

2013 Risk SUMMIT

Managing Fraud Risk: The Real Fraud Flatfoots

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Nonprofit
Risk Management
Center

Find the answer here | nonprofitrisk.org

Topics

- Objectives
- What is occupational fraud?
- Fraud myths
- Who commits it and why?
- How is it uncovered?
- What are the major risk factors?
- Countermeasures - Internal Controls and Risk Management

Objectives

- Understand the extent and types of occupational fraud in nonprofit environments
- Create awareness of the impact and importance to the organization
- Become knowledgeable about the key risk factors
- Learn essential practices to prevent, detect and mitigate it

What is occupational fraud?

- “Fraud is the dysentery of crime: even after the infection is contained, the unpleasant after-effects linger interminably.”

-Jed Rakoff (Federal Judge - NY District Court)

What is occupational fraud?

- The use of one's occupation for the personal enrichment through the misuse or misapplication of the employing organization's resources or assets"
 - Fraud against the organization (misappropriation of assets)
 - By far the most common reported for non-profits > 94 % of all cases
 - Fraud by the organization against its stakeholders (misstating financial statements)
 - Biggest loss impact but far less common: < 6% of all cases

Fraud Myths

- Fraud only happens in big companies or organizations
- Our Controller, is a respected elder, community leader and family man who would never steal from our nonprofit organization
- Our bookkeeper for the last 20 years is like family and would never steal!
 - 54% of perpetrators had tenures of > 6 yrs. \$26% > 10 yrs!
... Long enough to understand where the control gaps are
- Our nonprofit organization is audited every year, and if our employees are stealing our auditors will detect it

The Non Profit Industry

- Organizations - 1.9 Million
- Employees (*) - 13 Million
- Revenues - \$1.1 Trillion
- Fraud Losses - \$85 Billion

(*) Not Including Volunteers

Source: GuideStar & ACFE estimate, U.S.

Nonprofits Include

- Churches, Synagogues, and Mosques
- Homeless Shelters
- Social Service Agencies
- Recipients of Federal Funds
- Colleges and Universities
- Private and Parochial Schools
- Clinics, Hospitals, Health Care Providers
- Sports Clubs and Associations
- Non-Governmental Disaster Relief Agencies
- Cultural and Art Institutions
- Museums and Historical Societies
- Aviaries, Zoos, and Science Centers
- Symphonies, Ballets, and Theater Groups
- Charities
- Foundations and Supporting Organizations
- Certain Trusts, Donor-Advised Funds, and Community Funds

Impact of Occupational Fraud

- Typical organization loses 5% of its revenues to fraud
- This figure translates to a potential projected global fraud loss of more than \$3.5 trillion. (based on global world output)
- The median loss caused by the occupational fraud cases was \$140,000. **\$100,00 for NP's**. More than one-fifth of all cases saw losses of at least \$1 million
- The frauds lasted a median of 18 months before being detected!

Impact – Not Just the Dollars Lost

Reputational Risk

- Negative publicity
- Poor financial stewardship! – lack of confidence in NP governance
- Jeopardizes ability to secure future funds for vital programs – directly/indirectly
- Attracting/retaining key management and staff
- Cost of investigation and litigation
- Loss of vendors, customers, clients, contractors, volunteers
- Employee morale
- Damages ability to satisfy mission!

Fraud - Most Common Types

- Disbursements - fraudulent invoices or employee expenses
- Employees fraudulently writing or altering company checks
- Misuse of company credit cards
- Revenue skimming

Other Variations Include:

- Payroll Schemes
- Undisclosed Conflicts of Interest/Corruption
- Misuse of Grants and/or Sub-recipient Funds
- Deceptive Fundraising Practices

What can happen - *ultimately?*

Disabilities Services NP: Exec Dir- charged on 14 felony counts:

- \$21K missing funds from an bank account
- Writing bogus expense reimbursement checks to self
- \$45K of payroll taxes unpaid to IRS
- Processing pay increase for herself without approval

Results:

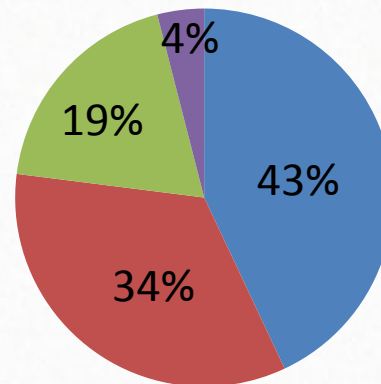
- \$500K+ contract pulled by state
- Board members resigned – board disbanded
- Office closed!

Who commits fraud?

- A long-time employee, the bookkeeper, defrauded the organization of more than \$1 million over eight years. She committed the theft by issuing unauthorized pay increases and bonus payments to herself, as well as tampering with checks
- An employee defrauded a large cultural organization of \$1.4 million by submitting invoices for unrelated services over 5 years
- A veteran program manager at a human services, direct care provider, was responsible for theft of over \$5,000 of program funds, and \$16,000 of client funds under their management over a 1 year period

Who commmits fraud?

- Most occupational fraudsters are first-time offenders with clean employment histories
 - *Approximately 87% of occupational fraudsters had never been charged or convicted of a fraud related offense*

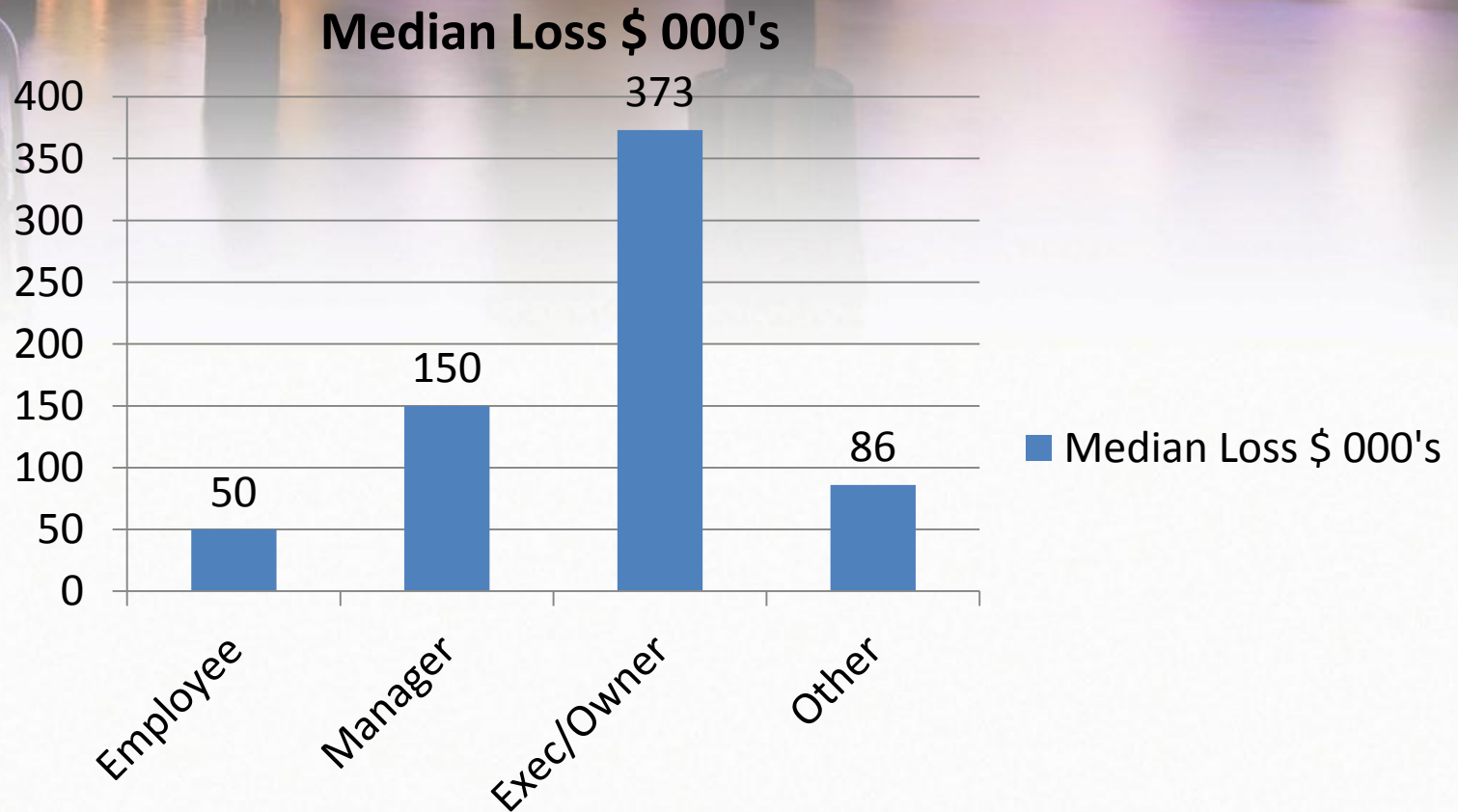


Perpetrator

■ Employee

■ Manager

Who commits fraud?



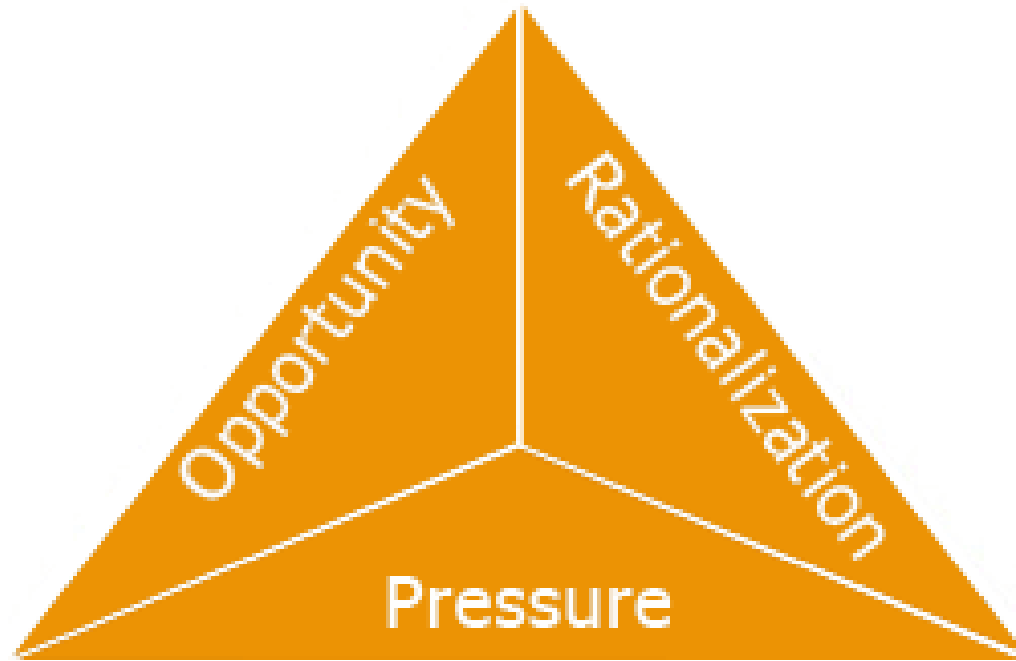
Source: ACFE

Other fraud examples

Organization	Fraud	Perpetrator
Private High School	\$900,000	Principal
Museum	\$3,000,000	President
Charity	\$1,200,000	President
Church National Office	\$2,200,000	Treasurer
College	\$300,000	AP Supervisor
Professional Org.	\$214,000	CFO
Town Little League	\$6,000	Treasurer
Charity	\$100,000	Executive Director
Addiction & Treatment Services Agency	\$10,000	Employee

The scope is broad, spans all types of organizations and employee levels, and loss range is wide!

The Fraud Triangle



D. Cressey

The Fraud Triangle Components

- Motive (or pressure) – the need for committing fraud (need for money, etc.)
- Rationalization – the mindset of the fraudster that justifies them to commit fraud
- Opportunity – the situation that enables fraud to occur (often when internal controls are weak or nonexistent).
- Of the three elements, removal of Opportunity is most directly affected by the system of internal controls and generally provides the most actionable route to deterrence of fraud.

Motivations and Pressures

- Medical problems—especially of a loved one
- Unreasonable performance goals
- Spouse loses a job
- Divorce
- Criminal conviction
- Civil lawsuit
- Purchase of a new home, a second home, home remodel
- Excessive gambling
- Drug or alcohol addiction
- Living Beyond One's Means
- Unexpected Financial Needs
- High Bills or Personal Debt
- Personal Financial Losses
- Gambling and/or Drug Addictions
- Failing Marriages/Multiple Partners
- Failing Health Needs
- Poor Credit
- Employees declining to take extended time off

Rationalizations

- Committing the fraud is justified to save a family member or loved one
- Belief that they will lose everything—family, home, car—if they do not commit the fraud
- Belief that no help is available
- Views theft as “borrowing” and fully intends to pay the stolen money back at some point
- Due to job dissatisfaction (salaries, job environment, treatment by managers), believes that something is owed to him/her
- Inability to understand or does not care about the consequences of their actions or of accepted notions of decency and trust

Red Flags

Common personality traits:

- Wheeler and dealer
- Domineering/controlling
- Resists people reviewing their work
- Strong desire for personal gain
- Has a “beat the system” attitude
- Lives beyond their means
- Close relationship with vendors
- Unable to relax
- Often has a “too good to be true” work performance
- Doesn’t take vacation or sick time
- Often works excessive overtime
- Displays a drastic change in personality or behavior

Changes in Behavior

- Sudden spending spree
- Brags about new purchases
- Carries unusual amounts of cash
- Creditors/bill collectors call/show up at work
- Borrows money from coworkers
- Becomes unreasonably upset when questioned
- Turns down promotions
- Irritable or moody
- Mentions family/financial problems

Why does fraud occur in a Nonprofit Environment?

- Climate of trust by virtue of being a “nonprofit”, especially in financial personnel
- Often place excessive control in their President or Executive Director, leaving tipsters feeling there’s no one they can report unusual events to
- Focus on the mission to the exclusion of administrative systems
- Internal controls and financial oversight – don’t want to invest here
- Limited or no segregation of duties – lack of internal controls
- High staff turnover or understaffing

Other Factors

- Frequently have an all-volunteer Board of Directors with little or no financial expertise or control consciousness
- Failure of the Board to challenge top management or Executive Director
- May have non-reciprocal transactions, such as charitable contributions
- Can have large amounts of cash flow from donations, fundraisers, etc.
- Often lack financial benchmarks, variance, or other ratio analysis
- Highly susceptible to the effects of negative publicity and, therefore, reluctant to report, or even discuss fraud.

How is Fraud Uncovered?

- Frauds are much more likely to be detected by tips than by any other method! 43%
- Next most common methods, management review 15%, internal audit, 14%, and “accident”, 7%
- Source of tips: employees or anonymous 63%!, customers 22%, and vendors 12%
- *Organizations with some form of hotline in place saw a much higher likelihood that a fraud would be detected by a tip (51%) than organizations without such a hotline (35%).*
- External Auditors uncover fraud only about 3% of the time!

Antifraud Practices & Internal Controls

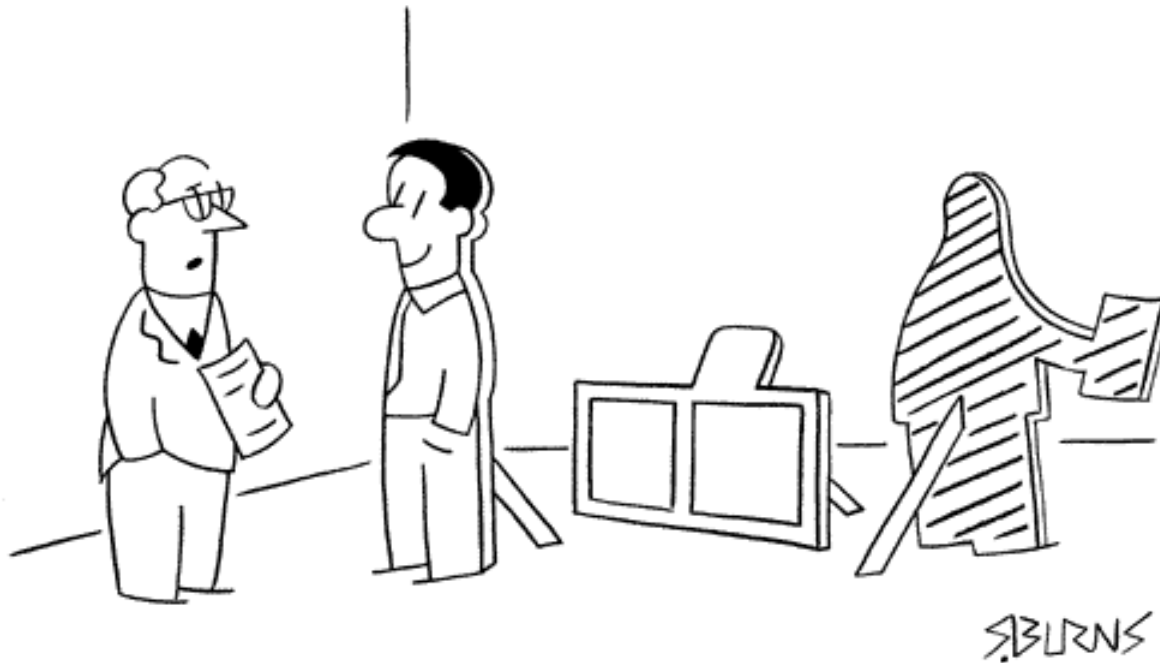
“Somebody is doing something today ... that you and I would be unhappy about if we knew of it. That’s inevitable: ... the chances of ... getting through the day without any bad behavior occurring is nil. **But we can have a huge effect in minimizing such activities by jumping on anything immediately when there is the slightest odor of impropriety.** Your attitude on such matters, expressed by behavior as well as words, will be the most important factor in how the culture of your business develops. **Culture, more than rule books, determines how an organization behaves”**

- Warren Buffett

Controls

- **Entity Level, preventive or detective**
 - **Entity level** are soft controls - controls that have a pervasive effect on an organization's internal control – **the tone at the top: values**
 - Entity level controls relate to integrity, ethical values and behaviors of key managers and the board
 - Values of an organization – expressed through **codified policies and procedures**
 - Influences the ability or likelihood of a company to engage in or avoid fraud

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**"We've had some reports of fraud in this department, Milby.
Know anything about it?"**

Entity Level – “Tone at the Top”

- Whistleblower policy & mechanism
 - Anonymous, non-retaliation & independent
- Code of ethics, anti-fraud, and conflict of interest policies
- Fraud awareness training, behavioral red flags and options for reporting fraud
- Background and credit checks
- Management/Board reviews of financial reports
- *Organizations lacking these controls experienced a 45% higher median loss!*

Preventive Controls

- Establish adequate segregation of duties
- Signature Authorities and thresholds policy
- Require at least 2 signatures on (higher) \$ checks
- Review of adds/changes to AP vendor master
- Review of payroll add/change report (ee's, pay rates)
- Separate approval of all expense reports with receipts and business purpose documented
- Review & approve credit card purchases
- Require employees take vacations
- Limit accounting and banking system access

Segregation of Duties Matrix

- For cash receipts, purchases, disbursements. Look at who:
 - Processes transaction
 - Authorizes/approves
 - Receives/custody
 - Records
 - Reconciles (Account)
- Eliminate conflicting responsibilities, or if not possible, diligent secondary reviews

Detective Controls

- Bank reconciliations
- Blank check stock secured
- GL account reconciliations and review
- Independent review of bank accounts and cancelled checks
- Results, variance analysis; follow-up
- Behavioral “red flags”
- Investigate all tips timely
- Spot audits!

Other Risk Management Measures

- Risk assessments
- Finance & accounting policy and procedures
- Accounting & financial systems with stronger application controls and reporting
- Terminate and prosecute offenders
- Board member with a financial background and understanding of internal control practices
- Employee dishonesty and theft insurance

Other Considerations: Dispersed programs

For those program with cash managed in the field, e.g. human services agencies – client funds, SSI

- Be wary of high risk factors:
 - vacancies and staff turnover (Kroll/Economist report)
 - vulnerable client populations
- Confirm that policies, procedures are observed; controls are operating effectively – spot audits!

Other Considerations

- For those organizations with a purchasing card program or other organization credit cards:
 - Sound policies including documentation
 - Appropriate card purchasing limits
 - Manager transaction review & approval process
 - Central monitoring of transactions
 - Spot Audit!

So ... Why do all this?

“... The central mission of compliance needs to be maintaining and developing a well-founded and enduring business.”

- Global Fraud Report , Kroll Advisory Unit -2011

Trust, but verify.

Ronald Reagan



Summary

- Be aware of the components of the fraud triangle
 - *motivation, rationalization, opportunity*
- Develop risk assessment; where are you highly exposed? business processes, systems, central, field programs, personnel
- Implement effective controls: entity level, preventive, detective
- *Verify*: reviews & internal audits

“There are risks and costs to a program of action. But they are far less than the long-range risks and costs of comfortable inaction.”

-John F. Kennedy (1917-1963), President of the USA

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Questions or Thoughts?
Thank You!

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