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CPAs' Role in Fighting Fraud in Nonprofit Organizations

By Andrea McNeal and
Jeffrey Michelman

Fraud in the nonprofit sector has been the object of increasing scrutiny by the U.S. Congress, notably the U.S. Senate Finance Committee, as well as by New York State Attorney General Eliot Spitzer. Recent studies indicate that frauds occur in nonprofits of all sizes and in every area of the country with astounding frequency. Furthermore, the cost of these frauds appears to be increasing at an alarming rate (see *Exhibit 1*). With small organizations suffering the most extreme losses from fraud and embezzlements, small, community-based nonprofits must be especially diligent in enacting fraud prevention and detection measures. Specifically, good board governance and internal control policies in these organizations are imperative to prevent or mitigate the negative impacts of fraudulent activity within the organization. Financial officers and CPAs advising nonprofits also have a role to play in facilitating and ensuring effective internal controls.

Board Governance

The implications of the Sarbanes-Oxley Act (SOA) for all organizations are far-ranging. Typically, the boards of small nonprofit organizations tend to comprise a few volunteer community members that know each other well and have established a level of trust and rapport. Additionally, nonprofit boards frequently experience a high turnover of members, and individuals that volunteer are

often untrained or unqualified to properly perform the oversight function. Combined, these factors can result in a board that is unwilling or unable to ask the tough questions necessary to detect financial mismanagement or fraud.

SOA requires public companies to estab-

lish a finance

committee. The role of a CPA volunteer, even if merely as an independent board member providing check-signing oversight, may be critically important in both substance and form. Small nonprofits should still consider retaining an independent accountant

to perform a review or compilation of the entity's financial records to supplement any fraud detection activities. Furthermore, nonprofits that choose to forgo an external audit should at least establish an independent finance committee to oversee the organization's financial employees and transactions.

Given the high turnover of board members and officers, as well as the volunteer nature of these positions, small nonprofits may experience difficulty finding volunteers with adequate business and financial qualifications. Furthermore, the turnover of these individuals makes continuity of oversight and fiscal initiatives more difficult. Nonetheless, nonprofits should attempt to engage "financial experts," or at least financially knowledgeable individuals, to serve on the finance committee. Active involvement of such individuals in the oversight function may provide additional scrutiny



and accountability for the financial officers and employees and therefore aid in not only detecting, but also deterring, fraudulent activity. Although nonprofits may be stratified into perhaps three categories—those receiving no CPA services, those using CPAs to complete a review, and those using a CPA to complete a full audit—the role of the CPA remains important in all three instances.

Internal Control Issues

The classic fraud triangle (*Exhibit 2*) illustrates the three factors that are necessary for a fraud to occur: pressures or incentives, rationalization, and opportunity. Although the convergence of these factors is what ultimately results in frauds, organizations can address the opportunity component, and thus reduce the likelihood of fraudulent activity, by establishing adequate internal controls.

While every nonprofit faces its own set of control challenges and weaknesses, small community-based organizations have characteristics that make them particularly susceptible to fraud. At the forefront of the problematic characteristics is the fact that these organizations are not only overseen, but generally also run, solely or largely by volunteers. The individuals responsible for carrying out executive and financial duties often have separate full-time jobs and receive no compensation for assuming these additional responsibilities. As a result, the volunteers may not be as fully committed to the tasks at hand as they should be, and may therefore fail to exercise an adequate level of care in performing their duties. Additionally, these volunteers may receive little or no instruction on the proper performance of their responsibilities.

These deficiencies in dedication and training can have dire consequences for any organization, and many good, honest volunteers may unknowingly perform their duties incorrectly. Furthermore, some volunteers may negligently breeze through tasks that deserve more attention, resulting in financial losses or administrative difficulties for the organization. At the far end of the spectrum, unscrupulous volunteers may exploit these weaknesses to their advantage, as exemplified in the First Coast Soccer Association case (discussed in *Exhibit 3*). Individuals looking for fraud opportunities will always choose organizations with the exploitable combination of high potential rewards and a poorly implemented internal control structure.

Because small nonprofit organizations rely so heavily on the integrity and ability of their volunteers, such entities must obtain background checks, both criminal and financial, on all board members and

EXHIBIT 1 Facts About Nonprofit Fraud

In a 2004 study of 508 occupational fraud cases*:

- 12.2% of the frauds occurred in the not-for-profit sector.
- The median loss of cases in not-for-profit organizations was \$100,000, up from \$40,000 in a similar study in 2002.
- Billing schemes were the most frequent form of fraud in not-for-profit organizations, accounting for 46.6% of the cases.
- 45.8% of the frauds occurred in organizations with fewer than 100 employees, with a median loss of \$98,000.

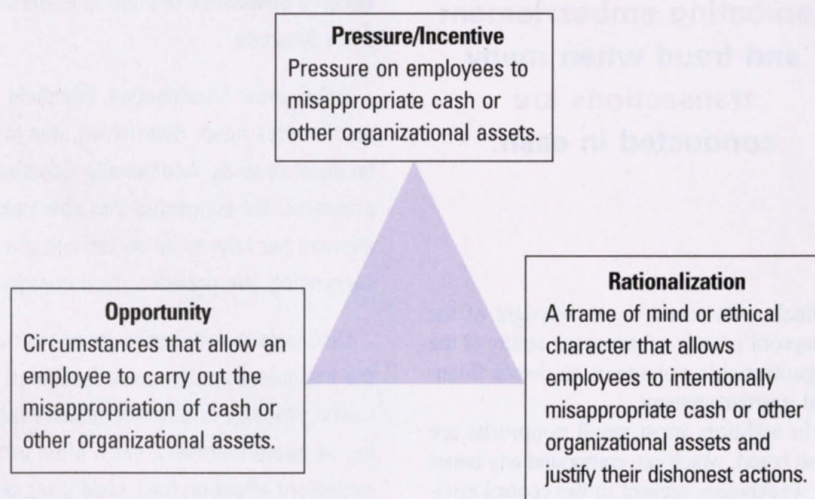
In a 2003 survey of more than 300 not-for-profit CEOs**:

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

* Association of Certified Fraud Examiners, *2004 Report to the Nation on Occupational Fraud and Abuse*.

** Grant Thornton LLP, *National Board Governance Survey for Not-for-Profit Organizations* (www.grantthornton.com).

EXHIBIT 2 The Fraud Triangle



Sources: *Occupational Fraud Abuse*, by Joseph T. Wells, CPA, CFE (Obsidian Publishing Co., 1997); *Fraud Examination*, by W. Steve Albrecht (Thomson South-Western Publishing, 2003).

officers, or at least on anyone handling cash or other liquid assets. In many cases, small nonprofits that have suffered at the hands of fraudsters would have uncovered previous financial transgressions or possible fraudulent motivations simply by conducting thorough background and reference checks on the perpetrators prior to hiring them.

Some organizations may wish to go one step further and obtain fidelity bonds to cover those volunteers that will handle cash. While fidelity bond coverage can mitigate financial losses suffered due to fraud, organizations must be aware that most policies require the nonprofit to establish and maintain sound accounting policies and procedures, and may refuse to pay indemnities if this requirement is not met. Organizations should also consider implementing a program to provide a certain level of financial-literacy education to board members and employees with financial responsibilities. Incorporating mandated training for indi-

Segregation of duties may be difficult in small organizations, but it is especially crucial in combating embezzlement and fraud when many transactions are conducted in cash.

viduals with access to or oversight of the nonprofit's funds enhances the ability of the organization's volunteers to detect financial mismanagement.

In addition, most small nonprofits are cash based, which can compound any issues or weaknesses present in the control environment. Marginally tempted employees may find the accessibility of cash too appealing and may engage in conduct that they otherwise would not. Consequently, organizations that receive much of their col-

EXHIBIT 3

Case Study: First Coast Soccer Association

Over a period of 22 months, Karen Edenfield was able to steal more than \$80,000 from a community's children and their parents. As the volunteer treasurer of a Jacksonville, Florida, youth soccer association, she managed the finances of an organization that served more than 1,500 children and collected funds in excess of \$400,000 annually. In this role, Edenfield's stated responsibilities included maintaining the records of the organization's funds, reconciling all of the association's bank accounts, and paying the debts of the association in a timely manner.

During the last two years of her four years as treasurer, Edenfield wrote more than 100 checks to herself, to cash, and to vendors for personal expenses. Additionally, she set up a new "business" bank account for a fake company with the same initials as a legitimate soccer association payee, in order to inconspicuously siphon funds from the organization. She then transferred the money from this account to her personal account.

Like many other frauds, the start of this embezzlement was motivated by personal financial difficulties, resulting from the recent loss of her previous job and her husband's previous businesses failures. A background check on Edenfield would have revealed a history of financially questionable situations, including numerous bad-check charges and a large tax lien levied against her husband from a failed professional endeavor. However, the board of the association did not undertake such an investigation. Furthermore, although Edenfield was required to submit frequent budgetary and accounting reports to the association's finance committee, the board members knew each other well and frequently exercised only perfunctory oversight. As a result, it took nearly two years for the board to become suspicious enough to undertake a thorough examination of the organization's finances.

Once under investigation, Edenfield admitted to the thefts, although the full amount was never determined, due in large part to the organization's poorly kept financial records. Additionally, Edenfield told the authorities that the association's president had suggested that she make use of the organization's funds, and had showed her how to do so without drawing attention. Very shortly after Edenfield's sentencing, the president was charged with embezzling \$5,000.

Discussions with board members revealed that the occurrence and duration of the fraudulent activity were facilitated by a systemic failure in the board governance process, due to two primary factors. First, parents, particularly those serving as board members, were often afraid to ask pointed questions for fear of a retaliatory effect on their child's soccer playing time. Second, cash payments to many of the volunteers for their "service" had become an accepted form of practice within the organization.

lections and pay many vendors in cash need controls in place to verify and oversee the cash receipts and disbursements.

Segregation of duties may be difficult in small organizations, but it is especially crucial in combating embezzlement and fraud when many transactions are conducted in cash. If nothing else, the duties of handling and reconciling funds should always be segregated, with one party responsible for approving disbursements, another for physically receiving and distributing funds, and a third for receiving bank statements and performing the cash and bank reconciliations. Furthermore, checks should never be signed in advance, and special authorization, such as dual signatures on checks, should be required for cash disbursements over a certain dollar amount. While such controls may not prevent a determined fraudster, they decrease the opportunity for dishonest individuals to embezzle the organization's funds, and may therefore deter many improprieties. Accordingly, organizations must emphasize the importance of adherence to such controls to employees and board members, both during training and throughout their tenure.

Responsibilities of the Accounting Profession

Accounting professionals are in a unique position to help small nonprofits fight fraud (see *Exhibit 4*). Their role is threefold:

■ As community members, CPAs

should get involved with the organizations they patronize and support. By attending board meetings, becoming familiar with the organization's policies, and asking tough questions of those in charge, they can bring an outside source of accountability to the individuals responsible for the organization's operations and finances.

■ By volunteering to serve as board members for small nonprofits, CPAs can provide some much-needed financial expertise to the board governance function, and can facilitate the implementation of proper governance and internal control policies throughout the organization.

■ CPAs should give back to the nonprofit sector by acting in their professional capacity. They can offer to perform pro bono or reduced-fee assurance engagements, or volunteer their time and proficiency to provide financial literacy and internal control training to the organization's board members and employees. □

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EXHIBIT 4

CPAs' Role in Good Board Governance

- Volunteer to be treasurer.
- Volunteer to chair the finance committee.
- Make sure that the organization has purchased adequate directors' and officers' insurance.
- Require fidelity bonding for individuals handling cash.
- Require background checks on all employees handling cash or working with children.
- Help identify high-risk areas of the organization.
- Volunteer to perform pro bono or reduced-fee audits, reviews, or bookkeeping services.
- Volunteer to provide financial literacy and internal control training to the organization's board members and employees.
- Become involved in hiring full-time staff as appropriate, particularly those employees involved in the finance function.