Preventing Fraud

This brief from the Nonprofit Risk Management Center focuses on fraud and internal controls nonprofits can use to prevent fraud.

A November 1996 headline in the **Wall Street Journal** proclaimed "A Nonprofit Hospital Finds Its Executives Were Making the Profit." The subtitles of the article were equally disturbing: "Board Wakes Up to Theft, Insider Self-Dealing - And Missing X-Ray Silver" and "Growing Problem, IRS Says." Some nonprofit readers may have dismissed the above account as indicative of the culture in a big-city hospital.

If you share this view, consider the recent report from a former executive director of a cultural agency who was dismissed after she discovered that her financial manager had embezzled $90,000 of the proceeds from a capital campaign and used the money to fund a gambling habit. The employee owned up to the theft when he realized he was about to be discovered by the newly appointed independent auditor. Large and small - every nonprofit organization is vulnerable to fraud.

What are the Financial and Other Consequences of Fraud?

For nonprofit organizations, the consequences of fraud are severe - ranging from a cash flow crunch and loss of donor confidence and support in the cultural organization cited above to the loss of 300 jobs in the nonprofit hospital example. According to Robert Hailstone at Australia’s Criminal Justice Commission, the true costs of workplace crime in Australia will run $10 billion in 1996. Hailstone also reports that fraud accounts for two-thirds of all crime. The total cost of fraud perpetrated by employees in the U.S. may be as much as 30 times greater than Australia’s figures.

Given the magnitude of the problem, why do we tolerate fraud and what special obligations do nonprofit managers have to curtail fraud in their agencies? While the total economic impact of lost funds and missing supplies may be similar in the nonprofit and for-profit sectors, the real effect on a nonprofit’s ability to function may be much more severe. After all, nonprofits are generally more vulnerable to fluctuations in income streams or other assets. If your agency is like most nonprofits, a single major theft of funds or equipment could seriously jeopardize your operations. The public reporting of a loss could be devastating as media reports impact donations, the availability of volunteers, and public goodwill.

What Can Every Nonprofit Do to Prevent Fraud?

Practice risk management. Practicing risk management is one strategy to minimize the likelihood of fraud - and reduce the potential for lost assets, bad publicity, legal liability, and IRS scrutiny. Risk management is an approach to strengthening an agency’s operations by acknowledging and controlling risk. With risk management tools in hand, you can anticipate losses and take measures to prevent them from occurring, reduce the extent of damage or injury when a loss is unavoidable, and, because no organization can control everything, finance losses when they do occur. Risk management includes the four strategies summarized below:

* **Avoidance.** A nonprofit can avoid some risks by never undertaking a high-risk activity in the first place, or by eliminating it from your operations. For instance, a nonprofit may decide not to sponsor a benefit concert that requires an up-front cash outlay of $50,000 or to forego a contribution of a parcel of land that may contain a toxic waste dump.
* **Prevention/Risk Reduction.** A nonprofit can eliminate or reduce risk by modifying the nature of an activity. For instance, an organization can adopt policies that enable it to detect applicants with

inappropriate criminal backgrounds, limit the number of people authorized to incur debt, and segregate duties so that one person cannot manage every stage of a financial transaction.

* **Transfer.** A nonprofit can delegate an activity or its inherent financial risk to someone else. For instance, consider retaining an accounting service to administer your payroll, transfer to the payroll service responsibility for paying taxes, issuing payroll checks, and complying with applicable tax withholding laws, and require the service to indemnify the organization for losses caused by their failure to fulfill these responsibilities.
* **Retention.** Risk not otherwise addressed is retained. Retention by default is a common, though rarely advisable, practice. As a deliberate risk management choice, retention makes sense (a) for small losses that will not unduly disrupt operations or affect the nonprofit's financial base, or (b) when it is combined with other risk management tools. For example, a nonprofit may want to keep pre-numbered petty cash vouchers in a locked drawer to track the use of funds and to prevent theft (risk reduction), buy a crime insurance policy to reimburse the nonprofit for financial loss (transfer), and reduce the annual insurance premium by choosing a large deductible (retention).

Implement accounting controls. Establishing internal controls requires more focus than money. By taking time to pay attention, your agency can (a) create an environment hostile to fraud, (b) improve the trustworthiness of staff, and (c) detect theft and financial losses before they cripple your operations and undermine your mission. Accounting controls are one facet of internal controls and generally concern one or more of the following areas:

* Authorization and Approval. Limit the number of people with decision-making authority for financial transactions, and adopt a procedure for the approval of all financial transactions. Such controls ensure that transactions conform to the nonprofit's mission and management's intentions.
* Proper Documentation. Establish accounting routines to ensure that transactions are recorded correctly and to minimize the likelihood of fictitious transactions.
* Physical Security. Control physical access, as well as indirect access through documents or computers, to money, securities, and valuable property.
* Early Detection. Establish a safety net so if someone overrides or disregards your internal controls, your can quickly detect and correct the breach.

What Other Steps are Important in Preventing Fraud?

Next to controls, the single most effective strategy for preventing fraud is creating an environment that is "hostile" to fraud. This strategy begins with a commitment by the your agency to:

* Define acceptable and unacceptable activities. The pervasiveness of workplace crime highlights the need to define for your employees acceptable versus unacceptable practices. Is the use of the agency's postage meter for personal mail acceptable? May an employee round up or estimate expenses incurred on an out-of-town trip, or are receipts required? High performing staff know what is expected of them. Since the "rules" differ widely from one agency to the next, defining what is acceptable is necessary before enforcement begins.
* Fully investigate suspected fraud. The second building block in the process is the commitment to fully investigate all suspected fraud. Potential offenders must understand that their actions will be subject to intense scrutiny and that, when appropriate, evidence concerning the fraud will be turned over the appropriate authorities.
* Treat offenders in a consistent manner. The final component of the process required to create an environment hostile to fraud is the commitment to treat alleged and proven offenders in a consistent manner. As in the management of personnel policies, consistency is critical to the effectiveness of your efforts to prevent fraud. If an employee believes that theft of office materials will be overlooked because of his position in the agency or contributions to the organization's income stream, your environment will

support and not deter fraud. Suspected theft should be subject to the agency's investigation procedure - regardless of the position or contributions of the individual involved.

The subjects of fraud and internal controls are explored in Healthy Nonprofits: Conserving Scarce Resources Through Effective Internal Controls, published by the Nonprofit Risk Management Center.

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