

Internal Controls For Small Non-Profit Entities

Waco Regional Baptist Association

Fraud is any intentional
act or omission
designated to deceive
others, resulting in the
victim suffering a loss
and/or the perpetrator
achieving a gain.

Types of Fraud

- Misrepresentation of facts
- Breach of fiduciary responsibilities
- Suppression of truth
- Omission of critical facts

Variations of Fraud

- Fraud to the non-profit
 - Embezzling fund from the non-profit
- Fraud by the non-profit
 - Medicare/Medicaid
- Fraud for the non-profit
 - Misleading donors about funds raised
- Fraud through the non-profit
 - Identity theft

Internal Frauds

- Revenue and cash receipts
- Purchasing and cash disbursement
- Payroll and employee expense reports
- Non-cash assets misappropriations

False Security

- Fraud (embezzlement) does not occur in non-profit entities
- Fraud does not occur in small entities
- We hire good, Christian people – they would not do things like this
- Our employees are loyal to our purpose and would not “steal from the poor”

Fraud in West Texas

- Tuscola Women – Stole \$200,000
- Lubbock Teach – Embezzled \$10,000
- Midland bookkeeper – Stole \$200,000+
- Wichita Falls Woman – Stole more than \$2 million
- Abilene Woman – Conspired to embezzle more than \$850,000 from Baptist Hospital

Fraud Stats – ACFE's 2008 Report

- Approximately 7% of revenue is lost each year due to fraud
- Median loss - \$175,000
- Median loss for companies of less than 100 employees - \$200,000
- 25% of cases had losses of at least \$1 million
- Typical length of time between date of fraud started and detected was two years

Fact About Non-Profit Fraud

- In a 2004 study of 508 occupational fraud cases
 - 12.2% of the frauds occurred in the non-for-profit sector
 - The median loss of \$100,000
 - Billing schemes were the most frequent
 - 45.8% of the frauds occurred in organizations with fewer than 100 employees

The Reality of Fraud

- Small entities are the most vulnerable to occupational fraud and abuse
- More than 82% involve misappropriations of cash
- Fraudulent financial statements are the most costly type of fraud

Characteristics of Non-Profits

- Environment of trust
- Excessive control by a “founder”
- Failure to include individuals with financial oversight
- Contributions are more difficult to track
- Failure to devote resources to financial management
- Job security linked to program reporting

Perception Gap

Many in the public think
any audit performed by a
CPA WILL discover fraud
if it exists.

How Is Fraud Detected

- Employee tip – 46%
- Internal Audit – 18%
- By Accident – 34%
- Financial Statement Audit – 2%
- Other study indicated between 11-15%

Perpetrator's Profile

- High income/education = Greater loss
- Highest median losses related to employees with 6-10 years of tenure (6+ years = \$261,000 vs. <1 year = \$50,000)
- Median loss for males = \$250,000
- Median loss for females = \$110,000
- More education = higher loss (postgraduate = \$550,000 vs. high school = \$100,000)

Who Commits Fraud

- 58% perpetrated by employees – not in management
 - Median loss = \$60,000
- 30% in management position
 - Median loss = \$250,000
- 12% by someone in an executive position
 - Median loss = \$1,000,000

Motivation To Do It

- Gambling problem
- Drug/alcohol addiction
- Financial difficulties
- Marital difficulties
- Medical bills
- Or - Just enjoy living “life on the edge”

Who Are They?

- Disgruntles employee
- Stressed out employee
- Employee living above their means
- Employee who never takes a vacation
- Employee overly compulsive about their job responsibilities

Fraud Triangle

- Incentive
- Rationalization
- Opportunity

Primary Reasons for Fraud

- Pressures to do “whatever it takes” to meet goals – 81%
- To seek personal gain – 72%
- They do not consider their actions fraudulent – 40%

General Categories Of Fraud

- Asset Misappropriation
- Corruption
- Fraudulent Financial Statements

All organizations are subject to fraud risks. Large frauds have led to the downfall of entire organizations, significant legal costs, incarceration of key individuals, and erosion of confidence in the public.

Good governance principles demand that an organization's board of directors ensure overall high ethical behavior in the organization, regardless of its status as public, private, government, or not-for-profit; its relative size; or industry.

The board's role is critically important because historically most major frauds are perpetrated by senior management in collusion with other employees.

Simple Ethical Rule

You must be faithful
to the public good
above your personal
interests.

2003 Survey Of More Than 300 Not-For-Profit CEOs

- 62% said their board had not discussed the Sarbanes-Oxley Act
- Only 20% indicated they had implemented any governance policy changes as a result of the SOX
- 77% said they have a separate audit committee
- Just 16% said they have a “whistle-blower” policy in place

Fraud Prevention And Detection

Fraud prevention and detection are related, but are not the same concepts.

Prevention encompasses policies, procedures, training and communication that stop fraud from occurring; whereas, detection focuses on activities and techniques that promptly recognize in a timely manner whether fraud has occurred or is occurring.

Burglar alarm companies have reported for decades that 80 percent of the businesses and homes that have alarms installed do so *after* they have been burglarized.

Every organization is
susceptible to fraud,
but not all fraud can
be prevented, nor is it
cost-effective to try.

Approach To Control Fraud

- High probability that some level of fraud or abuse already exists
- Real cost of the fraud cannot be measured only in dollars lost
- People change over time and some of those changes may increase the risk

Approach to Control Fraud Cont'd

- Traditional internal controls play a critical role BUT represent only the one facet of detection/prevention
- Reliance on an external audit is not enough
- Everyone in the organization has a role in the prevention/detection of fraud

Fraud Risk Management–Principle 1

As a part of an organization's governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

Fraud Risk Management-Principle 2

Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

Fraud Risk Management-Principle 3

Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

Fraud Risk Management-Principle 4

Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

Fraud Risk Management-Principle 5

A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

Breaking The Fraud Triangle

- Implies that an organization must remove one of the elements in the fraud triangle in order to reduce the likelihood of fraudulent activities
- Of the three elements, removal of opportunity is most directly affected by the system of internal controls and generally provides the most actionable route to deterrence of fraud

Elements Of A Fraud Risk Management Program

- Roles and responsibilities
- Commitment
- Fraud awareness
- Affirmation process
- Conflict disclosure
- Fraud risk assessment

Elements Of A Fraud Risk Management Program Cont'd

- Reporting procedures and whistleblower protection
- Investigation process
- Corrective action
- Quality assurance
- Continuous monitoring

Investigation And Corrective Action

No system of internal control
can provide absolute assurance
against fraud.

Internal Controls

- Very broad and concerns ALL
 - Policies
 - Procedures
 - Behaviors
 - Practices
- Segregation of duties
- Review and monitoring

Comprehensive Model

- Financial controls
- Nonfinancial systems
- Management oversight and behavior

Financial Controls

- Recording revenue
- Collecting payments
- Purchasing
- Distributing funds
- Payroll
- Administration of grants
- Reconciliation of accounts
- Timely and accurate financial information

Nonfinancial Systems

- Background checks
 - Criminal
 - Credit check
 - References
 - Social Security Number verification
 - Driving record
 - Verify degrees and credentials
 - Drug testing

Management Oversight

- Budgeting
- “Tone at the top”
- Review and evaluation of work performed and the people
- Financial analysis

Signed Agreements

- “Conditions of Employment Agreement”
- “Conflict of Interest Statement”
- “Whistleblowers Policy”
- “Confidentiality Agreement”

Fraud Self-Assessment

- Schedule a fraud “discussion” for managers and supervisors
- Identify fraud risks
- Assess whether the identified fraudulent risks could be the result in actual fraud and how large the fraud could be

Mitigate Identified Risks

- Bank reconciliations
- Segregation of duties
- Access and authorization controls
- Consider a surprise audit by internal or external auditors

Financial Statement Assertions

- Existence (Validity)
- Occurrence (Cutoff)
- Completeness
- Valuation
- Rights and Obligations
- Presentation and Disclosure (Classification)
- Reasonableness

Activity Categorization

- Segregation of duties
- Authorization of transactions
- Retention of records
- Supervision or monitoring of operations
- Physical safeguards
- Top-level reviews
- IT security
- Controls over information processing

Segregation Of Duties

- Authorization function
- Recording function
- Custody of asset

Control Activities - Segregation Of Duties

- No one person should
 - Initiate the transaction
 - Approve the transaction
 - Record the transaction
 - Reconcile balances
 - Handle assets
 - Review reports

Make It A Complete Package

- Set the tone at the top
- Establish a code of conduct
- Provide ethics training repeatedly
- Create a positive work environment
- Have a whistleblower policy – consider having a “hot line”
- Discipline or prosecute

Information Prepared By:

Jerry L. Love, CPA
Davis Kinard & Co, PC
Abilene, TX

PowerPoint Presentation Prepared By:
Waco Regional Baptist Association