



Internal Fraud: Why It Happens (And How To Stop It)

*In the last issue of **Nonprofit Insights**, we looked at some fraudulent activities (intentional or unintentional) committed by nonprofits. In this issue, we'll look at some common types of fraud perpetrated against nonprofits.*

Fraudulent activity — check forgery, asset misappropriation and other forms of stealing — has been a longstanding concern for nonprofit organizations. And one of the reasons it has intensified in recent years, experts say, is that it is often feebly prosecuted, if at all (some groups fear that donors might stop giving if the crimes are publicized).

Weak internal controls also make nonprofits ripe for the picking. Revenue typically flows from voluntary contributions, grants and other “nonreciprocal transfers” (i.e., the donor receives no goods or services in return). With no corresponding pay out to match against, incoming checks or cash contributions can easily “disappear.” Neither management nor an auditor would have any way to determine that the contribution was recorded. In the case of a check, the donor would still have a canceled check, and no one at the organization would be the wiser.

Beware Of The “Shoestring Effect”

Another problem is what is known as the “shoestring effect.” Operating with lean and low-paid staff, nonprofits often can't effectively segregate duties. The result is that the person opening the mail may also be responsible for depositing the donations — and may even be the one receiving and reconciling the organization's bank statement! Low pay and long hours can lead to the justification needed for fraud to occur (“They don't pay me enough ... I deserve this money.”)

Watch For The Signs

Like any crime, internal fraud typically leaves plenty of clues. For instance, certain accounting anomalies can be telltale signs:

Cash flow abnormalities. Cash receipts present a very high fraud risk, especially if there are many small-dollar transactions. Investigate significant/ongoing differences between expected and actual cash flow.

Unusual source documents. Be suspicious any time proper documentation is not presented to support purchase orders, checks, expense reports, requisitions, receiving reports and time cards.

Unreasonable costs. Costs that increase faster than inflation, the use of more items than usual or increases in purchases from one company might indicate fraud. Similarly, unreasonable costs for travel or other reasons may indicate a problem.

Bottom line: If something doesn't look right, it probably isn't.

3 Keys To Strong Controls

One place an organization can effectively exercise fraud control is in the “opportunity” area. In short, don't give employees the opportunity.

1) Segregate duties. Make sure your internal processes and software systems allow for thorough segregation of duties. For example, ensure that users who enter cash are not the ones creating the deposit tickets. And use processes that provide an audit trail so you can track who is doing what, see when they are doing it, and retrace the process from invoice or receipt entry through approval, posting and payment. This could be paper logs/ledgers or a software solution that provides log files.

2) Improve monitoring. Establish certain predefined parameters for your organization and regularly monitor that you are within them. For example, if you track your cost-of-fundraising ratio, use a system that allows you to constantly monitor that ratio. If you only calculate that ratio at the end of a period, you are not in a position to address and correct problems as they occur.

3) Make it part of your culture. Philosophically, the message to send is “we trust you, but we will verify.” Make sure employees are fully aware of internal controls, their purpose and their value. Constant, relevant communication of internal controls (“This is why it is important to you and the organization”) promotes buy-in and the support necessary for success.

Uncover vulnerabilities in your systems and beef up your organization's internal controls with help from our nonprofit accounting professionals.