

Fraud can be a painful experience – especially when you are a volunteer and you have told everyone that you have the business background to properly manage the organization. Understanding how such situations can occur can help you avoid a similar disaster.



Fraud: A Not-for-Profit Nightmare

by Margaret Swanton

Jack was a business executive who wanted to “give something back” to his community. In mid-2003, he became the volunteer president of a small not-for-profit organization. He promised to bring business-like procedures and internal controls to the organization. Many people at Jack’s organization believed that internal controls were not needed; they believed that no one would take advantage of their not-for-profit. Unfortunately, during Jack’s term as president, the organization was defrauded out of as much as \$20,000 – about 10% of the organization’s annual revenues.

For most of his two-year term, Jack thought the he was doing exactly what he had promised. However, in December of 2004, Lucy, the organization’s new paid administrator handed him copies of seven checks and the corresponding check stubs. The check stubs showed that they had been paid to various vendors but the checks were paid to Eric, the organization’s previous administrator. Jack was shocked; he had signed each of those checks but knew that he had not signed any checks to Eric.

At the same time, Sam, the organization’s treasurer, another volunteer, announced that he was resigning. Jack had assumed that Sam had done the Treasurer’s job properly but now Jack realized that Sam had often been late presenting financial reports, unable to answer financial questions, or unavailable. Jack reviewed the records. He found no bank statements except those received after Eric left, no bank reconciliations, additional invoices that seemed to have been paid twice, and one invoice that seemed to have been paid three times. Jack realized that Eric erased the payee’s name and wrote in

his own on certain checks when Jack returned the checks for mailing. Jack guessed that Eric waited until the next month and prepared a second check to pay the same bill. Jack remembered thinking that he had already paid certain bills but believed Eric when Eric said the bill had not been paid. Jack also realized that he had relied on Eric to forward the bank statements to Sam; he now knew that Eric had probably not sent them. In addition, after two of the organization's volunteers told him that they had not been reimbursed for expenses, Jack found their expense reports in the "Paid Bills" file. Each of them recalled calling Eric and being told that the organization was in financial difficulty and unable to repay them. Jack estimated that the total actual loss was probably about \$20,000.

Ultimately, Jack presented the altered checks to the bank and demanded repayment; the bank refused to reimburse the organization because the problem had not been reported in a timely manner. The organization provided copies of the altered checks in its position to the local police but the police did not prosecute.

The Fraud Triangle

According to the late Donald Cressey, when pressures/incentives, opportunity, and rationalization converge, the environment is ripe for fraud. Certified Fraud Examiners referred to these the factors as the Fraud Triangle.



Pressure or motivation for fraud may be the result of financial need caused by drug or alcohol addiction, gambling, financial losses, or attempting to "keep up with the Joneses."

Rationalization is the excuse for the crime; it allows people to justify their unethical actions. Sometimes people tell themselves "It is only a loan; I will repay it as soon as possible." Others justify their actions by saying "They don't pay me what I am worth; I am only taking what I should really be paid."

Opportunity is the weakness in the system that allows the fraud to take place. The following weaknesses may lead to fraud: insufficient job applicant screening, inadequate policies and procedures, overly broad access to information, failure to segregate financial duties and ineffective monitoring.

What Happened at Jack's Organization

What motivated Eric to commit fraud? Did he gamble or have a drug problem? Jack never knew. Eric had been hired before his administration. Looking at Eric's resume, Jack realized that it contained a number of "holes." Had anyone asked Eric about the times he was apparently not working? Had anyone checked his references? Had anyone checked his credit to learn if he was in debt? Jack realized that he had not checked Lucy's references; he hired her based on her resume and her interview.

How did Eric rationalize the fraud? To some extent, Jack's organization may have been right in its assumption that its nature protected it. In its study, *2004 Report to the Nation on Occupational Fraud and Abuse*, the Association of Certified Fraud Examiners (ACFE) estimates that organizations lose approximately 6% of revenues to fraud annually. To the best of Jack's knowledge, this was the first time that the organization had been defrauded – putting it ahead of ACFE averages. That thought did not help Jack; his organization had been defrauded and he felt responsible. He wondered whether Eric told himself that he was only borrowing the money but knew that he was unlikely to learn the answer to that question.

Where was the opportunity for fraud? Jack thought he implemented good internal controls. The administrator processed bills and wrote checks but did not have the authority to sign the checks. The administrator was required to provide documentation for each check for the signor's review. Jack always reviewed the checks carefully. However, Jack's internal controls were compromised when he returned the signed checks to Eric for mailing. Eric had the opportunity to both steal the checks and hide the theft by processing bills a second time. Even worse than the breach of internal controls was Jack over-reliance on those controls. Jack failed to consider how other business practices contributed to the risk of fraud. The fraud could have been stopped quickly and at much less cost if Jack had just done some of the following:

- made certain that the organization had a Treasurer who did the job,
- reviewed the bank statements and the cancelled checks,
- reviewed the computerized accounting system,
- handled collection calls and found that bills had already been "paid,"
- questioned and researched the sharp increases in certain expenses, or
- discussed the organization's financial status with its volunteers.

But the failure to prevent the fraud can not be blamed on Jack and the treasurer alone. The board failed to understand the organization's finances, tolerated a treasurer who did not present financial results on time and who could not answer questions, and did not conduct an audit. The board failed in

its fiduciary duty.

The only good news was that it could have been worse. The ACFE study found that frauds committed by owners and executives caused median losses 14 times higher than the losses caused by employees. Both the president and the treasurer could have taken more than Eric did.

Protecting Your Organization

- ◆ Understand your risks and protect yourself and your organization
Make certain that there is effective, vigilant and regular oversight to prevent fraud. Don't rely solely on internal controls; the ACFE study found that regardless of the size of the organization more frauds were identified *by accident* than through internal controls. Don't count on being a not-for-profit or small; the ACFE study found that no type of organization is exempt – not-for-profits are affected as are for-profit organizations and governments and small businesses suffer disproportionately large losses. Don't wait; the ACFE study also showed that most organizations recover little if anything.

- ◆ Understand your operations and financial results
Use your common sense. If you are told that the increase in the cost of mailings is due to the increased price of stamps, ask yourself if the numbers make sense – a 2 cent increase in the cost of a stamp will not by itself cause your postage expense to double. Use the financial reports to evaluate your operations and make decisions. This means of course that it is necessary to demand financial reports and make certain that you understand them. Replace non-performing people involved in financially-sensitive areas – even if they are volunteers.

- ◆ Audit
Use an outside auditor or an audit committee. Verify everything.

- ◆ Set a good example
The ACFE reported that having an ethical “tone at the top” can be the most effective means of avoiding fraud. Avoid giving people the rationalization to defraud. Treat people fairly. Follow the rules.

- ◆ Consider a confidential reporting mechanism
The ACFE reported that more frauds in the study were detected through tips than through other means such as internal audits, external audits, and internal controls. The ACFE also reported that confidential reporting mechanisms reduced fraud losses significantly.

The Finale

What happened to Jack and his organization? The organization recovered from its losses. Jack, however, was deeply embarrassed by what happened “on his watch” and is no longer involved.

About the author:

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Author's Notes:

The 2004 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE is available on-line at <http://www.acfe.com/fraud/report.asp>. Peg adds that the article is based on true stories but the names have been changed to protect the innocent.