

## Checks and Balances: What Associations Need to Be Safe

### Avoiding Trouble While Doing Good

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Director of Finance  
American Speech-Language-Hearing  
Association

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## Agenda

- Group Check
- What is Fraud?
- Examples of Fraud
- What do we need to know?
- What we can do to reduce Fraud?
- Questions and Discussion

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## Group Check: How many state associations have

- no professional staff?
- Less than 1?
- 1 to 3?
- Over 3?
- Outsource some or all administrative  
functions?

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Rename presentation:  
**Checks and Balances:**

- Why Associations Need to Be Vigilant!

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Miriam-Webster's *Dictionary of Law*

- Fraud: any act, expression, omission, or concealment calculated to deceive another to his or her disadvantage

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*The American Dictionary of the English Language*

- Fraud: A deception deliberately practiced in order to secure unfair or unlawful gain; a piece of trickery; a swindle; a cheat; one who assumes a false pose; an imposter; a sham

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*Microsoft Thesaurus*

- Fraud: deception, scam, con, scheme, swindle, racket, hoax, smoke and mirrors

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**Misconduct and Dishonesty**  
includes but is not limited to:

- theft or other misappropriation of assets
- misstatements and other irregularities in company records
- Wrongdoing
- forgery or other alteration of documents
- misapplication of funds or assets
- impropriety with respect to reporting financial transactions
- destruction or disappearance of records or assets

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A language has many words to describe that which is commonly found

- The Intuits have over 150 words for snow, but few for "car"
- Think how many words are in the English language to describe fraud.

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Recent For-Profit Frauds  
Hall of Shame



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Enron

Andrew Fastow    Kenneth Lay    Jeffrey Skilling



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Richard M. Scrushy  
(HealthSouth)



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## Bernie Ebbers (WorldCom)



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## The Not-for-Profit Sector as a Target of Fraud

- \$665 billion in revenue
- 9% of all workers are employed within the sector (nearly 12M people)
- 65 M volunteers

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## Volunteer Boards

- May bring a significant amount of valuable experience to the organization, but often have limited financial backgrounds
- Results in reliance on the executive director, controller or accounting supervisor to make the board aware of any financial concerns

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### Why Small Organizations are Especially Vulnerable to Fraud

- The person responsible for collecting and disbursing funds is also the individual who provides the financial reports
- Many small organizations raise much of their funds in cash. Cash is more easily misappropriated than checks

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### Financial Restraints

- It can be very difficult to adequately segregate incompatible financial functions, such as purchasing and payments
- supervision and monitoring activities are often limited

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### Not-for-Profit Culture

- The culture in a not-for-profit is one of trust

“It won’t come up....”  
*The Carrot Seed, Ruth Krauss*



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### Not-for-Profit Culture, cont.

- This trusting environment is what a dishonest employee exploits

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### In a 2006 study of occupational fraud cases

- 13.9% of all frauds occurred in the not-for-profit sector

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### Not-for-Profit Fraud Losses

- Not-for-profits have the second highest median loss (\$100,000 per fraud occurrence) of the organizations studied
- 45.8% of the frauds occurred in organizations with fewer than 100 employees, with a median loss of \$98,000.

*Report to the Nation on Occupational Fraud and Abuse*  
Association of Certified Fraud Examiners

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### Duration of Fraud Schemes

- Median length of time before discovery = 18 months
- More than 13% lasted 5 years or more
- Only 3.4 % detected within one month

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### The Impact of Fraud may include:

- the actual financial loss incurred
- cost of investigation
- Cost of Litigation
- damage to the reputation of organization and employees

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### Impact of Fraud, cont.

- loss of customers
- damaged relationships with contractors and suppliers
- damaged employee morale
- loss of employees
- negative publicity

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## Fear of Negative Publicity

- Charities have a strong motivation to keep stories involving theft, embezzlement, and mismanagement of charitable funds off the front pages
- Fear of effecting future contributions and grants..

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## Group Check: How many state associations have experienced a fraud?

- How many organizations think you may be vulnerable for a fraud?
- How many state associations are "pretty sure" a fraud cannot occur in their organizations?
- How many are certain you are "fraud-proof"?

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## Not-for-Profit Frauds

- Ripped from the headlines



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### Salvation Army

- The onetime financial manager for the charity's Newark office was sentenced to 37 months in prison for stealing \$385,000 from the Salvation Army

*Newark Star-Ledger, November 7, 2006.*

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### Orange County Arts Center Embezzler Sentenced

- An employee of the Orange County Performing Arts Center was sentenced to 10 years in prison for embezzling \$1.85 million
- The scheme was perpetrated over a five-year period, with the bulk of the proceeds being used to finance the employee's gambling activities.

*LA Times, Mar. 28, 2006.*

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### Red Cross Quietly Settles Case of a \$120,000 Theft

- The Connecticut chapter of the American Red Cross settled for less than half the money stolen
- Payment from its insurance company
- Rather than pursue the full amount through litigation
- Wanted to avoid the bad publicity that would come with litigation.

*April 28, 2006*

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## FBI

- More than 2,000 of the internet sites seeking contributions for Katrina relief were fraudulent

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## Good Judgment

Comes from Experience;

## Experience

Comes from Bad Judgment

*The Blind Assassin, Margaret Atwood*

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David F. Durenberger  
(United States Senator from  
Minnesota 1978 - 1995)



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## American Speech-Language-Hearing Association

- Yes, it has happened to us too

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## Asset Misappropriation

- the most common form of not-for-profit fraud (97%); 95% in cash
  - Skimming – stolen before it is recorded
  - Larceny – stolen after it is recorded
  - Fraudulent disbursements – entity pays an expense it does not owe

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## ASHA Mailroom

- Skimming – taking checks from envelopes, changing the payee name
  - Mailroom Temps

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## ASHA Travel Disbursements

- Larceny – stolen after it was disbursed
  - Accommodated a staffer's expressed financial need
  - Allowed exception to travel documentation policy

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## Credit Card and Expense Reimbursement

- Fraudulent disbursements
  - Affiliated entity
  - Submitted reimbursement requests (with receipts) for amounts already charged to corporate credit card
  - Charged personal items to corporate credit card

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## And those are just a few of the ways of fraud.....

- "Let me count the additional [sic] ways..."

Elizabeth Barrett Browning

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## #1 Cause of Fraud in Not-for-Profits: Fraudulent Billing

Billing schemes (submitting or altering an invoice) causing a check to be written

- fictitious vendor
- collusion with a dishonest vendor
- Payroll - overstated hours or ghost employees

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## Fraudulent Financial Statements



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## Fraudulent Financial Statements

- Financial Statement Fraud is least common (5%)
- But it generates the most substantial loss
- Median loss = 30x asset theft

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**Before we can talk more about this**

Here is

**A Brief Introduction to Financial Statements**

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**Financial Statements**

- A not-for-profit's financial performance and status are captured in 3 primary statements:
  - Statement of Activity (Income Statement)
  - Statement of Financial Position (Balance Sheet)
  - Statement of Cash Flows

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**Income Statement:**

- measures financial performance (over a period of time)
  - Revenue
  - Expense
  - Net Income (loss)

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### Income Statement: Revenue

- Earned as a result of providing goods or services
- Examples: Dues, Convention registration
- Also, Investment Income

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### Income Statement: Expense

- Incurred as a result of consuming goods or using services
- Examples: Personnel, Travel, Supplies, Services, Rent, and Utilities

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### Income Statement: Net Income (loss)

+ Revenue  
- Expense  
= Net Income (loss)

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## Balance Sheet: Financial Position

- At a point in time
- Assets
- Liabilities
- Net Assets

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## Balance Sheet: Assets

- Something of value owned by or owed to the entity
- Provides future benefit to the entity
- Examples:
  - Cash, Accounts Receivable, Prepaid expenses, Investments, Land, Building, and Equipment

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## Balance Sheet: Liabilities

- Obligations of the entity
- A promise to pay in the future
  - Examples: Accounts Payable, Mortgage Payable
- or, a promise to provide goods or services in the future
  - Examples: Deferred Dues, Deferred Subscription Revenue

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## Balance Sheet: Net Assets

+ Assets  
- Liabilities  
= Net Assets,  
*aka "Net Worth"*

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## Financial Statement Misstatement (Fraud)

- overstating revenue (largest losses)
- understating liabilities or expenses
- recognizing revenue or expense in the wrong period
- reporting assets at more or less than the actual value
- failing to disclose significant information

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## Franklin Raines (Fannie Mae)



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## Corruption

- The wrongful use of influence in a business transaction to procure benefits for one's self or others at the expense of one's employer.
  - Bribes - cash is paid to aid in the fraud
  - Rewards – improper gifts given/received after the fraud
  - Extortion – asset obtained by force of the threat of force
  - Conflicts of Interest – one party to the transaction is not independent

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## United Way of America

- William Aramony 
- Scandal involving fraud, embezzlement, sexual affairs, and executive arrogance
- Unrelated for-profit subsidiaries established to be run by his son (related party)

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## United Way of the National Capital Area

- Former CEO Oral Suer
- Defrauded organization of \$1.6 M
- Misreported expenses such as billing private travel to his company
- Drew retirement benefits while he was still working there

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## United Way of the National Capital Area

- The charity initially denied the questionable practices and ousted employees and board members who pushed for an investigation



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## United Way of the National Capital Area

- Impact of Negative Publicity

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## Who is a fraudster?

- Larger not-for-profit employee frauds are correlated with collusion (multiple perpetrators), higher salaries, age, longer tenure, educational level
- >25% of frauds committed by managers; 8.6% executives
- Median fraud case resulted in loss of <\$50K, committed by a female with no criminal record, who earned less than \$50k per year, had worked for the org at least 3 years.

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## Why Do They Do It?

- "Honesty pays, but it don't seem to pay enough to suit a lot of people." -

*Kin Hubbard*

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## Why Do They Do IT?

- GONE Theory
  - Greed
  - Opportunity
  - Need
  - Expectation of not being caught

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## Why Do They Do It?

- Fraudsters do not expect to be caught - they generally do not view themselves as criminals.
- Rationalization
  - They're not really stealing
  - Reassure themselves because they have every intention of paying back their ill-gotten gains

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## Why Do They Do IT?

- Financial problems, possibly due to marriage breakdown or heavy debt load
- Delusions of grandeur
- An inflated ego
- A craving for success
- A compulsion, such as gambling or substance abuse problems.

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## Why Do They Do It?

- In some instances they convince themselves that they deserve, and are in fact justified in taking, whatever they can get their hands on
- An unrealized promotion, a salary level below current market rates or expectations, or feelings of being unappreciated may create a fertile environment for this sort of reasoning.




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## Warning Signs

- Material related-party transactions
- High turnover in key accounting positions
- Inadequate segregation of duties
- Personal financial difficulty of management and/or staff

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## Warning Signs, cont.

- Management's reluctance to provide periodic financial reports, clear explanations
- Reluctance to take vacations
- Living beyond one's means
- Sudden mood swings or personality changes
- Inability to keep up with regular work responsibilities

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## Internal Control Policies and Procedures

- **Goals**
  - Prevention
  - Detection
  - Response

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## Control Environment (tone at the top)

- Information and communication
- Training
- Conflict of interest policy
- Code of ethics policy
- Whistle blowing policy
- Fraud Policy
- Prohibition on personal loans to board members and not-for-profit executives

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## Risk Assessment

- Management fraud/Management override of controls
- Fidelity Bond (insurance)
  - covered organizations recovered about 57% of their losses

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## Control Activities – Deterrents

- Competence of personnel
- clearly defined roles and responsibilities
- Execution in accordance with authorization

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## Most Important Organizational Characteristics Where Loss Was Suffered

- Lack of proper procedures for authorization of transactions.
- lack of enforcement of clear lines of authority

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### Controls, cont.

- Segregation of duties
- Background checks on new financial personnel
- Background checks on those with responsibility/authority for purchasing or receiving assets

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### Controls, cont.

- Control over receipts – consider lockbox
- Endorsement stamps spelling out full name of organization
- Outsource payroll

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### Controls, checks

- Proper and adequate documentation for disbursements
- Ensure that original documentation is made void
  - to prevent against duplicate payments
- Check stock control

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## Controls, checks

- Check number control
- Examine for pre-numbering of documents
- Use checks in sequential order
- Prevent erasure alterations

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## Controls, cont.

- Prompt bank reconciliation by other than AR or AP
- Physical safeguards
- Mandatory vacation policies
- Internal and/or Annual independent audits (admittedly impractical for small orgs)

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## Compensating Controls

- Cross training
- Checks signed by officer
- Positive Pay

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**Compensating Controls, cont.**

- Bank statements sent to officer and opened promptly (also deterrent)
- Bank reconciliations performed promptly

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**Compensating Controls, cont.**

- Budgets and Budget analysis
  - if we didn't meet expectations, why not?

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**Response**

- internal investigation protocols
- enforcement and accountability
- remedial action protocols
  - no action – more and higher fraud

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## Fiduciary Responsibilities

- .....Fiduciaries have discretionary authority over another's money, property, or other assets, and a legal duty to act in a manner that benefits the other person, or organization.

Kilpatrick Stockton LLP

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## Fiduciary Responsibility of Board Members

- Monitoring
  - What financial statements to ask for
  - What do the statements mean?
- Financial analysis
- Ratio analysis

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## Group Check Revisited

- How many organizations think you may be vulnerable for a fraud?
- How many state associations are "pretty sure" a fraud cannot occur in their organizations?
- How many are certain you are "fraud-proof"?

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## How Can I Start to Deter Fraud?

(we don't have much \$)



- Checks signed by Officer
- Bank Statements to Officer
- Periodic financial statement preparation and review
- Budget and budget comparisons

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## We Want to Invest in More Control; What Else Can We Do?

- Lockbox
- Positive pay
- Outsource Payroll
- Separation of responsibilities

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## Questions and Discussion

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## Resources

- Board Source  
<http://www.boardsource.org>
- Independent Sector  
<http://www.independentsector.org>
- National Council of not-for-profit Associations  
<http://www.ncna.org>
- Grant Thornton LLP  
<http://www.grantthornton.com>
- KPMG International  
<http://kpmg.com>
- American Institute of Certified Public Accountants  
<http://AICPA.org>

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