

The Impact of Fraud on the Nonprofit and Social Services Sector

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ABSTRACT

This white paper sets forth a discussion on the breadth of fraud occurring in the nonprofit community and its over-all impact on the nonprofit sector and the community at large. The paper begins with a brief overview of the size and scope of the nonprofit sector. It then delves into the types of fraud common to nonprofits, provides a profile of a typical perpetrator and traces the cost of fraud in the nonprofit community. Examples of nonprofit fraud are cited in order to share lessons learned in the real world. Suggestions and guidelines are offered for improving internal controls in order to more effectively detect and deter fraud in the future.



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## **Introduction – Nonprofit Organizations are Big Business**

As we began the research for this white paper, we confronted some key facts about the breadth of the nonprofit community, its impact, its influence, as well as recognizing the importance of having a strong and vital nonprofit sector. For more than three centuries, charitable organizations have been making a difference every day for anyone living in the United States. It might be the upkeep of a local city park in Chicago, a relief agency supporting victims of natural disasters, or a children's theater and dance group – no matter what the cause or issue, nonprofit organizations provide critical services, making a contribution to every community in America. This long tradition has created a powerful legacy with more than 1.3 million public charities, private foundations and religious congregations in existence according to the Report to Congress and the Nonprofit Sector on Governance, Transparency and Accountability. In New Jersey alone there are more than 48,000 organizations and chapters listed as tax-exempt organizations. What is also interesting is that, according to the Independent Sector's report on Giving and Volunteering in the United States, in this decade nearly one-half of all adults volunteer for a charity during the course of a year, and nine out of ten households report making a charitable donation. These facts clearly demonstrate the commitment of individual volunteers who collectively provide the efforts that are the equivalent of more than nine million paid employees.

Despite the goodwill of their efforts and the pride that we feel for the nonprofit organizations that are woven into the fabric of our communities, the scandals in the corporate world that have been played out in the news since 2002 have begun to trickle into the nonprofit world as well. The media is carefully watching this sector, concerned over the possibility that fraud and misuse may taint charitable entities as it has for-profit corporations like Enron, WorldCom and Adelphi - to name a few of the highly publicized cases.

## **The Cost of Fraud**

The nonprofit sector in the United States is now worth more than \$665 billion, making it a rich and tempting opportunity for the 12 million people who work within the sector and are in a position to commit acts of fraud!

Given its enormity, it is no surprise that the nonprofit community has become a major target for fraud. While it is hard to imagine someone stealing from our nation's most critical social service, religious, healthcare and educational programs, the FBI reports remind us that more than 2,000 internet sites set up to solicit relief for Katrina hurricane victims proved to be phony upon thorough investigation.

Although fraud like this occurs in both the for-profit corporate world and the nonprofit and social services sector, somehow the concept of stealing from a charitable organization seems more heinous than when a business is victimized in the same manner. Perhaps it is because we have an image of nonprofit organizations as stewards of the community, performing good deeds and offering services to the most needy. Or it might be that we expect the leaders of nonprofit organizations to be more trusting and less business-like, therefore making them more vulnerable to fraud. In fact, while the average fraud scheme only lasts about 18 months in the corporate world, fraud in the nonprofit sector goes on for a longer time period without being detected because of the less-business like atmosphere and the dependence on volunteer leaders (board members) who, or may not, have financial expertise. One further reason why nonprofit fraud is such an affront to us may be because it represents the theft of dollars that have been donated in good faith for specific purposes. The loss of those dollars means that the organization, whether it provides affordable housing, a shelter for battered women and children or sustains cancer research, will not be as effective because it will have less to work with.

Whatever the reason for our emotional reaction to fraud when it is committed against a nonprofit, the fact remains that it does occur with as much frequency within nonprofits as it does in the for-profit world and therefore must be handled in the same way. To remedy this, nonprofits are coming under attack for their inability to protect their assets and are being encouraged to adopt many of the same principles that are working for the for-profit sector.

It should be noted that as the current economic situation continues to disintegrate, nonprofit leaders are being forced to cope with the stress of running efficient organizations in a challenging climate. Worse, many of the administrative staff is under stress themselves as they try to maintain their own personal financial stability. Prolonged, tense situations like this frequently set the stage for fraud. People in positions of authority and trust who are operating on the edge of financial ruin may behave in a desperate manner. The negative atmosphere that has resulted from the recent global economic instability seems to increase the sense of desperation that fuels many cases of fraud.

The purpose of this white paper is two-fold. First, we will clarify how to define fraud and then discuss how to detect it. This will include providing information regarding the frequency and types of fraud that most typically occur within nonprofits. Secondly, we will offer a range of options that can be implemented to lessen, or prevent, the likelihood of fraud and abuse in nonprofit organizations.

We hope you find the information on the following pages to be interesting, timely and relevant for your organization.

There has been much written on the subject of fraud in the nonprofit sector and much of the current data that is integral to this paper was published by the Association of Certified Fraud Examiners (ACFE) in their Report to the Nation on Occupational Fraud and Abuse. This document was an excellent source to support the ideas set forth here. Other key sources are listed at the conclusion of this paper.

## Defining Fraud and its Impact on the Nonprofit Sector

### *The Definition*

Fraud, as it is defined in *Miriam Webster's Dictionary* is, "any act, expression, or concealment calculated to deceive another to his or her disadvantage." Further, fraud perpetrated in a nonprofit organization involves the "use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets."

Additionally, economic crime is defined in *Breaking Out of the White Collar Crime Paradigm* as an illegal act (or constantly evolving set of acts) generally committed by deception or misrepresentation (fraud) by someone (or a group) who has special professional or technical skills for the purposes of personal or organizational financial gain or to gain (or attempt to gain) an unfair advantage over an individual or entity.

### *Motivation for Fraud*

Individuals committing fraud are normally very trusted employees. The level of trust and/or responsibility will be a determinant factor as to the amount of funds an individual has access and could misappropriate; however, the motivations of these individuals will remain constant. This list is an example as to why this trusted employee would commit an asset misappropriation.

- *Living beyond their means*
- *An overwhelming desire for personal gain*
- *High personal debt*
- *A close association with customers*
- *Feeling pay was not commensurate with responsibility*
- *A wheeler-dealer attitude*
- *Strong challenge to beat the system*
- *Excessive gambling habits*
- *Substance abuse*
- *Undue family or peer pressure*

In most instances, proceeds from fraud and embezzlement are not hoarded, rather they are used to meet current or past due financial obligations, meet expenses or increase one's lifestyle.

### *The Impact*

Every fraud is, by definition, conducted in a purposeful, planned way. The individual involved, whether a staff person in the office, a volunteer, or someone serving as an executive leader, is in a position to conduct fraud, which means taking funds or misusing the organization's finances over time without being detected.

In 2005, Joseph T. Wells conducted a highly-cited research project entitled *Principles of Fraud Examination* that identified three major types of fraud that are most common in nonprofits. These are:

- Misappropriation of assets (which involves stealing of the organization's funds, usually cash)

- Corruption (which involves inappropriately influencing a financial transaction such as with bribes, rewards, extortion or by having a lack of independence)
- Financial statement fraud (which involves the deliberate falsification of the financial statements)

The first type of fraud mentioned above, misappropriation of funds, represents more than 95-97% of all reported nonprofit fraud cases. This category includes skimming (cash is stolen before it is recorded); larceny (cash is stolen after it is reported); and fraudulent disbursements (paying an expense that is not owed, paying an inflated invoice, falsifying expenses, check tampering or paying nonexistent employees).

While misappropriation of assets is by far the most common of all frauds, financial statement fraud is the least common, representing only 5% of all the fraud cases. Interestingly, although financial statement fraud occurs with the least regularity, it tends to generate the largest losses for the victims, according to research done by KPMG, especially in the area of misreporting expenses. In a study by Krishan in 2006 of 101 charities that received individual and corporate donations, 38 reported an average \$7 million less earned from fundraising on their 990 forms than appeared on their audited financial statements. Since the information on the 990 is used by the public – regulators and donors – to compare program expense ratios, it is critical that these numbers be reported accurately.

It is interesting to note that only about 19% of nonprofit fraud involves collusion but the median loss from this type of activity was four times higher than the fraud conducted by one individual acting alone.

Each type of fraud occurs with consistent frequency and with results that can be measured. So, for example, Wells found that the loss from financial statement fraud, while not as frequent as the losses from asset misappropriations, had results that were 30 times greater. Where the median loss for theft was just \$100,000, the median loss for financial statement fraud cases was \$3 million!

Armed with the information like this about the various types of fraud to watch for – and the anticipated cost and extent of each type of fraud – the organizations can act as more effective and more informed “watch dogs” as they protect their integrity and their finances.

## Tracking Trends

The findings discussed above from various research studies and the ACFE Report provide an important wake-up call for everyone involved. The numbers are staggering, and the ACFE confirms that 12-13% of all reported workplace fraud occurs in the nonprofit sector.

*So what do we know about fraud in the nonprofit community?*

- Studies show that it tends to typically involve the unauthorized taking of funds for personal use
- Payroll fraud and check tampering are also more common in the nonprofit organizations than in the general business community
- The average age of a person committing fraud in a nonprofit is 41 years old with perpetrators ranging from 20-60 years old
- Women earning less than \$50,000 and with less than three years at the association were the most likely to commit fraud
- 25% of all nonprofit fraud is committed by individuals at the management level with accounting personnel leading the way, followed by executives and upper management
- More than 43% of all nonprofit fraud was discovered through tips, with half of those reported by employees and vendors

Identifying who is most likely to steal from the organization can give you an advantage as you work to eliminate your vulnerability and establish processes to keep you financially strong.

The closest thing a nonprofit organization has to a true financial measure of performance is the ratio of program expenses to total expenses (or to total income) some of the common methods individuals will use to commit fraud against a nonprofit will include:

- Netting the results of special fundraising events and activities
- Exaggerating the values of non-cash gifts received and made
- Improperly reporting contributions raised on behalf of other nonprofits
- Misapplying the accounting rules applicable to “joint” activities that purport to serve both programmatic and fundraising objectives
- Outright misclassification of fundraising or management expenses as program expenses



## Preventing Fraud

Recognizing and detecting fraud is essential, but preventing fraud is even more vital. Strong management and leaders that act as role models for the organization can go a long way in preventing occurrences of fraud for the nonprofit. The board itself must establish a commitment to core values and behave in a manner that is highly ethical. A board that consistently shows integrity will create a culture that encourages honesty across all levels. Along with a positive attitude and a focus on reliability, the board should try to establish the following initiatives:

- Require independent directors
- Prohibit personal loans to board members
- Create an audit committee
- Hire an independent auditor who has significant knowledge about nonprofit accounting
- Conduct background checks for all employees with access to cash
- Purchase insurance/bonding for employees with access to cash
- Check the websites of state charities offices for the names of individuals convicted of nonprofit fraud
- Develop and document a whistle-blower policy
- Develop a conflict of interest policy, including annual written reporting by board members and officers
- Review internal controls periodically to ensure that they can detect fraud (this is the most highly rated of all prevention techniques!)
- Talk to each employee and volunteer about the harmful effects on the organization and its objectives when fraud is committed
- Establish a policy to deal with anyone caught committing fraud against the organization because the unwillingness of the organizations to punish those who steal is one of the most significant reasons that fraud continues in this sector
- Perform and document an annual risk assessment of financial statement fraud
- Establish a records retention-a policy to maintain records
- Purchase fidelity insurance-although having insurance will not deter embezzlement, it will cover, at least some of the losses

Implementation of these suggestions will have a significant impact on the organization, not only in detecting and preventing fraud but in sending a message to the community about the leadership and its intent to safeguard the organization.

## Examples of Nonprofit Fraud

To highlight how some organizations have become victims of fraud, we will share a few documented case studies from the nonprofit community:

- *Misappropriation of funds.* In March 2008, the volunteer treasurer of the Madison County Humane Society in Indiana was charged with using \$65,000 of the charity's money to make personal purchases.
- *Misappropriation of funds.* In April 2008, a Priest in Warren County, NJ was sentenced for embezzling more than \$600,000 from various charities and a parish raffle over a four-year period.
- *Misappropriation of funds.* In November 2008, the former associate vice president of student development of Hoboken, New Jersey-based Stevens Institute of Technology, pleaded guilty to the embezzlement of \$264,000 between May 2000 and January 2002 from the college.
- *Misappropriation of funds.* In November 2008, the former director of a breast cancer charity in Meridian, Idaho, pleaded guilty to embezzling more than \$100,000.
- *Misappropriation of funds.* In San Francisco, the CFO of the Music Concourse Community Partnership was accused of taking more than \$3 million of the organization's money to play the stock market.
- *Misappropriation of funds.* Time Magazine ran a brief article in their December 8, 2008 issue entitled: Muslim-Charity Leaders Guilty. The article went on to say that after an earlier mistrial, five former leaders of the Holy Land Foundation for Relief and Development were found guilty of funneling \$12 million to Hamas. A jury convicted the group on 108 criminal counts, including money laundering.
- *Corruption – the failure to maintain proper internal controls.* In 2006 the Arlington Community Action Program (ACAP) ended its 40 year history of serving the Washington, D.C. area when it was deemed to be a high risk organization by its independent auditors. Having just received a commendation from Congress for its fine work, nonetheless it had failed to maintain proper internal controls to safeguard the organization's Head Start assets. What this means is that their management practices raised serious doubts about their ability to assure proper programmatic use and financial stewardship of grant funds.

A variety of colorful and confirming headlines provide further evidence:

- Ex-lawman convicted in big charity scam (Gathright 2004)
- Tax Abuse Rampant in Nonprofits (Crenshaw 2005)
- California: Jail term for charity fraud (New York Times 2004)
- As charitable cheating rises, so does cost to taxpayers (USA Today 2005)

It is all too obvious that nonprofit organizations, like their for-profit counterparts, are susceptible to fraud. The general public cannot afford to take the 'good intentions' of

nonprofits for granted. As a result, there are no longer any expectations that being a nonprofit will realistically provide a safeguard from fraud simply because of the high regard, loyalty, passion and affection that a nonprofit enjoys. Instead, they have to follow the guidelines and establish the internal controls that will keep them alert and prepared for the potential for fraud.

## **Conclusion**

The ACFE report finalized in 2006 states that fraud costs the nonprofit community nearly \$40 billion just in that year alone. This number represents about 13% of all donations that year, which means that help for thousands of needy people and situations was drastically diminished. It is clear that in the post-Sarbanes-Oxley world, transparency is demanded from donors, regulators, and constituents. The public expects, and has a right to expect, nonprofit organizations to have sound internal controls that ensure resources are appropriately maintained, managed and distributed. To convince the public that they are getting a true and accurate financial picture, reporting is changing and becoming more specific. The new 990 Form will even have a question forcing nonprofits to disclose if they have experienced theft, embezzlement or fraud throughout the year.

Understanding what fraud is, and how it occurs, is the first step to detection and prevention within a nonprofit organization.

As we have shown, though, much of the research that has been conducted suggests it is consistently easier for fraud to occur in a nonprofit organization because of the atmosphere of trust, the weak internal controls, the reliance on volunteers (and the ensuing turnover) and the overall lack of business and financial expertise. This just demonstrates how important it is for all nonprofits to be vigilant, to be more prepared, to educate their volunteer leaders and to begin to behave in a more professional manner – including the implementation of internal controls and planning for stricter accountability and effective governance – to deter fraudulent behavior.

We believe that the facts are clear. Organizations that adopt stricter controls and monitoring and have a better understanding of their financial situation are less likely to experience fraud than their counterparts who do not take these steps.

## Research Cited

There were many sources used to provide background information and statistical facts to support the conclusions drawn in this paper. These include:

An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents by Janet Greenlee, Mary Fischer, Teresa Gordon and Elizabeth Keating.

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## **About the Authors**

### *Ron Matan, CPA*

Ron Matan, a Member of the Firm and Member in Charge of Sobel & Co.'s Nonprofit and Social Services Group, brings a unique blend of public accounting and business acumen to every client engagement. A key member of Sobel & Co.'s Leadership Team since joining the firm in 1997, Ron works primarily with nonprofit organizations, including United States Department of Housing and Urban Development ("HUD") projects, A-133 engagements, and low income housing tax credit programs ("LIHTC").

Ron is a Certified Public Accountant licensed to practice in New Jersey, New York and Pennsylvania and holds a New Jersey Public School license as well. He is a member of the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants (NJSCPA). Ron has been elected to the PKF North America Network's Nonprofit Committee, and in June 2004, Ron was appointed to the New Jersey Society of Certified Public Accountants Peer Review Executive Committee. Ron is also a member of the NJSCPA's Nonprofit Interest Group.

Ron is responsible for the firm-wide quality of this practice area, including audits of A-133, HUD and LIHTC programs and is the firm liaison for the AICPA's Government (Nonprofit) Audit Quality Center. With over 30 years experience of public accounting and private industry experience with all types of nonprofit and social service organizations, Ron brings a unique blend of experience and insight to these specialized engagements. Ron is a Certified Tax Credit Compliance Professional and is listed in the Guide which is circulated to all State Agencies Allocating Tax Credits as well as the Internal Revenue Service. He also has taken courses in advanced training for peer reviews and performs peer reviews of other accounting firms.

Ron is a member of the Board of Directors of First Occupational Center where he serves as Treasurer and he is also a member of the Education Committee for the New Jersey Chapter of the Society for Association Executives (NJSAE). Ron has been appointed to the Plainfield Neighborhood Health Center Board and Union County Educational Services Foundation Board. Ron was the former treasurer and board member of Kids Peace Treatment Centers for emotionally disturbed children, located in Bethlehem, Pennsylvania.

### *Darryl Neier, CFE, MS*

Darryl Neier, Principal of the Firm, is in charge of the Forensic Accounting / Litigation Services Group. He holds this role because of the unique experiences he brings to the firm. Having spent 20 years with the Morris County New Jersey Prosecutor's Office, retiring as a Detective Sergeant, Darryl has been involved in the detection and prevention of fraud in a variety of situations and cases. Darryl's reputation as one of the experts in this field is widely recognized. He has been involved in cases that include white collar crime investigation, money laundering, insurance fraud and computer forensic investigation.

Since joining Sobel, Darryl has been involved in domestic and international engagements involving forensic accounting (criminal and civil fraud investigations, banks and shareholder disputes; computer forensics; business valuation; fraud vulnerability studies; loss profits calculation; damage claim analysis; asset recovery; due diligence

review; discovery production; intellectual property investigations; anti-money laundering compliance and expert witness testimony).

Darryl is a faculty member at New York University along with Utica College and is a certified instructor with the National White Collar Crime Center. In 2004, Darryl was appointed as a national committee member to the Technical Working Group ("TWG") for Education in Fraud and Forensic Accounting to develop a model curriculum to aid academic institutions, forensic, and law enforcement agencies. The TWG was funded by a grant from the National Institute of Justice, Office of Justice Programs, U.S. Department of Justice. He has lectured extensively throughout the United States to federal, state, and law enforcement agencies and other regulatory bodies. Darryl is also a frequent speaker at national conferences lecturing on a variety of forensic accounting and investigative topics. He is trained in advanced computerized analytic methods, money laundering, disaster and insurance fraud, financial investigative analysis and computer crimes, and has given testimony for a variety of high-profile cases during his career. Additionally, he has been qualified as an expert in New Jersey Superior Court.

Darryl is a member of the Association of Certified Fraud Examiners, where he obtained his certification in addition to sitting on the Board of Directors of the NJ Chapter. He is also a member of the National White Collar Crime Center, where he is a contributing author to the "Financial Records Examination and Analysis" text book used to teach advanced fraud classes throughout the country, and is a member of the Association of Certified Anti-Money Laundering Specialists. Darryl was appointed to the 2006-2007 PKF North America Network Litigation Committee. Darryl is also highly decorated, having received commendations from the Morris County Prosecutor's Office, the Federal Bureau of Investigation, and the United States Secret Service.

Darryl holds a Master of Science degree in Economic Crime Management from Utica College of Syracuse University and a Bachelor of Science degree in Accounting from William Paterson University.