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# Preventing Embezzlement and Fraud in Nonprofit Organizations

NYSSCPA.ORG

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# Recent Examples of Nonprofit Embezzlement



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# Discovery Counseling Center of the San Ramon Valley

- On March 11, 2011, the president and executive director of Discovery Counseling Center, a non-profit that provides counseling and other mental health services, was charged with 4 felony counts of grant theft embezzlement for stealing more than $150,000 in funds.
- The director used a company credit/debit card linked to the centers checking account for his own daily expenses.
- The Board hired an accounting company to do an audit after receiving concerns of alleged misconduct.

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# Caribbean Woman's Health Association ("CWHA")


- On July 19, 2010, the former executive director of CWHA, a non-profit that provides services to low-income woman and immigrants related to HIV/AIDS prevention and maternal and child healthcare, pled guilty in Manhattan Federal Court to one count of embezzling federal funds and one count of conspiring to commit wire and bank fraud.
- The former director raised her salary without receiving CWHA Board approval.
- She embezzled $17,500 from a 2006 grant CWHA received from NY State Department of Health NYS Aids Institute.
- She attempted to defraud FDIC–insured banks in order to procure home mortgage loans.



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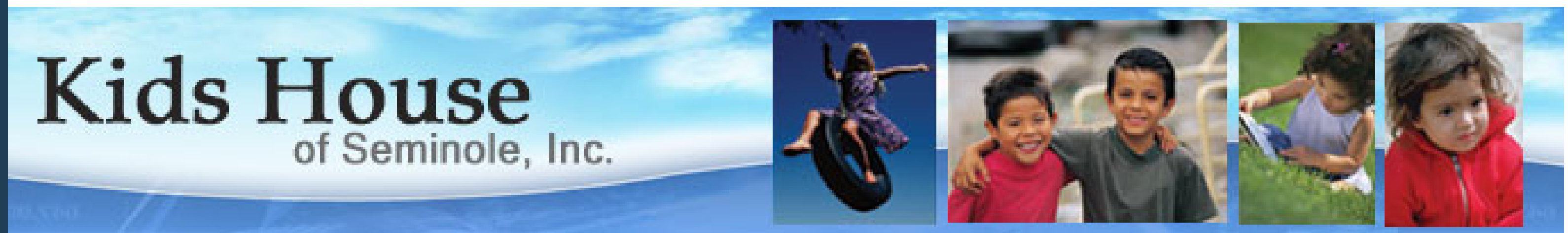
# Kids House of Seminole




- On June 19, 2010, the former finance director of Kids House of Seminole, a nonprofit that supports children who are victims of abuse and neglect, was accused of stealing $48,000 from the organization by writing checks from the organization to himself, then depositing the money into his personal bank account.
- The check amounts ranged from a few hundred dollars to two or three thousand dollars.
- The finance director allegedly admitted to the embezzlement and told investigators that he did it because he was a "compulsive spender."
- The agency is reviewing its accounting system and reported that it will make any adjustments necessary.



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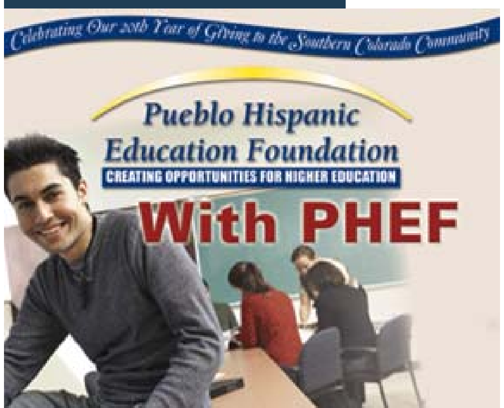
# Pueblo Hispanic Education Foundation (PHEF)




- On June 5, 2010, the director of the Pueblo Hispanic Education Foundation (PHEF), a nonprofit that helps local graduates attend college, was arrested for embezzling more than $57,000 from the nonprofit organization.
- He was charged with two counts of theft, two counts of identity theft and 232 counts of forgery.  The executive director used the foundation funds to pay for a Las Vegas trip, patio furniture and $7,500 worth of jewelry, among other personal purchases.
- The director forged the board president’s name on checks totaling $30,143 in purchases, funneled checks destined for colleges, some that didn’t even exist, into his own personal bank account, and without the 12-member foundation board knowing, he obtained a debit card and spent $27,531 in PHEF funds for personal use.
- After the arrest, the board of directors learned that the director had pled guilty to theft in 2006 and was on probation for stealing from a Denver nonprofit, the Latin American Educational Foundation. PHEF’s founder stated that the board of directors should have scrutinized the director’s background much closer before hiring him.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# Why Does Employee Fraud Occur?

## Three Key Factors




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# Why Does Employee Fraud Occur?

- **Motivation**
  - Economic factors such as personal financial distress, substance abuse, gambling, overspending, or other similar addictive behaviors may provide motivation.
  - The current national economic recession may serve to increase the incidence of such financial motivations.

- **Rationalization**
  - The employee finds a way to rationalize the fraud.
  - Such rationalizations can include perceived injustice in compensation as compared to their colleagues at for-profit enterprises, unhappiness over promotions, the idea that they are simply "borrowing" from the organization and fully intend to return the assets at a future date, or a belief that the organization doesn't really "need" the assets and won't even realize they are missing.

- **Opportunity**
  - The employee has sufficient access to assets and information that allows him or her to believe the fraud can be committed and also successfully concealed.



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# Why Are Nonprofits Frequently the Victims of Embezzlement?

Management and board members are often more trusting

Less stringent financial controls for nonprofits

A belief that audits will catch any fraud

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# A Note About Audits

- External audits can be helpful in ensuring that financial controls and fraud prevention measures are being followed and are effective.
- The standard audit, however, is not designed and should not be relied upon to detect fraud.
- The Association of Certified Fraud Examiners reports that less than 10% of frauds are discovered as a result of an audit by an independent accounting firm.
- Auditors generally only have a responsibility to give “reasonable” assurance that no material misstatements in financial statements have been made.
- While auditors are required to approach the audit with a skeptical attitude and must not overly rely on client representations (SAS 99), auditors do not have an absolute responsibility for the detection of fraud.
- Specific fraud audits are available and are encouraged when there is any suspicion of fraud. When fraud audits are conducted, the auditors give greater scrutiny to certain items and another auditor within the firm will often take a second look at the audit to decrease the chance that anything was missed.
- It is also a good idea to have auditors review and test your financial controls to ensure that appropriate controls are in place and working.



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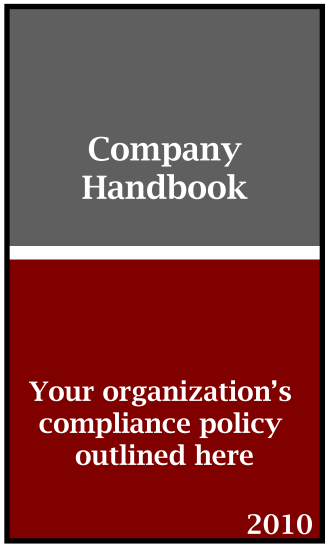
# Strong Compliance Program

- **The best way to prevent embezzlement and to protect an organization given the nature of respondeat superior liability is a comprehensive and vigorous compliance program that must be more than a "mere paper program."**
- **Any effective compliance program will:**
  - Be tailored to the specific organization, such that the controls mitigate the risks inherent in that organization's business and address any applicable government regulations and industry standards.
  - Include a corporate code of ethics. The organization's commitment to ethical behavior should be clearly and concisely communicated to the board, management and employees. This commitment to the code should be affirmed by all employees on a periodic and ongoing basis.
  - Be owned by senior management. Management must be proactive. The Board must have ultimate oversight and control of the program.
  - Provide for regular education and training for directors, management, employees, volunteers and staff.

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# Strong Compliance Program

- Be regularly monitored and audited to ensure that it is working.
- Contain effective means to report violations and concerns, such as whistleblower hotlines or other anonymous reporting mechanisms.
- Provide for meaningful discipline for violation of the policy.  A reputation for aggressively investigating fraud can have a strong deterrent effect while a reputation for ignoring possible fraud is an invitation to commit fraud.
- Require that appropriate steps are taken if a crime occurs.
- Address any control weaknesses uncovered.




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# Preventing Embezzlement

## Set the tone at the top




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# Role of the Board

- **Boards of Directors have a fiduciary duty to ensure.**
  - Financial decisions are made soundly and legally
  - Individual directors and management always put the organization's financial and business interests ahead of personal financial and business interests
  - The Board prudently manages the organization's assets in furtherance of the organization's stated purpose

- **Business Judgment Rule protects actions taken by board members, however those actions must be taken in good-faith with that degree of diligence, care and skill which ordinary prudent people would exercise under similar circumstances.**
- **Satisfying these obligations requires hands-on oversight of management.**
  - Review financial and other business records
  - Question management
  - Ensure the organization's policies, procedures and mission are followed
- **At least one board member should have relevant financial experience.**
- **At least some board members should not be current or former associates of management.  Consider a seasoned lawyer as a board member, as well as members with nonprofit and sector expertise.**

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# Role of the Board: Case Example

## Spitzer v. Schussel et al.

- NY State Attorney General, on behalf of a nonprofit organization known as the New Dance Group Studio, commenced an action against the board for breach of fiduciary duty.
- Complaint alleged lead defendant, Rick Schussel, an officer or director in various capacities, misappropriated funds from the organization through a loan scheme, charged personal expenses to the organization, lived rent free in New Dance's property, and sold New Dance's most significant asset, it's New York building, keeping an excessive commission for himself.
- The New Dance board of directors was also sued for failing to properly oversee Schussel's stewardship of New Dance.


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# Control Measures to Consider #1

## Double Signatures & Authorizations

- Multiple layers of approval will make it far more difficult for embezzlers to steal from your organization.
- For expenditures over a pre-determined amount, require two signatures on every check and two authorizations on every cash disbursement.
- Consider having an officer or director be the second signatory or provide authorization for smaller organizations.
- With credit cards, require prior written approval for costs estimated to exceed a certain amount.
- The person using the credit card cannot be the same person approving its use.
- Have a board member or officer review the credit card statements and expense reports of the Executive Director, CFO, CEO, etc.



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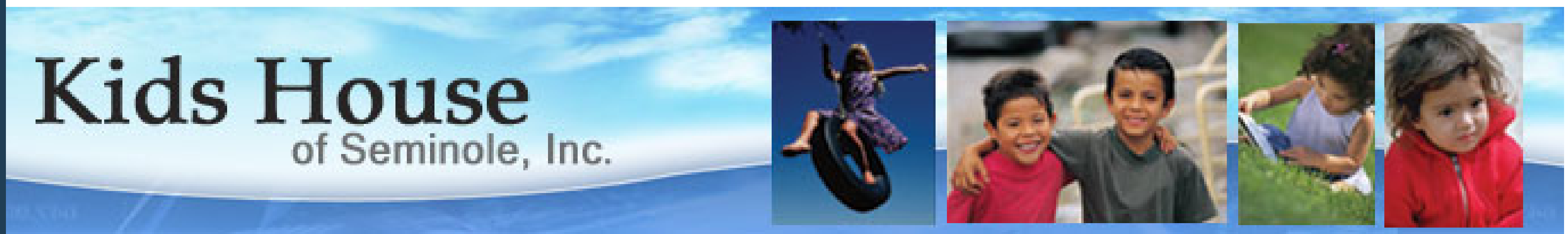
# Case Example




**The Financial Director of Kids House of Seminole would not have been able to steal $48,000 if the organization had implemented a control requiring that two signatures were necessary**

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# Control Measures to Consider #2

## Require Backup Documentation

- All check and cash disbursements must be accompanied by an invoice showing that the payment is justified.
- If possible, the invoices or disbursement request should be authorized by a manager who will not be signing the check.
- Only pay from original invoices.



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# Control Measures to Consider #3

## Never Pre-sign Checks

- Many nonprofits do this if the executive director is going on vacation.
- Keep blank checks and signature stamps locked up.

**CASE EXAMPLE**

**An assistant to an executive director of a nursing home had the directors signature stamp locked in her drawer. She stole millions of dollars from the organization by writing checks to herself and using the director's signature stamp. The director never looked at the checks.**



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# Control Measures to Consider #4

## Segregation of Duties

- **One individual should not be responsible for an entire financial transaction.**
- ***Money Coming In:*** **No single individual should be responsible for receiving, depositing, recording and reconciling the receipt of funds.**
- ***Money Going Out:*** **No one person should be responsible for authorizing payments, disbursing funds, and reconciling bank statements.**
- **If the organization does not have enough staff on hand to segregate these duties, a board director or officer should reconcile the bank and credit card statements.**
- **Require employees who hold financial positions to take an uninterrupted vacation for two weeks – do not let them work from vacation – This permits transactions to clear properly in their absence. If you have an employee who refuses to go on vacation – that could signal a problem.**



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# Control Measures - Case Example

- **Former vice president for finance at large national nonprofit.**
  - Worked there for 20 years
  - Embezzled $11.9 million
- **Wrote checks to herself, forging the signatures of the required co-signers.**
  - Destroyed the canceled checks when the bank mailed them back to her
- **No one noticed because she also kept the organization's books.**
- **She was able to cover up for the losses by inflating the reported amount of unfulfilled pledges.**
- **Had someone else reconciled the bank statements, she would not have been able to destroy the checks that she had written to herself.**
- **Or, if someone else were responsible for unfulfilled pledges, she would not have been able to cover up the losses.**

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# Control Measures to Consider #5

## Conduct Background Checks

- Background checks on new employees and volunteers are important. Many organizations skip this basic step.
- The Association of Certified Fraud Examiners reports that 7% of embezzlers have been convicted of a previous crime.
- Background checks can reveal undisclosed criminal records and prior instances of fraud, allowing you to avoid a bad hire in the first place.
- They are also fairly inexpensive, and should be made a part of your hiring process.

**CASE EXAMPLE**
**A thorough background investigation by the Pueblo Hispanic Education Foundation would have likely revealed that the candidate had pled guilty to embezzling money from another nonprofit**



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# Control Measures to Consider #6, #7, #8

6.

## Fair Bidding Process

- All contracts should be subject to at least three bids, and approved by a manager uninvolved in the transaction.
- Large contracts should be reviewed and voted on by the board.

7.

## Fixed Asset Inventories

- Conduct a fixed asset inventory review at least once per year to ensure that no equipment (computers, printers, etc.) is missing.
- Record the serial numbers of the equipment and consider engraving an identifying mark on each item in case of theft.

8.

## Audits and Board Level Oversight

- Regular audits will not catch every instance of fraud, however, they are critical to prevent fraud and there should be board level review, if not oversight, of the audit.



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# Control Measures to Consider #9

## Encourage Whistleblowers

- Provide a means of anonymous communication.
- Employees may not report theft or mismanagement if they believe their job is in jeopardy.
- Employees must have a manner in which to contact a board member in the event something needs to be reported, and they do not feel comfortable reporting to management.
- Board members must be prepared to take these reports seriously, keep the reporting employee protected and contact legal counsel.



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# QUESTIONS?



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