

Nonprofit Internal Control Check-Up

Reducing the Risks of Errors and Fraud

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Accountants and Consultants

In the News

- Museum Director steals \$51,000 of Egyptian Art
- Child care nonprofit uses \$400,000 of state funds for personal use.
- Accountant for Harvard nonprofit steals \$780,000
- Executive Director of Work-Family connection pays boyfriend salary as fictitious employee
- Alaska man steals \$100,000 from nonprofit employer using credit cards and false reimbursements
- Volunteer at Washington Cooperative Support Center embezzles \$89,000. 62 felony counts charged
- President and Finance Director steal \$110,000 from company assisting disables and fired workers

In the News

- Former Trustee indicted for \$6 million theft from Northshore Supporting Organization charity.
- Woman embezzles \$50,000 through overpaid payroll, unauthorized credit card charges and fake expense reimbursements at Coalition to End Family Violence
- Director of Better Brooklyn Community Center accused of stealing more than \$500,000 in federal aid intended to pay for food for poor children
- Finance Director of child abuse nonprofit admits stealing payroll checks
- Accountant for American Society for International Law pleads guilty of embezzling more than \$500,000.

Reducing the Risks of Errors and Fraud

- Fraud
- Objectives
- Governance
- Risk Management
- Internal Controls



FRAUD

Greed, Need and Opportunity



Taking Action

“Some organizations have significantly lower levels of misappropriation of assets and are less susceptible to fraudulent financial reporting than other organizations because these organizations take proactive steps to prevent or detect fraud.”

“It is only those organizations that seriously consider fraud risks and take proactive steps to create the right kind of climate to reduce its occurrence that have success in preventing fraud.”

--AICPA

Management Antifraud Programs and Controls

Why Fraud Matters

- All organizations face risk of fraud
- Regulations increase your responsibility to manage fraud risk
- Public and stakeholders expect “no fraud tolerance”
 - Greater public scrutiny
 - A result of more detailed financial data
- Your senior employees commit most fraud
- Fraud drains your resources
- Bad publicity endangers future contributions and grants

Fraud in Non Profits

Susceptibility to Fraud

- High Turnover
 - Board, Officers, Staff and Volunteers
- Atmosphere of trust
- Reliance on volunteer boards
- Weaker segregation of duties
- Lack of sufficient training
- Difficulty in verifying certain revenue streams

Allows the knowledgeable person to take advantage of the system

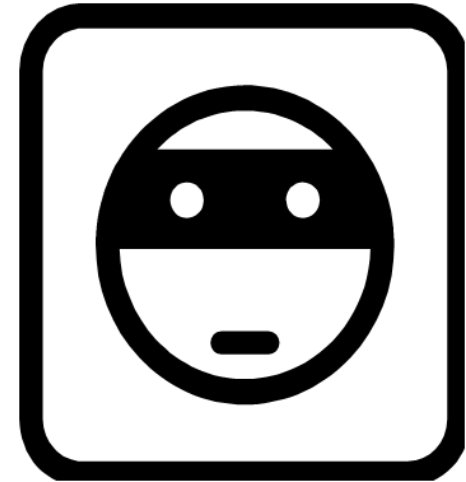
Nonprofit Fraud

- Nonprofit fraud accounts for \$40 billion in losses per year
 - Roughly 13% of all philanthropic giving
- Nonprofits were 14% of all occupational fraud cases
 - Average Duration: 24 months
- Median losses per incident are similar in all organizations
 - Median loss: \$109,000
- Misappropriation = 97% of all fraud
 - 95% of misappropriations involve cash
 - 75% involve fraudulent disbursements
 - Median loss: \$145,000
 - 22% involve skimming
 - Median loss: \$40,000
 - Payroll and check tampering fraud are most common
 - 80%, no collusion
- Losses 4x with collusion

*Based on the ACFE's 2008 Report to the Nation & the NY Times

Non Profit Fraud Who Commits Fraud?

- 9% by executives
- 25% by managers
 - Average \$150,000 loss
 - Average tenure: 7 years
- Most typical
 - No criminal record
 - Salary <\$50,000
 - More than three years tenure
- Most Expensive
 - Longest tenured employees
 - 51-60 years old
 - Average loss \$257,000
 - Over 10 years tenure
 - Average loss \$230,000



Nonprofit Fraud

Where To Look-Misappropriation

- Fraudulent billing—*Most prevalent (50%)*
 - False Invoices
 - Inflated Invoices
- Payroll Fraud
 - Fictitious employees
 - Inflated hours
- Falsified expense reimbursement-*Least costly (\$83,000)*
- Check tampering
 - Checks stolen
 - Checks altered
- Fraudulent register disbursements-*Most expensive (\$350,000)*
 - False entries in register
 - Undocumented refunds/disbursals

Non Profit Fraud Detecting Crimes

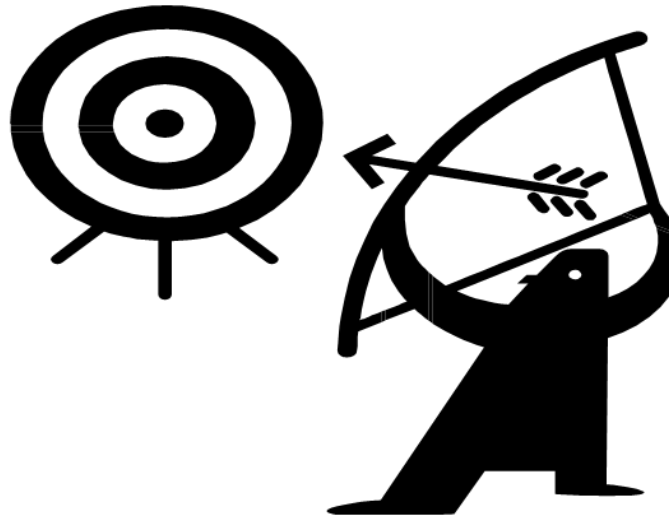


- Tips account for 49% of detection
 - Half of all tips come from employees
- Internal audit detects 25% of cases
- Internal controls plus internal audit helped identify 38% of all fraud cases
- External audit detects <13%
 - 86% of detected fraud had undergone prior external audit
- 11% are found by accident

Fraud management is a governance challenge!!

Objectives

Your Board, Your Auditors and You



Objectives Your Board

- No surprises!
- Mission Statement: Articulated and Adhered to.
- Executive compensation reviewed and 'transparent'
- Form 990 accurate and reviewed
 - No IRS scrutiny
- Governance “Best Practices” implemented
 - Conflict of interest policy
 - Investment Policy
 - Whistleblower protection policy
 - Document retention and destruction policies.
 - Gift acceptance policy
 - Review of contracts and agreements with contractors
- Risk management is applied throughout the organization
 - Understand management’s process
 - Continual communication

Objectives

Your Auditors

- Sufficient internal controls over financial reporting exist
 - Segregation of duties
 - Reconciliations
 - Journal entry controls
 - Cash controls
- Management monitors effectiveness of controls
- Fraud prevention and detection procedures exist (SAS 99)
- Nonprofit status can be supported to the IRS and Board
- The fourteen A-133 compliance areas are addressed

Objectives You

- An ethical culture is established
- Risks have been identified
- Risks have been addressed
- 990's can be properly executed
- Your Board is happy
- Your auditors are happy
- **No surprises!**

The Act of Fraud is Always a Surprise!

Antifraud Programs & Internal Controls

Reduce the Risk of Fraud and Error

Prevention (Inexpensive)

Deterrence (Inexpensive)

Detection (Expensive)

Internal Control Check-up

- Governance
- Risk Management
- Internal Controls



“Governance”

“Sound risk management starts with good governance practices.”

Governance: *“The Control Environment”*

- Sets the tone of the organization
- Is the foundation for all other components of internal control
- Provides discipline and structure

Basic Principles of Good Governance

- Integrity and Ethical Values
- Active Board of Directors
- Management's Philosophy and Operating Style
- Organizational Structure
- Financial Reporting Competencies
- Assignment of Authority and Responsibility
- Human Resource Policies and Practices

Develop Appropriate Oversight Process

A Team Effort

- Audit Committee or Board of Directors
- Management
- Internal Auditors
- External Auditors
- Certified Fraud Examiners

Governance Steps to Take

- Articulate Management's Values in Writing.
 - Monitor adherence
 - Address deviation.
- Define and Communicate Board Authority
 - What is delegated to management.
- Ensure the Board is Active
 - Oversight of risk, internal controls & audit activities.
- Evaluate Management & Board Competencies
 - Do they meet your requirements?
- Define Organizational Responsibilities
 - What are the limits of authority.
- Establish Personnel Processes
 - Recruiting, Training, Retention and Evaluation.

Risk Management

Addressing What Matters



Risk Management

The Internal Control Environment

Definition:

“A process, effected by the entity’s board of directors, management and other personnel, designed to provide *reasonable assurance* regarding the achievement of objectives:”

Risk Management

A Changing World

- Regulation and Government
 - SOX, NAIC, OMB, GLBA
- External Pressures
 - Bernard Madoff (\$65B), Allen Stanford (\$8B), Enron (\$7B), United Way (\$1.5M), NewEra Philanthropy (\$135M), Melodyland Christian Center (\$160M)
- Changes to Auditing Standards
- Capital Suppliers
 - Grants, Donor Requirements
- Best Practices
 - Business, Government, Insurance
- Common Sense

Risk

- If you can *identify risk*, you can *do something!!*
- Identifying what can harm you is *risk assessment*.
- Once Risks Are Defined and Assessed
 - Management's daily focus changes
 - Tools are developed to prevent and detect threats
 - Reliability of information gains importance
 - Timeliness of information gains importance
 - Management collaboration & communication become critical
- Doing something is *Risk Management*

Risk Ownership

A Team Effort

- Accounting and Finance
- Nonfinancial business unit and operations personnel
- Risk management personnel
- Legal and compliance personnel
- Internal auditors
- External consultants
- Management

Fraud Risk Assessment

Steps to Take

- Identify potential fraud risks
- Assess the likelihood of occurrence
- Assess the significance to the organization
 - Evaluate people and departments most likely to commit fraud
 - Identify the methods they're likely to use
- Identify and chart existing preventive and detective controls
- Evaluate the efficiency and effectiveness of the controls
- ***Respond*** to what you know.

Reporting Risk Assessment Steps To Take

- Identify financial “pain points”
- Prioritize a solution plan to provide:
 - The right information
 - Accurately
 - Timely
- Identify existing controls over significant financial accounts
- Identify any existing control deficiencies
- Prepare a road map for improving control design:
 - Enhance reliability of information
 - Improve your ability to prevent and detect potential problems

Risk Management

Risk Management is the **second** most important component of an effective internal control environment

The **first** is Governance (The Control Environment)

Internal Controls



Internal Controls

What They Provide

- Ability to detect indicators of fraud
- Ability to produce consistently reliable financial information
- A process that prevents material errors
- Information that allows detection of other errors
- Ability to *act* on the data; not question it
- An improved ability for you to share information and manage proactively.

Internal Controls

Identifying Risks of Error

- Errors in recording restrictions to donations
- Errors in recording expenses by program or grant
- Failure to capture and record all transactions
- Recording assets that do not exist or transactions that did not occur
- Recording transactions in the wrong period or wrong amount, or misclassifying transactions
- Losing or altering transactions once recorded
- Failing to gather pertinent information to make reliable estimates
- Recording inappropriate journal entries
- Improperly accounting for transactions or estimates
- Inappropriately applying formulas or calculations

Internal Controls Highest Risks of Error

- Elements involving significant accounting estimates.
- Related party transactions.
- Critical accounting policies.
- Controls subject to management override.
- Controls requiring significant judgment.
- Controls that are complex in nature.

Internal Controls Weaknesses Contributing to Fraud

1. Lack of Internal Controls 35.2%
2. Lack of Management Review 17.4%
3. Override of Existing Controls 17.4%
4. Poor Tone at the Top 8.6%
5. Lack of Competent Oversight 7.2%
6. Lack of Independent Checks/Audits 5.5%
7. Lack of Clear Lines of Authority 1.3%
8. Lack of Employee Fraud Authority 1.3%

CFE'S Ranking of Internal Controls Importance in Detecting or Limiting Fraud

1. Internal Audit/Forensic Examination Department
2. Surprise Audits
3. Management Review of Internal Controls
4. Fraud Hotline
5. Mandatory Job Rotation/Vacations
6. Rewards for Whistleblowers
7. Audit of ICFR
8. Audit of Financial Statements

Changes Implemented in Response to Fraud

1. *Management Review of Internal Controls* 55.7%
2. Surprise Audits 22.4%
3. Fraud Training for Management 16.6%
4. Fraud Training for Employees 15.7%
5. Job Rotation/Mandatory Vacation 13.4%
6. Anti Fraud Policy 12.8%
7. Internal Audit/FE Department 11.2%
8. Code of Conduct 10.4%
9. External Audit of F/S 10.0%
10. External Audit of ICFR 10.0%
11. Independent Audit Committee 7.3%
12. Hotline 6.2%

Antifraud Programs and Controls

Steps to Take

- Set the Tone at the Top
 - A Culture of Honesty, High Ethics & Oversight
- Create a Positive Workplace Environment
 - Assign Proper Authority and Responsibility
- Mandate Fraud and Ethics Training
- Implement Effective Disciplinary Measures
- Establish a Whistleblower Policy & Confidential Hotline
 - Follow Through on Reports of Misconduct
 - Maintain an Open Door Policy
- Promote Effective Internal Controls
 - *Obtain 'Best Practices' Checklists*

Antifraud Programs and Controls (More) Steps to Take

- Hire and Promote Appropriate Employees
- Consider Employee Dishonesty Coverage
- Reconcile Bank Statements
 - Enforce Segregation of Duties
- Require Employees to Take Vacations
 - At Least 5 Consecutive Days
- Conduct an Annual Audit
- Conduct Surprise Audits
- Require Background Checks
- Consider Bonding Employees Who Handle Cash

Median Loss Based on Presence of Anti-Fraud Controls

Control	% of Cases Implemented	Yes	No	% Reduction
Surprise Audits	25.5%	\$70,000	\$207,000	66.2%
Job Rotation/ Mandatory Vacation	12.3%	\$64,000	\$164,000	61.0%
Hotline	43.5%	\$100,000	\$250,000	60.0%
Employee Support Programs	52.9%	\$110,000	\$250,000	56.0%
Fraud Training-Mgmt	41.3%	\$100,000	\$227,000	55.9%
Internal Audit	55.8%	\$118,000	\$250,000	52.8%
Fraud Training-Employees	38.6%	\$100,000	\$208,000	51.9%
Anti Fraud Policies	36.2%	\$100,000	\$197,000	49.2%
External Audit-ICFR	53.6%	\$121,000	\$232,000	47.8%
Code of Conduct	61.5%	\$126,000	\$232,000	45.7%
Management Review of IC	41.4%	\$110,000	\$200,000	45.0%
External Audit F/S	69.6%	\$150,000	\$250,000	40.0%
Independent Audit Committee	49.9%	\$137,000	\$200,000	31.5%
Management Cert of F/S	41.6%	\$141,000	\$200,000	29.5%
Rewards for Whistleblowers	5.4%	\$107,000	\$150,000	28.7%

SOX Related Internal Controls in Non-Profits

Control	Control In Place?				Median Loss			Months to Detection		
	Yes	No	Yes	No	% Reduction	Yes	No	% Reduction		
Independent Audit Committee	69	53.5%	57	44.2%	\$115,000	\$109,000	(5.5%)	19	24	20.8%
External Audit ICFR	68	52.7%	51	39.5%	\$90,000	\$100,000	10.0%	24	30	46.7%
Management Cert of F/S	56	43.4%	61	47.3%	\$110,000	\$109,000	(0.9%)	24	24	0.0%
Hotline	41	31.8%	80	62.0%	\$50,000	\$124,000	59.7%	12	30	60.0%
Management Review of IC	35	27.1%	82	63.6%	\$50,000	\$115,000	56.5%	12	24	50.0%

The Management of Risk is in Your Hands!



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