Checks and Balances: What Associations Need to Be Safe

Avoiding Trouble While Doing Good

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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

Group Check: How many state associations have

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

- Why Associations Need to Be Vigilant!

Miriam-Webster’s Dictionary of Law

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

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

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

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.
Recent For-Profit Frauds
Hall of Shame

Enron
Andrew Fastow  Kenneth Lay  Jeffrey Skilling

Richard M. Scrushy
(HealthSouth)
Bernie Ebbers (WorldCom)

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

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
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

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

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*
Not-for-Profit Culture, cont.

• This trusting environment is what a dishonest employee exploits

In a 2006 study of occupational fraud cases

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

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
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

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

Impact of Fraud, cont.

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

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”?

Not-for-Profit Frauds

• Ripped from the headlines
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


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.


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
FBI

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

Good Judgment

Comes from Experience;

Experience

Comes from Bad Judgment

The Blind Assassin, Margaret Atwood

David F. Durenberger
(United States Senator from Minnesota 1978 - 1995)
American Speech-Language-Hearing Association

- Yes, it has happened to us too

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

ASHA Mailroom

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

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

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

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

• “Let me count the additional [sic] ways...”

Elizabeth Barrett Browning
#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

Fraudulent Financial Statements

- Financial Statement Fraud is least common (5%)
- But it generates the most substantial loss
- Median loss = 30x asset theft
Before we can talk more about this

Here is

A Brief Introduction to Financial Statements

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

Income Statement:

- measures financial performance (over a period of time)
  - Revenue
  - Expense
  - Net Income (loss)
Income Statement: Revenue
- Earned as a result of providing goods or services
- Examples: Dues, Convention registration
- Also, Investment Income

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

Income Statement: Net Income (loss)
+ Revenue
- Expense
= Net Income (loss)
Balance Sheet: Financial Position

• At a point in time

• Assets
• Liabilities
• Net Assets

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

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
Balance Sheet: Net Assets

+ Assets
- Liabilities
= Net Assets,  
_aka “Net Worth”_

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

Franklin Raines (Fannie Mae)
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

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)

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
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.

United Way of the National Capital Area

- Impact of Negative Publicity

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.
Why Do They Do It?

• “Honesty pays, but it don't seem to pay enough to suit a lot of people.” - Kin Hubbard

Why Do They Do It?

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

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
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.

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.

Warning Signs

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

Internal Control Policies and Procedures

- Goals
  - Prevention
  - Detection
  - Response

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
Risk Assessment

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

Control Activities – Deterrents

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

Most Important Organizational Characteristics Where Loss Was Suffered

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

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

Controls, cont.

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

Controls, checks

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

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

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)

Compensating Controls

- Cross training
- Checks signed by officer
- Positive Pay
Compensating Controls, cont.

• Bank statements sent to officer and opened promptly (also deterrent)

• Bank reconciliations performed promptly

Compensating Controls, cont.

• Budgets and Budget analysis

  • if we didn’t meet expectations, why not?

Response

• internal investigation protocols

• enforcement and accountability

• remedial action protocols
  • no action – more and higher fraud
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

Fiduciary Responsibility of Board Members

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

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"?
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

We Want to Invest in More Control; What Else Can We Do?
• Lockbox
• Positive pay
• Outsource Payroll
• Separation of responsibilities

Questions and Discussion
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