

AN INVESTIGATION OF FRAUD IN NONPROFIT ORGANIZATIONS:
OCCURRENCES AND DETERRENTS

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Key words:

fraud in nonprofits; types of fraud; internal controls; audit committee; nonprofit organizations, employee theft, malfeasance

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ABSTRACT

Losses due to fraudulent activities are particularly troublesome in the nonprofit sector because they directly reduce resources available to address tax-exempt purposes. The ensuing bad publicity may also reduce contributions and grants in subsequent periods. This paper uses data provided by Certified Fraud Examiners to report on the types of fraud they identified in nonprofit organizations and the characteristics of both the victims and the perpetrators of the fraudulent activities. Based on the analysis of the data, the authors suggest ways that fraud losses can be prevented or mitigated. In particular, governing boards are urged to consider important controls in addition to the annual financial statement audit.

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Media attention has focused recently on cases of fraud and abuse in all sectors of the economy. The growing nonprofit sector is certainly a tantalizing target with \$665 billion in revenues. In addition, many people have potential access to nonprofit revenues and assets since nine percent of all workers are employed within the sector (nearly 12 million people) and an estimated 65 million adults provide volunteer services each year.¹ While the breadth of the problem is unknown, recent media reports suggest the level of fraud might be extensive. For example, the FBI reported that more than two thousand of the internet sites soliciting relief for Hurricane Katrina victims were fraudulent (Aviv 2005, p. 9). Below are other recent headlines that suggest that a considerable problem may exist:

- FTC wants AmeriDebt founder to refund \$172 million (Ambrose 2005)
- Ex-lawman convicted in big charity scam (Gathright 2004)
- As charitable cheating rises, so does cost to taxpayers (USA Today 2005)
- Tax Abuse Rampant in Nonprofits, IRS Says (Crenshaw 2005)
- California: Jail term for charity fraud (The New York Times 2004)
- Two former officers of Dallas charity ordered to pay \$14 million in damages (Healy 2004)

These headlines all postdate the Senate Finance Committee hearings and legislative initiatives that were inspired by earlier nonprofit scandals. This suggests a continuing problem

although many nonprofit leaders claim that publicity focuses almost exclusively on those few “bad apples” within the sector.

Little empirical research has been conducted to see if there are, in fact, only a few instances of fraud among nonprofit organizations and whether fraud is comparatively less prevalent in the nonprofit sector. An understanding of the extent of fraud in the nonprofit sector is important for several reasons. First, every dollar lost to fraud represents a lost ability to provide needed public services. Second, the sector is facing increased public scrutiny primarily as a result of the widespread availability of detailed financial information (Gordon et al 1999). Finally, a “Gresham’s Law” may be at work, where publicized fraud cases may result in an unwillingness of donors to give to any nonprofit (Greenlee 2000).

Although empirical research examining fraud has been conducted in the business sector (Sharma 2004, Carcello and Nagy 2004), the little existing research into nonprofit sector fraud has been based on newspaper reports (Fremont-Smith 2004a, Fremont-Smith and Kosaras 2003, Gibelman and Gelman 2001, 2002). Unfortunately, articles published in newspapers do not get at the real extent of fraud in the sector since most fraud goes unreported (Ayers 2006). A survey conducted by the Association of Certified Fraud Examiners (ACFE) estimates that all organizations lose on average six percent of their revenue to fraud every year (ACFE 2005). Applying this percentage to the nonprofit sector would suggest that the fraud loss would be approximately \$40 billion each year.

Rather than media reports of suspected fraud, this paper analyzes information on actual fraud cases reported by ACFE members. Survey data provided by ACFE is used to explore the following questions:

1. What are the characteristics of organizations that experience fraud?

2. What types of fraud are committed?
3. How are frauds first detected?
4. What anti-fraud methods are used and do they work?
5. Who perpetrates these frauds?
6. What are the legal outcomes?

The paper is organized as follows. The first section defines the concept of fraud. We then briefly describe previous studies that have examined this subject in both the business and nonprofit sectors. Following this literature review is a description of our study followed by the findings and implications for fraud prevention.

1. Literature Review

Fraud is defined in Miriam-Webster's Dictionary of Law (1996) as "any act, expression, omission, or concealment calculated to deceive another to his or her disadvantage." Under common law (J. T. Wells 2005), four elements must exist for fraud to be present:

1. A statement is materially false.
2. Knowledge that the statement is false when made.
3. A victim relies on the statement.
4. The victim suffers damages as a result of relying on the false statement.

This definition can encompass an extensive range of activities as illustrated by the following examples pertinent to nonprofit entities.

- Occupational fraud, e.g., a nonprofit employee overcharges his or her employer for travel expenses or steals cash from the bank account.

- Consumer fraud, e.g., an attendee at a fund raising auction replaces the price tag on an item with the goal of purchasing it at a lower price.
- Insurance fraud, e.g., a nonprofit policy holder falsely claims its van or car has been stolen with the goal of collecting the value of the “stolen” vehicle in cash.
- Medicare fraud, e.g., a nonprofit healthcare worker “codes” services rendered with the goal of increasing Medicare reimbursement to the organization.

This paper focuses on occupational fraud which is “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets” (J. T. Wells 2005, 44). Two major types of occupational fraud exist: fraud against the organization (such as the misappropriation of cash or other assets, or the use of one’s position to benefit one’s self or others) and fraud by the organization against its “owners” or stakeholders (such as misstating financial statements). Figure 1 details various types of occupational fraud.

[INSERT FIGURE 1 ABOUT HERE]

1.1 Fraud in Businesses Entities

An increasing quantity of empirical research dealing with fraud in the business sector has focused on fraud against the owners. KPMG (2003) reported that the incident of fraud was rising as compared to a similar survey five years earlier. Three-quarters of surveyed companies reported that they had experienced fraud within the prior 12 months. Employee fraud was the most common, followed by consumer fraud. Least common was financial reporting fraud, but it was the most costly type of fraud for victim organizations. Beasley (1996), Rezaee (2005), Sharma (2004), Dunn (2004) and Farber (2004) focused on the relationship(s) between corporate

governance and financial statement fraud. All found that the likelihood of financial statement fraud increases as the number of outside members on a firm's board of directors decreases. Carcello and Nagy (2004) found no relationship between audit firm tenure and financial statement fraud, using SEC Accounting and Auditing Enforcement Releases (AAERs) issued between 1990 and 2001 that alleged a violation of Rule 10(b)-5 of the 1934 Securities Exchange Act.

1.2 Fraud in Nonprofit Entities

Fraud among nonprofit entities may also be on the rise. Jamie Katz with the Attorney General's State Charity Office in Massachusetts reports that nonprofit fraud cases in the state have been higher during the past five years as compared to the previous decade. Due to the lack of regulatory resources, action may not always be taken. In the telemarketing area, he reports finding a number of cases where fees paid to solicitors have been reported as program expenses (Jamie Katz, personal communication, May 11, 2006).

Prior literature has conjectured that fraud may be easier to perpetrate in a nonprofit organization. For example, Douglas and Mills (2000) argue that an atmosphere of trust, the difficulty in verifying certain revenue streams, weaker internal controls, lack of business and financial expertise and reliance on volunteer boards are all contributory factors. Prior research into the existence of fraud in the nonprofit sector has differed significantly from business sector research in two ways: (1) the focus has been on fraud against the organization rather than against the owners of the organization and (2) newspaper reports have been the empirical source. Gibelman and Gelman's (2001, 2002) studies focus on governance issues rather than dollars lost. Their 2001 paper concentrated on a limited number of international and U.S. nonprofit

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organizations involved in the financing or delivery of health care or human services. Their 2002 paper, which examined public allegations of both financial and non-financial misconduct in faith-based organizations, found that these organizations were as vulnerable to such wrongdoing as were secular organizations. Fremont-Smith and Kosaras' (2003) study of fraud was more extensive. They examined newspaper articles published from 1998 – 2002 that described frauds perpetrated by officers or directors of all types of charitable organizations. They found 131 cases, with a median loss in excess of \$130,000. Fremont-Smith (2004a) gathered published accounts of alleged criminal acts by employees of nonprofit organizations that were reported for the first time in 2003. She found 32 cases with fraud losses ranging from \$1,209 to \$1,900,000. The total amount stolen was over seven million dollars. Fremont-Smith (2004a) provides aggregate descriptive information on the nonprofit sub-sample from the 2004 ACFE survey; the underlying data from this survey is the basis of our paper.

Financial statement fraud tends to generate the largest losses for victim organizations (ACFE 2005, KPMG 2003). In the nonprofit sector, expense misreporting may be the most prevalent type of financial statement fraud. The largely anecdotal evidence on this topic has recently been more rigorously examined by Krishan et al. (2006). For a sample of 101 charities that received contributions from individuals and corporations, 38 nonprofits reported an average of \$7 million (66 percent) less fundraising on their Form 990 than on their audited financial statements. There are a number of valid reasons other than fraud that might explain the Krishnan et al. finding, including systematic differences in reporting requirements (Keating and Frumkin 2003). However, donors and regulators often rely on program expense ratios from the publicly available Form 990 return and the differences could be due to deliberate misreporting.

1.3 Association of Certified Fraud Examiners (ACFE)

The ACFE uses a different approach to examining fraud. Since 1996, they have surveyed members regarding the details of fraud cases the ACFE members have investigated (ACFE 1997, 2003, 2005). The ACFE distributes a questionnaire by mail to randomly selected members in the United States typically employed in government, business and public accounting. Survey recipients are asked to provide information on the case, or cases, that they have most recently investigated that meet specified criteria: the case had to involve occupational fraud that had occurred within the last two years, the investigation had to be complete and the CFE had to be reasonably sure that the perpetrator had been identified.

ACFE's Report to the Nation on Occupational Fraud and Abuse published in 2005 focuses on both internal and external fraud. Five hundred eight cases of occupational fraud, representing more than \$761 million in losses, are studied in depth. Although the true extent of fraud is unknown, participants in the survey, anti-fraud experts with a median of 16 years of experience, collectively estimated that the United States economy loses approximately six percent of its Gross Domestic Product to fraud each year, or approximately \$600 billion. Median loss per firm in the business sector was \$110,000. Although the median loss for the smallest organizations (\$98,000 for firms employing fewer than 100 employees), was somewhat less than for the largest organizations (\$105,000 for firms employing more than 10,000 employees), the impact of losses was disproportionately greater for the smaller organizations.

The ACFE's Report to the Nation (2005) segregated its findings by sector. Table 1 displays the percentage of fraud incidents by type of organization. The ACFE found that both payroll and check tampering fraud were more common in the nonprofit sector than in the business sector while false invoices and skimming revenues were more prevalent in for-profit

entities (Well 2005a, 52). However, the ACFE report focuses primarily on business organizations.

[INSERT TABLE 1 ABOUT HERE]

2. Data and Methodology

Our paper uses the 2004 survey data provided to us by the ACFE to more thoroughly examine occupational fraud in the nonprofit sector. The surveys provide the most complete in-depth data presently available concerning fraud in the nonprofit sector. The seventeen-page survey instrument used to collect the data focused on the following six areas: cost of occupational fraud, methods used to commit fraud, methods used to detect fraud, characteristics of the organizations victimized by fraud, characteristics of the perpetrators of fraud, and legal outcomes of the fraud.

Of the 508 occupational fraud cases reported by ACFE members (Table 1), 58 of the cases occurred in nonprofit organizations. The survey explicitly does not ask the respondents to provide the name of the organization, thus all data is anonymous. Given the small size of the data set, we provide primarily descriptive statistics using bivariate correlations (as appropriate) to test the significance of selected relationships between variables.

3. Findings

Fraud losses in the 58 nonprofit cases ranged from a low of \$200 to \$17 million, with a median loss of \$100,000. Four nonprofits realized losses of more than \$1,000,000. An equal number of organizations saw losses of \$2,000 or less. The total loss from all nonprofit frauds

was nearly \$30 million. If the estimated annual loss of \$40 billion is correct, the cases reported in the survey represent less than one percent of all losses.

[INSERT TABLE 2 ABOUT HERE.]

3.1 Victims and Perpetrators of Fraud in Nonprofit Organizations

Table 2 presents the descriptive statistics related to the organizations where fraud occurred and the employees who engaged in the fraudulent activities. The typical organization employed less than 100 (53.0 percent) people and had been in operation for 30 years. However, distribution was skewed with the mean size at 4,606 employees and organization age ranging from one to 183 years. Given that a fraud occurred, there appears to be no significant relation between the size of the fraud and the size or age of the organization as seen in Table 3.

[INSERT TABLE 3 ABOUT HERE.]

Since the survey asked about occupational fraud, all of the reported frauds were committed by employees, managers or executives of the victimized organization. The respondents provided information on perpetrators' position, salary, gender, educational attainment and tenure with the organization.² The correlations in Table 4 indicate that the larger frauds are associated with the following variables: collusion (multiple perpetrators), higher salaries, age, longer tenure with the organization prior to the detection and educational level ($p < .01$, one-tail test) and to a lesser extent with males ($p < .05$).³ An examination of the data suggests the following profiles:

[INSERT TABLE 4 ABOUT HERE]

The typical (median) fraud case resulted in a loss of less than \$50,000 and was committed by a female with no criminal record who earned less than \$50,000 per year and had worked for

the nonprofit at least three years. More than 25 percent of the reported frauds were conducted by managers and 8.6 percent of the perpetrators were executives. The most costly frauds were those perpetrated by male manager/executives earning between \$100,000 and \$149,000 per year. Fraud committed by organization managers resulted in the greatest median loss to the organization (\$150,000).

The perpetrators' ages ranged from 20 to 62, with median age of 41. Median tenure with the organization was seven years, but ranged from less than one year to 35 years. The greatest losses were from those perpetrators who had been with the organization the longest (more than ten years with a median loss of \$223,000) and were between the age of 51 and 60 (median loss of \$257,000).

Collusion exists when two or more people combine to perpetrate the fraud. Although only 18.6 percent of the frauds involved collusion, the median loss was more than four times that of frauds perpetrated by a single individual. As part of the survey data gathering, respondents were asked to disclose the criminal history of the perpetrator(s). Most perpetrators had not been charged or convicted of any crime prior to the fraud, and the size of the loss was not correlated with criminal background.

3.2 Types of fraud committed against nonprofit organizations

J. T. Wells (2005) reports three major types of occupational frauds. The first is misappropriation of assets and occurs when organization's assets are stolen or misused. The second is referred to as corruption and occurs when influence is inappropriately used in an economic transaction. Third, financial statement fraud is the deliberate falsification of an entity's financial statements.

Asset misappropriations comprise more than 97 percent of all reported frauds. It was by far the most common among the nonprofit organizations. Financial statement fraud (J. T. Wells 2005) was the least common, representing only 5 percent of the nonprofit sample. However, the median loss from the three cases of financial statement fraud, at \$3 million, was 30 times greater than the median \$100 thousand loss from asset misappropriations.

Cash is the most common type of asset misappropriated in our sample. Almost 95 percent of all reported asset misappropriations involved cash, with a median loss of \$100,000. However, noncash misappropriations resulted in the same median loss. According to J. T. Wells (2005, 13) there are three major types of cash misappropriations: Skimming occurs when cash is stolen before it is recorded. Larceny exists when cash is stolen after it is recorded. The third type of cash misappropriation is fraudulent disbursements that occur when the organization pays an expense that it does not owe. More than 75 percent of cash misappropriations involved fraudulent disbursements, with a median loss of \$145,000. Only skimming, which represented 22.4 percent of the sample, had a smaller median loss of \$40,000.

Since fraudulent disbursements comprise the majority of cash misappropriation, the survey asked respondents to identify losses by type of fraudulent disbursements. There are five major types of fraudulent disbursement transactions: (1) Fraudulent billing occurs when false or inflated invoices are paid. (2) Payroll fraud occurs when a payroll check is issued based on overstated hours worked or to fictitious “ghost” employees. (3) Expense reimbursement fraud occurs when falsified claims for expenses are submitted by employees for such things as travel reimbursement. (4) Check tampering occurs when an organization’s check is stolen or altered. (5) Fraudulent register disbursements occur when false entries are made in a cash register or cash refunds are made from the register without documentation.

Fraudulent billing is the most common type of fraudulent disbursement, comprising almost 50 percent of the total. However, the most costly fraud involves register disbursements, with a median loss of over \$350,000. The least costly type of fraudulent disbursement is expense reimbursement, with a median loss of only \$83,373.

Corruption is the wrongful use of influence in a business transaction to procure benefits for one's self or others at the expense of one's employer (J. T. Wells 2005). Corruption occurred in slightly more than 20 percent of all reported cases. Corruption appears to have an impact on the size of the fraud: the median loss to organizations reporting corruption as part of the fraud was \$189,400. Organizations not reporting corruption lost less than half that amount. Corruption includes four major practices: (1) Bribes - cash or another asset is accepted or paid to aid in the fraud. (2) Rewards - an improper gift is accepted or paid after the fraud. (3) Extortion - an asset is obtained by force or the threat of force. (4) Conflicts of interest - one party to the transaction is not independent.

Conflict of interest was the most frequently reported type of corruption but had only a median loss of \$200,000 per incident. The second most common type of corruption was bribes, comprising one-third of those organizations reporting corruption and resulting in median losses of \$269,000. Losses related to cases of extortion were \$100,000 (median) and the largest corruption losses appeared in cases of improper gifts with a median loss of \$3 million.

Fraudulent financial statements have been widely publicized in the business sector. Typically, financial statements are falsified by: (1) overstating revenues, (2) understating liabilities or expenses, (3) recognizing revenue or expenses in the wrong period, (4) reporting assets at either less or more than the actual value, or (5) failing to disclose significant information. Three cases of fraudulent nonprofit financial statements were reported by the fraud

examiners. Overstating revenues resulted in the largest loss at \$10,000,000. Inappropriate asset valuation and lack of disclosures both resulted \$100,000 losses.

3.3 Discovery of Fraud and Legal Outcomes

More than 86 percent of the sample organizations had undergone external audits, much higher than the rate of audits experienced by the overall nonprofit population. The survey asked firms about five types of internal controls: background checks on new employees, presence of an anonymous reporting method, existence of an internal auditing or fraud examination function, annual audit by certified public accountant, and carrying insurance to cover losses from fraud. After the external audit, the next most common control was bonding key employees or other types of insurance against fraud (60 percent of organizations). Internal audit departments and anonymous fraud hotlines existed at 40 percent of organizations but just 21 percent did background checks. As indicated by the correlations presented in Table 3, older and larger organizations tend to have more internal controls or an internal audit function in place.

Survey respondents were asked to identify how the frauds were discovered.⁴ Over 43 percent of the frauds were detected by tips, with half of those coming from employees, while only a quarter of the frauds were detected by the internal audit department. Tips from vendors led to detection of the frauds with the greatest losses. Frauds detected through customer tips were the smallest with a median loss of \$2,600. More than 22 percent of the reported frauds were caught by accident while only 12 percent were found by the external auditor. Internal controls were credited with helping to detect nearly 14 percent of the cases while an internal audit department detected another ten percent. The fact that nearly two-thirds of the reported frauds

were discovered as the result of tips or by accident is consistent with earlier findings (Midkiff 2004, Fremont-Smith and Kosaras 2003).

Although internal controls and internal and external audits were useful in identifying a third of the fraud cases, we found no reduction in the size of fraud losses for those nonprofit organizations that had internal or external audits (Table 3). However, this is a truncated sample: internal controls and audits may have deterred fraud in other nonprofit organizations.

When a fraud is discovered, the organization can charge the perpetrator(s) criminally and/or civilly. Seventy-two percent of the nonprofit frauds resulted in termination, but seven percent resulted in no punishment. In comparison, for-profit fraudsters were more likely to be terminated (88 percent) but had an equal chance of not being punished (6.5 percent). This does not mean that employers necessarily retained the fraudsters. In many cases, it was reported that the perpetrator quit or disappeared when it became apparent that his or her scheme was about to be discovered. Not surprisingly, large losses were more commonly referred to law enforcement for criminal prosecution (72 percent). The median loss related to frauds reported to the authorities was \$140,000 as compared to just \$6,700 when no criminal referral was made. Of those cases resulting in criminal prosecution, 70 percent of the accused individuals pled guilty or no contest and there were five acquittals. The prosecutor declined to prosecute in 25 percent of the cases, possibly because of insufficient evidence. These findings are consistent with Fremont-Smith (2004a, 336): Only those cases with a strong probability of success are prosecuted. In that study of press reports, there were 26 guilty or no contest pleas and three convictions out of 32 cases.

Survey respondents were aware of only seven civil suits that were filed. Despite claims that organizations are hesitant to prosecute fraud offenders, the survey indicated that a majority

of victim organizations referred their cases to law enforcement authorities. The 70 percent referral rate is higher than anecdotal evidence frequently suggests. However, the median loss from those cases that were pursued civilly was more than twice as large as those cases where no civil suit was filed. Of the civil suits that were filed, four were still pending, one was settled, one resulted in a judgment for the organization, and one resulted in the insurance company being sued. When survey respondents were asked why they believed no legal action was taken, the answers varied and ranged from “fear of bad publicity” to “internal discipline sufficient” to “lack of evidence”.

Finally, survey respondents were asked what percentage of the loss was recovered. Fifty percent recovered nothing with a median loss of \$95,873. Thirty-four percent completely recovered their loss (median loss of \$25,350). The insured organizations recovered about 57 percent of their loss.

4. Lessons Learned - Fraud and Loss Prevention -

Albrecht et al (1984) state that, taken as a group, occupational fraud perpetrators are hard to profile and that fraud is difficult to predict. Their research assembled a list of pressure, opportunity, and integrity variables that resulted in a list of possible red flags or indicators of occupational fraud and abuse. These variables fell into two primary classes: perpetrator characteristics and organizational environment. Chief among the personal characteristics was high personal debts and living beyond ones means. The most important organizational characteristics were a lack of enforcement of clear lines of authority and proper procedures for authorization of transactions. |

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4.1 Protection

Nonprofit organizations tend to invest in insurance or surety bonds to protect against fraud typically after a loss has been incurred (Ayers 2006). Insurance companies generally require that nonprofit clients make sure someone other than the treasurer reviews the monthly financial statements. The insurance coverage also requires an annual audit.

Some nonprofits are attempting to boost accountability by providing orientation to volunteers about thefts and increasing training efforts. Interestingly, parent-teacher association and organization leaders believe that some of the simplest policies would be good enough to stop 90 percent of the fraud (Ayers 2006).

4.2 Board Membership

Improving the quality of the board could improve accountability and lessen fraud. One of the most effective ways to reduce wrongdoing is to create a positive workplace environment (AICPA 2002b). The board can help set the “tone at the top” for ethical behavior by (1) providing a model for ethical behavior and (2) communicating expectations of ethical behavior for employees, particularly for employees unable to directly observe management behavior. When employees feel abused, ignored or mistreated, they may be more willing to commit fraud. In contrast, empowered employees in a positive workplace environment may be more attuned to the nonprofit’s mission and less willing to let inefficiency or fraud go unreported. A strong management response to alleged or suspected fraud is also important in deterring future incidents.

In addition to general advice on fraud prevention, some pertinent recommendations from the Independent Sector’s Panel on the Nonprofit Sector (2005) include:

1. Require independent directors. Three states (California, Maine, and New Hampshire) require independent directors serve on the board (Fremont-Smith 2004b).
2. Prohibit individuals barred by the SEC from serving on the boards of nonprofit corporations. The Sarbanes-Oxley Act grants the U.S. Securities and Exchange Commission the authority to bar individuals from serving on the boards of publicly traded companies subject to the approval of a federal judge or an SEC administrative law judge.
3. Prohibit personal loans to board members and nonprofit executives. The Sarbanes-Oxley Act (SOX) generally prohibits loans to any directors or executives of publicly owned companies,⁵ and many states expressly prohibit loans to directors and officers of nonprofit organizations. Private foundations are already prohibited from making loans to board members.

4.3 Audit Committee

Current best practice suggests that a nonprofit organization should have a strong board of directors that, in turn, creates an audit committee to deter or detect financial mismanagement and other fraud within the organization (Owens 2003). Although some claim fraud occurs in nonprofit organizations at about the same rate as in for-profit entities, nonprofits organizations are particularly vulnerable because of the way they operate. Nonprofit organizations tend to have unpaid boards of directors who may or may not have financial expertise. Nonprofit organizations tend to assume that everyone involved with the organization is dedicated to the cause. Accordingly, employees and volunteers operate in an atmosphere of trust. Essential tasks may be undertaken by individuals with little financial expertise and no training in the design of

appropriate controls against errors or fraud. Without financial expertise at the board level and little, or limited, supervisory capabilities at the operation level, a steady flow of cash donations become a magnet for fraud.

Ideally, the audit committee serves as the interface and link between the board and the independent auditor. The audit committee may also be charged with oversight of management's performance regarding the financial responsibilities and disclosure obligations. Audit committees require effort (Floch 2004). The committee needs to be staffed with the right people and they often must make difficult or unpopular decisions. A board of directors with a diligent audit committee has a greater opportunity to discover any financial irregularities before the activities create a financial threat to the organization. As discussed above, we recommend having independent board members serve on the audit committee.

Some nonprofit board members believe that an audit committee is not necessary because any fraud within the organization will be found by the annual audit process. Prior to SAS No. 99 Consideration of Fraud in a Financial Statement Audit (AICPA 2002a), auditing standards did not encourage fraud detection procedures. Under SAS No. 99, there is a better opportunity for the annual audit process to detect at least major fraud activity, but it is not a guarantee. Certainly, the external audit cannot be relied upon as the sole detection or prevention strategy. Of the 58 cases examined in this study, only ten percent were discovered during the annual audit. Nonprofit audit committees and boards must install a variety of methods to reduce the risk of loss from fraud. Some key recommendations to reduce the risk of fraud as set forth by Floch (2004) and R. Wells (2005) include the following:

1. Require background checks for all employees with access to cash and other liquid assets.

2. Check the websites of various state charity offices for advisories and final judgments identifying individuals or fundraising firms involved with fraud as well as more general advice on fraud prevention and detection.
3. Consider insurance or bonding for all employees with access to cash or other assets.
4. Make it easy for employees, vendors, customers and others to confidentially report suspected fraud or abuses.⁶
5. Periodically review internal controls to make sure that they are capable of detecting more than just small frauds. Managers, executives and others in positions of power have opportunities to bypass internal controls and perpetrate major frauds. When CFEs were asked on a scale of one (ineffective) to five (effective) about the rankings of fraud prevention measures, strong internal controls ranked higher (3.66) than any other measure (J. T. Wells 2005, 41). The ACFE recommends the use of their “fraud prevention check-up” to help identify and fix problems before it is too late (ACFE 2004). This might be an excellent resource for nonprofit audit committees.
6. Most important of all, educate employees about the consequences and the harm that perpetrating fraud or abuse would be to them, the organization, its charitable mission, and their clients.

5. Summary and Conclusion

Nonprofit organizations are by no means immune to fraud losses. This study discussed characteristics of 58 fraud cases reported in a survey conducted by the Association of Certified Fraud Examiners. Investigations of these cases were complete and the Certified Fraud Examiner (CFE) was reasonably sure that the perpetrator(s) had been identified. While the dollar amounts

were often small, some cases involved large dollar losses for the nonprofit organization. In total, nearly \$30 million was wasted – presumably thousands of people did not receive charitable goods and services that could have been provided had these nonprofit organizations been able to prevent the crimes.

Nonprofit board members and management need to be made aware of the magnitude of the risks related to occupational fraud so that they can take steps to limit the frequency and amount of losses. Human failings lead trusted people to abuse their positions. Greed is part of the problem but opportunity makes temptation harder to resist and then the crime is rationalized as a way to “make up” for low wages or other perceived affronts.

Outsiders no longer take for granted the good intentions of nonprofit organizations. The general public expects nonprofit organizations to establish sound internal controls, distribute external audit documents, and provide more performance information to both the internal and external stakeholders (Birchard 2005). Nonprofit organizations must convince the public that they have the right systems and policies in place to ensure that contributions and other resources are being prudently maintained, managed and deployed. It is not necessarily about money but rather the fiduciary responsibility to use donated funds in the manner intended.

End Notes

1. Statistics on the size of the nonprofit sector were obtained from various documents available on June 26, 2006 at <http://www.independentsector.org>. The information is derived primarily from Independent Sector (2002) but more up-to-date facts are provided on-line.

2. The majority of perpetrators were female (71 percent) which is consistent with the concentration of females in the nonprofit workforce (estimated at 70 percent by the Urban Institute). Incidents of fraud in the overall study (ACFE 2005) were almost evenly divided between males and females. The “glass ceiling” phenomenon is prevalent in all types of entities – men tend to be in positions with more authority and therefore have more access to organizational assets (Joslyn 2003). The ACFE (2005) reported that median losses in schemes perpetrated by males was significantly higher than losses caused by females in both 2004 and 2002.

3. Salary and level of education are ordinal measures and should be evaluated using the Spearman correlations in the upper-left portion of the table.

4. In a few cases, CFE respondents indicated multiple detection methods per case. Therefore the percentages mentioned do total to more than 100 percent.

5. During the pre-SOX era, recent evidence suggests that financial statement fraud (the most costly type) was more prevalent in for-profit corporations that made loans to executives (Cullinan et al. 2006).

6. A whistleblower mechanism (along with record retention rules) is one of the few parts of the Sarbanes-Oxley Act of 2002 that applies to private organizations including nonprofit entities. (See McDowell 2004).

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Table 1

Organizational Victims of Fraud with Median Dollar Loss

Type of Organization	Percentage of the 508 Reported Cases	Median Loss from Fraud
Private Company	41.8	\$123,000
Public Company	30.2	100,000
Government Agency	15.8	37,500
Nonprofit Organization	12.2	100,000

Table 2

Characteristics of the Victims and Perpetrators of Fraud in Nonprofit Organizations

<u>Panel A – Means & Distribution</u>	<u>N</u>	<u>Mean</u>	<u>Median</u>	<u>Minimum</u>	<u>Maximum</u>
Size of organization - total employees	58	4,606	58	0	100,000
Age of organization -- years in business	56	40.2	30	1	183
Number of perpetrators involved in the scheme	58	1.6	1	1	14
Age of principal perpetrator	52	41.0	41	20	62
Tenure with organization (in years) of main perpetrator	52	7.4	4	1	35
Total Dollar Loss Caused by the Fraud	56	\$ 535,104	\$ 100,000	\$ 200	\$ 17,000,000

Table 3 – Pearson Correlations between Characteristics of Victim Organizations and Existence of Select Controls

	Loss	Employees	Organization Age
	1.000	0.002	(0.049)
Total Loss (natural log)	56	56	54
	0.088	1.000	0.682 ***
Size of organization - total employees	56	58	56
	(0.099)	0.325 ***	1.000
Age of organization—years in business	54	56	56
	(0.016)	0.309 ***	0.615 ***
Number of internal controls (ranging from 0 to 5)	56	58	56
	0.072	0.456 ***	0.549 ***
Anonymous tip mechanism (1=yes, 0=no)	56	58	56
	(0.099)	0.376 ***	0.658 ***
Internal audit function (1=yes, 0=no)	56	58	56
	0.136	0.101	0.167
External audit (1=yes, 0=no)	56	58	56
	0.004	(0.229) **	0.181 *
Bonding or insurance (1=yes, 0=no)	56	58	56
	(0.105)	0.269 **	0.297 **
Background checks (1=yes, 0=no)	56	58	56

* Correlation is significant at the 0.10 level (1-tailed).

** Correlation is significant at the 0.05 level (1-tailed).

*** Correlation is significant at the 0.01 level (1-tailed).

Note: n for each correlation is shown below correlation.

Table 4 – Correlation Matrix for Characteristics of Perpetrators

	Loss	Number of Perpetrators	Age of Perpetrator	Tenure with Employer	Salary	Gender	Education Level	Criminal Record
Total Loss (natural log)	1.000 56	0.414 *** 56	0.479 *** 50	0.481 *** 51	0.526 *** 54	0.259 ** 55	0.400 *** 40	(0.021) 56
Number of perpetrators	0.261 ** 56	1.000 58	(0.037) 52	0.078 52	0.189 * 56	0.098 57	0.000 56	(0.050) 58
Age of principal perpetrator	0.468 *** 50	(0.121) 52	1.000 52	0.473 *** 50	0.620 *** 52	0.294 ** 52	0.190 * 51	(0.058) 52
Tenure (in years) of main perpetrator with organization	0.388 *** 51	(0.006) 52	0.445 *** 50	1.000 52	0.369 *** 52	0.020 52	(0.064) 51	(0.148) 52
Main perpetrator's annual income (ordinal)	0.448 *** 54	0.018 56	0.583 *** 52	0.393 *** 52	1.000 56	0.429 *** 56	0.138 55	(0.064) 56
Gender (1=male, 0= female)	0.290 ** 55	(0.014) 57	0.314 ** 52	(0.050) 52	0.420 *** 56	1.000 57	0.212 * 56	(0.177) * 57
Main perpetrator's highest educational level (ordinal)	0.438 *** 40	(0.133) 40	0.564 *** 36	(0.025) 37	0.540 *** 39	0.550 *** 40	1 56	(0.152) 40
Main perpetrator previously charged or convicted of fraud (1=yes, 0=no)	(0.022) 56	0.177 * 58	(0.042) 52	(0.147) 52	(0.108) 56	(0.177) * 57	(0.156) 40	1 58

Note: Pearson parametric correlations are in lower left and Spearman rank-order correlations are in the upper right of the matrix. The n for each correlation is presented below it.

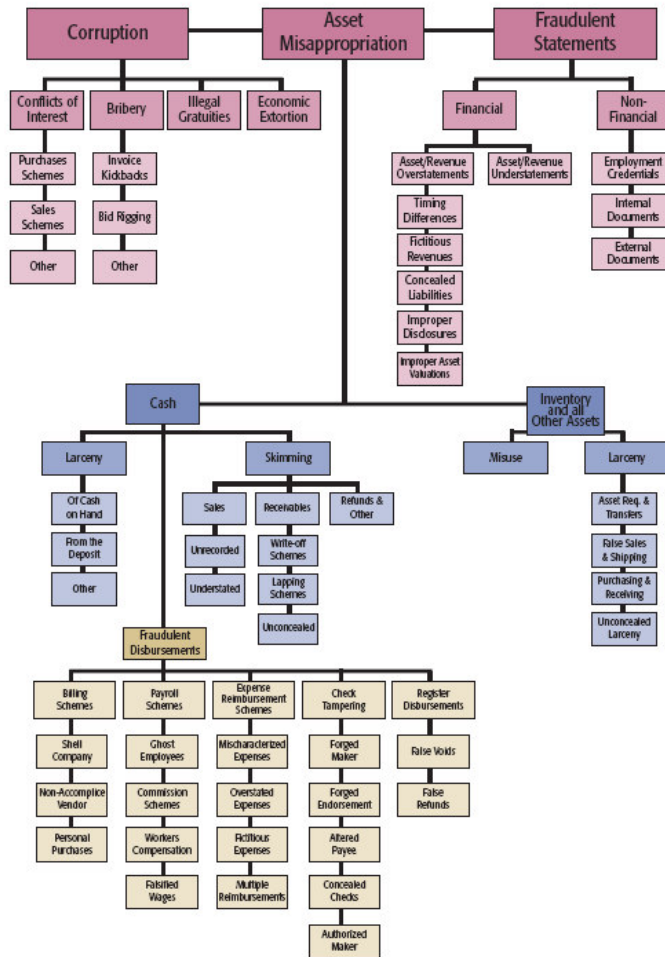
* Correlation is significant at the 0.10 level (1-tailed).

** Correlation is significant at the 0.05 level (1-tailed).

*** Correlation is significant at the 0.01 level (1-tailed).

Figure 1

Uniform Occupational Fraud Classification System



From: Association of Certified Fraud Examiners (2005), *2004 Report to the Nation*, p. 10. (Reproduced with permission)