud is *poor* internal control.

Controls may be good in theory but not in application. Many frauds occur when controls are in place but are being circumvented. Therefore, you should constantly monitor and evaluate your control system. You should also create written policies which spell out proper and improper employee behavior.

Separation of duties is a major factor in an internal control structure. Be sure to separate the following three duties:
- authorization of transactions
- custody of assets
- record-keeping related to those assets.

> *Famous last words:*
> *"We trusted her completely."*

The cardinal principle concerning controls is simple: The more liquid the assets, the more controls are needed to protect the assets from fraud. Cash is, of course, the most liquid asset. If your organization ever receives cash, it's especially vital that you establish proper internal control. Ideally, the same individual should not be responsible for receiving cash, depositing it, and handling the record-keeping (that is, reconciling the bank account and recording the accounting entries). Under no circumstances should a director be personally handling the organization's cash donations.

If your organization is so small that you can't separate duties, you should require an independent check of work being done. You can have a board member or an independent auditor perform this check.

Another way to perform an independent check is to require employees to take vacations. While one employee is gone, have someone else take over the duties and verify that no fraud has taken place.

In one recent fraud, a bookkeeper stole in the simplest way possible. She wrote checks to herself and deposited them in her own bank account. She could do so because she had authorization over transactions, kept the records, and had custody of the assets. These three duties should have been separated, but they weren't. That was the organization's first mistake. Its second mistake was that no one reviewed the bookkeeper's work. As the organization's director put it, "We trusted her completely."

Proper separation of duties will not stop all frauds. Employees in the segregated areas or even outside the organization may conspire to commit fraud. Management may override the internal control system. But having such a system in place will dramatically cut your risk.

A True Independent Reviewer

No matter what the size of your organization, your board of directors should require an audit, not just a review of your financial statements. An audit can be expensive, but it's well worth it when you consider the devastating price of fraud.

Only a certified public accountant (CPA) can perform a financial audit and express an opinion on the organization's financial statements. A professional auditor is bound by special standards. These standards don't apply if someone simply reviews your financial records. In a professional audit, the following standards apply:

- The auditor is required to assess the risk of errors and irregularities which may cause your financial statements to be materially misstated.
- Based on the level of risk, the auditor is required to design the audit to assure that material errors and irregularities are detected.

So concerned is the auditing profession about fraud that the American Institute of Certified Public Accountants (AICPA) recently issued a new auditing standard. This standard, "Consideration of Fraud in a Financial Statement Audit," describes two types of fraud:

- intentional falsification of financial statements
- theft of assets.

The standard requires auditors to assess the risk of material misstatement arising from fraud on every audit. It notes that if auditors discover fraud, they must tell appropriate levels of management, the organization's audit committee, and appropriate regulators.

What to Do If Fraud Occurs

When fraud does occurs, you must punish the offender. You may be tempted to keep it quiet so that the public won't get wind of it. But if you hide what has happened or allow the guilty employee to resign, you send a lethal message to the rest of your employees: "Go ahead and commit fraud. The worst thing that can happen is that you will be let go."

A Fraud Response Plan

The best strategy is to have a plan in place *before* fraud occurs. In your plan, describe ways to prevent fraud and procedures to follow if fraud occurs. Answer such questions as these:

> *All organizations are susceptible to fraud.*

- What is the organization's policy on fraud?
- Who should be contacted first when fraud is detected or suspected?
- What approaches should employees take to secure the organization's assets?
- What key people outside the organization may be helpful in preventing, detecting, or correcting fraud? (Examples include police, insurers, regulatory agencies, and forensic accountants.)
- What steps should be taken if fraud is detected?
- Who will act as spokesperson for the organization if a major fraud occurs?

Remember, fraud can hurt more than your bank account. It can be devastating in terms of employee morale and community reputation. When fraud occurs, it may be impossible to recover if you don't have a plan in place.

Don't take the position that fraud occurs only in other organizations. In fact, all organizations are susceptible to fraud. Fraud can never be totally eliminated, but proper actions and some common-sense approaches can reduce your risk. ■

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