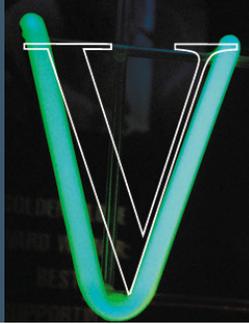


# A Primer on Detecting, Preventing, and Investigating Nonprofit Fraud, Embezzlement, and Charitable Diversion

Increasing Scrutiny of Nonprofit Fraud,  
Embezzlement, and Charitable Diversion

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### Increasing Scrutiny of Nonprofit Fraud, Embezzlement, and Charitable Diversion

#### ***Media Coverage and Recent Examples***

On October 26, 2013, *The Washington Post* reported that from 2008 through 2012, more than 1,000 nonprofit organizations disclosed hundreds of millions of dollars in losses attributed to theft, fraud, embezzlement, and other unauthorized uses of organizational funds and assets. According to a study cited by the *Post*, nonprofits and religious organizations suffer one-sixth of all major embezzlements—second only to the financial services industry. While the numbers are shocking, the underlying reasons for nonprofit susceptibility to fraud and embezzlement are easy to understand. Many nonprofits begin as under-resourced organizations with a focus on mission rather than strong administrative practices. As organizations established for public benefit, nonprofits assume the people who work for them, especially senior management, are trustworthy. Often these factors result in less stringent financial controls than implemented by their for-profit counterparts.

Of course, nonprofit employees are not immune to the vulnerabilities of economic distress, including financial difficulties, overspending, and even gambling. Further, high-level employees and their close associates have significant access to organizational funds and financial records, causing them to believe they can successfully commit the fraud and embezzlement and conceal their conduct from outside scrutiny. Employees may rationalize their unlawful conduct as just compensation for lower salaries or unfair treatment, or as legitimate financial arrangements whereby the employee is simply "borrowing" money from the organization.

Recent examples of nonprofits that have fallen victim to these crimes include:

- In 2012, the Global Fund to Fight Aids, Tuberculosis, and Malaria reported to the federal government a misuse of funds or unsubstantiated spending of \$43 million.
- In 2011, the Vassar Brothers Medical Center in Poughkeepsie, New York, reported a loss of \$8.6 million through the theft of certain medical devices.
- From 1999 to 2007, the American Legacy Foundation, a nonprofit dedicated to educating the public about the dangers of smoking, suffered an estimated \$3.4 million loss as a result of alleged embezzlement by a former employee.

In light of the disturbing numbers reported by the *Washington Post*, Congress and numerous state attorneys general have pledged to launch investigations, and reportedly, some have. This will likely lead to even greater scrutiny by government regulators. External audits are necessary to ensure that effective financial controls and fraud prevention measures are being followed, but a standard audit is not the method by which nonprofit organizations should expect to detect fraud. The Association of Certified Fraud Examiners ("ACFE") reports that less than 4% of frauds are discovered through an audit of external financial statements by an independent accounting firm.

Nonprofits may no longer elect to handle instances of fraud or embezzlement quietly to avoid unwanted attention and embarrassment. As of 2008, a larger nonprofit must publicly disclose any embezzlement or theft exceeding \$250,000, 5% of the organization's gross receipts, or 5% of its total assets.<sup>1</sup> A tax-exempt organization whose gross receipts are greater than or equal to \$200,000—or whose assets are greater than or equal to \$500,000—is subject to additional public disclosure requirements on its IRS Form 990 concerning the embezzlement or theft.

### ***The Regulators***

Oversight of nonprofit activities falls under the jurisdiction of the attorneys general of the various states. State attorneys general normally require all registered charities to annually report whether they have experienced theft, embezzlement, diversion, or misuse of the organization's charitable property or funds in any amount in the past year. Where appropriate, state prosecutors could elect to bring charges for embezzlement or theft.<sup>2</sup>

As discussed below, the IRS and state tax authorities have co-extensive jurisdiction over nonprofit organizations that have been granted recognition of tax-exempt status under federal and state law, respectively, and can levy penalties or excise taxes, or revoke tax-exempt status altogether, if a significant diversion of assets is involved.

A nonprofit that receives federal funding faces additional scrutiny by that federal agency's Office of Inspector General ("OIG"). In addition to performing traditional audits, the OIG—and in some cases, the FBI—works hand-in-hand with federal prosecutors across the country to investigate fraud and embezzlement. Federal prosecutors may elect to bring charges under, among other applicable federal statutes, 18 U.S.C. § 641, which makes it a crime to

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<sup>1</sup> The *Washington Post* scrutinized a database of IRS Form 990 information returns. Since 2008, Form 990 information returns have required filers to report "any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to embezzlement or theft." A "charitable asset diversion" is defined as "any unauthorized conversion or use of the organization's assets other than for the nonprofit's authorized purposes." 501(c)(3) organizations that file a Form 990 information return are required to report the gross value of all diversions discovered during the nonprofit's tax year if exceeding a threshold more than the lesser of (i) 5% of the organization's gross receipts for its tax year; (ii) 5% of the organization's total assets as of the end of its tax year; or (iii) \$250,000.

In addition, asset diversions (in any amount) by a charity's insider—including, but not limited to, a charity's founders, members of its governing body, officers, senior employees, persons with financial oversight responsibilities, or anyone in a position to exert significant influence on the charity—must also be reported. Called "excess benefit transactions," these sorts of charitable asset diversions occur whenever such insiders (or, as referred to by the IRS, "disqualified persons") receive some kind of economic benefit from the nonprofit organization that exceeds the value of the benefit they provide to the organization. The Internal Revenue Code Regulations state in Section 53.4968.4(c) that "in no event shall an economic benefit that a disqualified person obtains by theft or fraud be treated as consideration for the performance of services." Thus, embezzlement by a disqualified person is an automatic excess benefit transaction, and as such, it must be reported.

<sup>2</sup> California Penal Code Section 503, for example, defines embezzlement as "the fraudulent appropriation of property by a person to whom it has been entrusted." Under New York Penal Code Section 155, embezzlement occurs when a person, having been entrusted to hold property on behalf of the rightful owner, causes the conversion of such property.

steal money from the United States or any department or agency thereof, and 18 U.S.C. § 1341, which makes it a crime to devise a scheme to defraud another of property or money with the use of interstate wire communications.

### ***The Role of the Board of Directors***

Directors are charged with conducting and overseeing the management of a nonprofit organization. While day-to-day operations are often delegated to staff, directors maintain the ultimate authority and responsibility for the organization's activities. State law and judicial decisions impose fiduciary duties of care and loyalty on nonprofit directors. A director who observes these duties is generally insulated from personal liability. However, a board must carry out actions in good faith, employing the degree of diligence, care, and skill that an ordinary prudent person would exercise under similar circumstances.

### **Detecting the Warning Signs at Your Nonprofit Organization**

According to the ACFE, if you know what to look out for, most employees who commit fraud or embezzlement exhibit tell-tale signs that are easily identifiable. If you notice a combination of the following warning signs, you may be able to detect and prevent fraud within your organization:

- A review of financial statements and account records demonstrates an unusual and unexplainable drop in the organization's profits;
- Check requests for reimbursement of expenses do not contain original receipts;
- Financial records are disorganized, and documents such as vendor contracts are missing;
- An employee who refuses to take vacation, continually works overtime, or wants to take work home with them;
- An employee who exhibits signs of or discusses financial hardship or personal issues;
- Excessive or lavish personal spending by an employee that does not seem reasonable based on salary;
- Inventory or petty cash is unexpectedly missing;
- An employee who has an unusually close relationship with vendors; and
- Vendors who do not appear to have legitimate websites or contact information.

### **Recommended Preventative Measures**

Nonprofits are not defenseless against charitable asset diversion. In fact, there are several proactive steps a nonprofit and its board can, and should, take to prevent and detect fraud and embezzlement. Below are common internal controls that can be modified for nonprofit organizations of various complexities and sizes and applied to volunteers and/or employees.

#### ***Require Double Signatures/Authorizations and Back-Up Documentation***

Multiple layers of approval increase the difficulty for embezzlers to steal from a nonprofit. For expenditures over a predetermined amount, require two signatories on every check and two different signatories on every authorization or payment. If a nonprofit's professional staff is too small to effectively implement a double signatory/authorization policy, consider having a volunteer officer or director be the second signatory. All check and cash disbursement requests should be accompanied by an invoice or other document showing the payment or disbursement is appropriate. Never allow checks to be pre-signed. It is preferable for an administrative assistant to be responsible for bringing the checks to the two signatories for signing, so that a buffer is always maintained between signatories. Require prior written approval from two individuals for credit card expenditures estimated to exceed a certain amount (e.g., \$20), and require back-up documentation demonstrating expenditures are bona fide. The person using the credit card should not be the same person who authorizes its use.

### ***Segregate Financial Duties***

No single person should be responsible for receiving, depositing, recording, and reconciling the receipt of funds. Task different employees with the responsibility of preparing payment records, authorizing payments, disbursing funds, reconciling bank statements, and reviewing credit card statements. If there is not enough professional staff to effectively segregate duties, use a volunteer officer or director to reconcile the bank statements and review credit card statements. Similarly, all contracts should be approved by a manager who is uninvolved and personally disinterested in the transaction, and large contracts should be the product of competitive and transparent bidding.

### ***Conduct Fixed Asset Inventories***

At least annually, an organization should perform a fixed asset inventory to ensure that no equipment or other goods are missing.

### ***Implement Automated Controls***

Use electronic notifications to alert more than one senior member of an organization of bank account activity, balance thresholds, positive pay exceptions, and wire notifications.

### ***Perform Background Checks***

Background checks on new employees and volunteer leaders are crucial in unearthing undisclosed criminal records, prior instances of fraud, and/or heavy debt loads that may render the person more vulnerable to succumbing to fraud. The ACFE reports that 6% of embezzlers were previously convicted of a fraud-related offense.

### ***Establish Audits and Board-Level Oversight***

The above control measures are effective only if someone is monitoring the organization. Regular external audits are necessary to ensure effectiveness. Establish an audit committee on the board of directors, composed of at least one person familiar with finance and accounting to serve as the primary monitor of the anti-fraud measures. In lieu of an audit committee, smaller nonprofits should consider including a CPA or other financially knowledgeable person on the board of directors to serve a similar function.

### ***Encourage Whistleblowers***

Nonprofits must encourage volunteers and employees to report suspected wrongdoing to management and/or a designated board member. A means of anonymous reporting is essential—if employees believe reporting could jeopardize their jobs, they may be reluctant to report theft or mismanagement. The board must ensure such reports are taken seriously, that the reporting employee is protected, and that outside legal counsel is brought in, if appropriate. An active board will inspire confidence among employees and ensure employees follow proper internal controls and protocols, including reporting troubling activities among the organization's personnel.

### ***Construct a Strong Compliance Program***

An effective compliance program must be more than a mere "paper program." It must be tailored to a specific organization, include a written code of ethics, be effectively implemented through periodic training, have real consequences for violations, have an effective reporting mechanism, and be periodically audited to ensure its effectiveness. A nonprofit's commitment to ethical behavior should be clearly and concisely communicated to the board, management, and employees, and commitment to the code should be affirmed by all employees on a periodic and ongoing basis.

### ***Communicate with Donors***

Regular conversations with donors can also serve as an early warning system against embezzlement. Donors are often privy to issues with donations that may not be obvious to management, such as checks being cashed without record from the organization, or donor contributions that are not properly acknowledged. In the case of an organization that receives federal or state grant funds, the board should review all correspondence between the nonprofit and the funding agencies to ensure that the board is kept apprised of any of grant agency concerns.

### ***Perform Self-Audits***

Outside expertise—such as CPAs experienced in conducting fraud audits (different from the standard annual financial statement audit) and attorneys experienced in evaluating and enhancing internal controls as well as training staff on best practices—can be a critical tool in identifying fraud and embezzlement that may be occurring and/or in shoring up weak controls or other process deficiencies that make an organization more susceptible to theft.

### ***Acquire Insurance Coverage***

Various types of insurance help ensure stolen property or money can be replaced or repaid. Fidelity insurance protects a nonprofit from theft by "covered individuals" of property owned by it. Generally "covered individuals" include the insured's employees, but not necessarily all of its volunteers. A separate endorsement may be required to protect against that risk. Depositor's forgery insurance covers theft of blank checks, credit cards, and instances of altered checks. Some insurance policies cover the cost of hiring outside counsel to conduct an internal investigation of alleged fraud or embezzlement. A good insurance broker – familiar with the nonprofit sector – can help a nonprofit navigate the choices and make informed decisions about coverage.

### **Steps for Investigating Allegations of Fraud and Embezzlement**

Fraud and embezzlement can severely undermine a nonprofit's mission through damage to an organization's public reputation, loss of donor funds, revocation of tax-exempt status, and even closure of the organization. Thus, it is crucial that every nonprofit create a comprehensive plan of action to handle cases of suspected fraud or embezzlement before there is ever a need for it.

This plan must include the following:

#### ***Address Preliminary Considerations***

If a nonprofit board suspects embezzlement or other charitable asset diversion, the board must investigate quickly and carefully. A thoughtful investigation is the first step the board should take to discharge its fiduciary responsibility to protect the nonprofit's charitable assets and help insulate its members from any claim of personal liability for the loss. To satisfy these duties, directors should (i) exercise independent and informed judgment; (ii) judge what is in the nonprofit's best interest, irrespective of other entities with which the director is affiliated or sympathetic, or to which the director owes his board appointment; and (iii) have adequate information and assure the adequacy and clarity of information.

For the sake of confidentiality, the board may initially choose a small sub-committee or an individual to conduct the inquiry. Depending on the sensitive nature of the investigation, the board may elect to retain the services of an attorney or auditor experienced in handling such investigations. The duty of care permits a director to rely on information, opinions, reports or statements, including financial statements, prepared or presented by others whom the director believes are reliable and competent in the matters presented. If the embezzlement scheme has been sophisticated or longstanding, the nonprofit may require a forensic accountant or certified fraud examiner to determine the amount stolen.

#### ***Evaluate the Need to Retain Outside Counsel***

In determining whether outside counsel is necessary, at the outset of the investigation, the board should evaluate the following considerations to ensure the matter is handled fairly, impartially, and consistent with personnel policies:

- Whether anyone on the board has sufficient investigative skill and experience to lead the inquiry;
- The likelihood that employees with first-hand knowledge of the alleged fraud or embezzlement will be honest and forthright with board members;
- The relative scale of the suspected misconduct, and the management level of the person(s) implicated;
- The board members' relationships and personal history with the subject and whistleblower (the investigator should never be the subject's supervisor);
- Whether the nonprofit's insurance policy will cover the costs of the internal investigation;<sup>3</sup>

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<sup>3</sup> If a nonprofit's insurance policy provides coverage, prompt notice to the insurer may be needed. It is possible that the insurer will provide advice about preparing for, or elect to participate in, the investigation. The insurance company may require the organization to file a police report in connection with an insurance claim.

- Whether it may be important to rely on the attorney-client privilege to protect from subsequent disclosure to private third parties or the government in the event of a future investigation or litigation; and
- If insurance coverage is not available, the availability of other nonprofit resources to pay for outside investigative expertise.

### ***Anticipate Employment Law Ramifications***

Employment-related investigations must be prompt, thorough, and fair to those being investigated. An employee accused of misconduct should always be confronted with the allegations and given a fair opportunity to present his or her side of the story. If a preliminary investigation establishes credible evidence of embezzlement involving a current employee, a nonprofit should consult with employment counsel. While the facts may seem to constitute grounds for immediate termination, the most prudent employer response will depend on the offense, state of employment law, employment policies, and relevant employment agreements.

### ***Secure Relevant Records and Files***

If the allegations merit a full internal investigation, the board must take steps to preserve evidence and maintain relevant records, including emails, handwritten notes, files, calendar entries, checks, financial statements, and related documents. Circulate a "litigation hold" notice requesting persons with access to relevant documents and information to maintain such materials and provide copies to the board. Consider restricting the employee's access to the organization's computer network and other books and records. Other security measures may be necessary, *i.e.*, changing passcodes, locks, and bank account signatories. Exercise caution to ensure these steps are taken in accordance with the organization's policies and bylaws.

### ***Interview the Suspect and "Witnesses"***

Once immediately available relevant information has been gathered and the board's preliminary findings reviewed, a senior member of the nonprofit or retained outside counsel should take the lead on interviewing the suspect. The interviewer should not promise confidentiality or make any such assurances to the subject. Have a second person take notes during the interview, if such activity is not disruptive. It is imperative to memorialize the suspect's inculpatory and exculpatory statements in a formal memorandum or legible notes. Use the same level of care when interviewing employees with first-hand knowledge of the unlawful conduct. These statements will be critical sources of information in subsequent litigation and/or a government investigation. Consider placing the suspected embezzler on a leave of absence immediately after the interview.

### ***Recover Funds or Assets***

The board has a fiduciary obligation to try to recover embezzled assets and will be expected to explain efforts taken in the reports to the relevant state attorney general and the IRS, as described below. Some nonprofits anticipate the risk of insider theft and obtain fidelity or crime insurance. If no insurance is available to compensate the nonprofit for the loss, the organization must weigh the benefits and drawbacks of litigation to collect the debt from a possibly judgment-proof (*i.e.*, financially insolvent) defendant. Private resignation/restitution arrangements can be negotiated, but this should be undertaken with the assistance of an attorney and fully documented under a settlement agreement and payment plan. Consult employment counsel before attempting to recover any funds from the embezzler's final paycheck or vacation time. Nonprofits should never threaten criminal prosecution as a negotiation tactic. Such threats could be construed as a type of extortion, which in and of itself is a crime. That being said, an organization should keep in mind that a successful criminal prosecution could be the most cost-effective way to recover stolen money or assets, as discussed below.

### ***Consider Referring the Matter to Law Enforcement Authorities***

Some states require directors to refer the matter to the local district attorney for possible criminal prosecution. Many nonprofits struggle with this expectation because they fear bad publicity or sympathize with the embezzler. Instead, a nonprofit may accept restitution and keep the fraud quiet in the hope they will not lose funders. This may seem to be in the best interest of the nonprofit, but failure to prosecute means the perpetrator can change employment and steal from another nonprofit. In addition, a criminal prosecution of the wrongdoer could result in the court ordering the individual to pay restitution to the organization. This may be the easiest, most cost-effective way for an organization to recover embezzled funds, particularly in the case of smaller thefts. An organization's board or audit committee should consult with outside counsel to evaluate whether a situation calls for a criminal referral to law enforcement authorities.

If a nonprofit receives funding from state and/or federal agencies, it must present its findings to the grant agency's OIG and take steps to ensure the incident does not disrupt the nonprofit's current funding or plans for renewal. Prompt and thorough investigation and disclosure of employee misconduct will inspire confidence in the grant agency and minimize potential funding problems for the organization.

### ***Manage Public and Internal Disclosure***

Because of the potential harm to a nonprofit's reputation, it will take significant care to determine how much to disclose and to whom. Select a spokesperson and develop a communication plan to assure key stakeholders of the nonprofit's plans to recover stolen assets and take steps to prevent future theft. Carefully consider the specific contents of any public disclosure, because a public accusation linking a specific employee to the theft, if proven false, could lead to a defamation action. Notify affected staff early on with "need-to-know" details to quash rumors. If litigation is likely, consider privately informing major funders before the news is made public.

Even if litigation or public media disclosure is unlikely, evaluate the possible impact of publicly available incident reports made to regulators. Have a general crisis communication plan prepared in advance to deal with any number of unexpected events.

### ***Address Federal Reporting Requirements***

Every 501(c)(3) tax-exempt organization must annually file a series 990 return with the IRS. Small organizations (annual gross receipts of \$50,000 or less) are eligible to file a 990-N e-Postcard, which reports only very basic contact and operational status information. Organizations that normally have less than \$200,000 of gross receipts and less than \$500,000 of total assets can file a simplified return, the 990-EZ. Larger organizations must file the longer and more complex Form 990 return.

The type of Form 990 return a nonprofit files determines whether it must publicly report a significant asset diversion or excess benefit transaction. The Form 990 return, in Part VI, Section A.1.a, asks if, during the year, the nonprofit has become aware of a material diversion of its assets, regardless of whether the loss actually occurred during that tax year. If so, the nonprofit must explain the nature of the diversion, the amounts or property involved, the corrective actions taken to address the matter, and any other pertinent circumstances. If the diversion constituted private inurement or an excess benefit transaction, this must be disclosed in the relevant schedule of the form.

An organization that files a 990-EZ is only required to report an excess benefit transaction, but not a significant diversion of assets. An organization that files a 990-N e-Postcard is not required to report either excess benefit transactions or charitable asset diversions. However, any nonprofit can voluntarily report embezzlement to the IRS on Form 3949-A. This form is used for reporting suspected tax fraud, and an organization filing this form provides the contact information and details of the embezzler.

### ***Avoid Federal Penalties***

When the suspected embezzler is also a "disqualified person," the risk to the organization and its directors of IRS intervention and penalties increases. Under section 4958 of the Internal Revenue Code, if a section 501(c)(3) tax-exempted corporation provides an excess benefit, **the insider who receives the excess benefit is subject to excise taxes, as are any organization managers—including officers and directors—who approved the excess benefit.** With an automatic excess benefit transaction like embezzlement, where there was no literal approval of the action, directors are not likely to be personally subject to the excise tax (unless one or more were knowing participants in the scheme). Nevertheless, the board must be vigilant in their plans to explain and rectify the fraud.

The cost of receiving an excess benefit is severe. The disqualified person must correct the excess benefit by making a payment in cash or cash equivalents equal to the correction amount (no promissory note). The correction amount is the sum of the excess benefit, plus interest at a rate that equals or exceeds the applicable federal rate, compounded annually. The disqualified person is also taxed 25% of the excess benefit. The IRS notice of deficiency outlines the penalties imposed. Failure to make the correction to the nonprofit by the due date will result in an additional tax of 200% of the excess benefit.

No tax or penalty is imposed on a nonprofit that was victim to an excess benefit transaction. However, a tax equal to 10% (up to \$20,000 per transaction) of the excess benefit may be imposed on each organization manager who participated in the transaction, knowing that it was an excess benefit transaction, unless the participation was not

willful and was due to reasonable cause. The \$20,000 is an aggregate figure; all organization managers participating in the transaction are jointly and severally liable.

While the Forms 990 or 990-EZ can alert the IRS and the public that an excess benefit transaction has occurred, these are not the only filings used to report such transactions. Form 4720 is a separate annual filing that must be made by disqualified persons or managers who owe the taxes described above. The victim nonprofit is not required to file Form 4720, but nonprofits may be able to use this form to try to trigger an IRS collection action against a fraud perpetrator who has made no attempt to repay embezzled funds.

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Nonprofit boards of directors should facilitate establishment and supervision of strong policies that support the best practices explained above. Nonprofit organizations should put policies and procedures in writing to clearly communicate the organization's stance. While the board should not micro-manage the day-to-day operations of an organization with paid staff, neither should it be complacent about its fiduciary obligation to *"act with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances."* Periodic review of financial reports and the Form 990 return, appointment of an audit committee, and hiring a strong chief staff executive who is in sync with all of these risk management measures are all actions a board can take to fulfill its duty of care and protect the charitable funds and other assets entrusted to it.

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