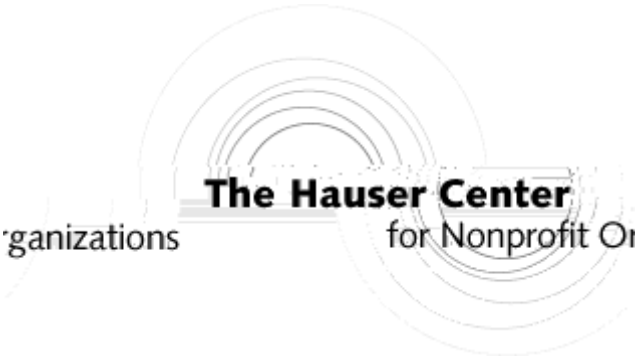

An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents

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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.

Key words: *fraud in nonprofits; types of fraud; internal controls; audit committee; nonprofit organizations*

AN INVESTIGATION OF FRAUD IN NONPROFIT ORGANIZATIONS: OCCURRENCES AND DETERRENTS

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 (*n convicP 0.3 Tw 12 0 0 12 126 318.8401*

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

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.

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 (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 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

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.

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 respondees 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.

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.

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

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.

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 disburseme

types of insurance against fraud

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

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 primary organizational characteristics were a lack of enforcement of clear lines of authority and proper procedures for authorization of transactions.

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

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]

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.

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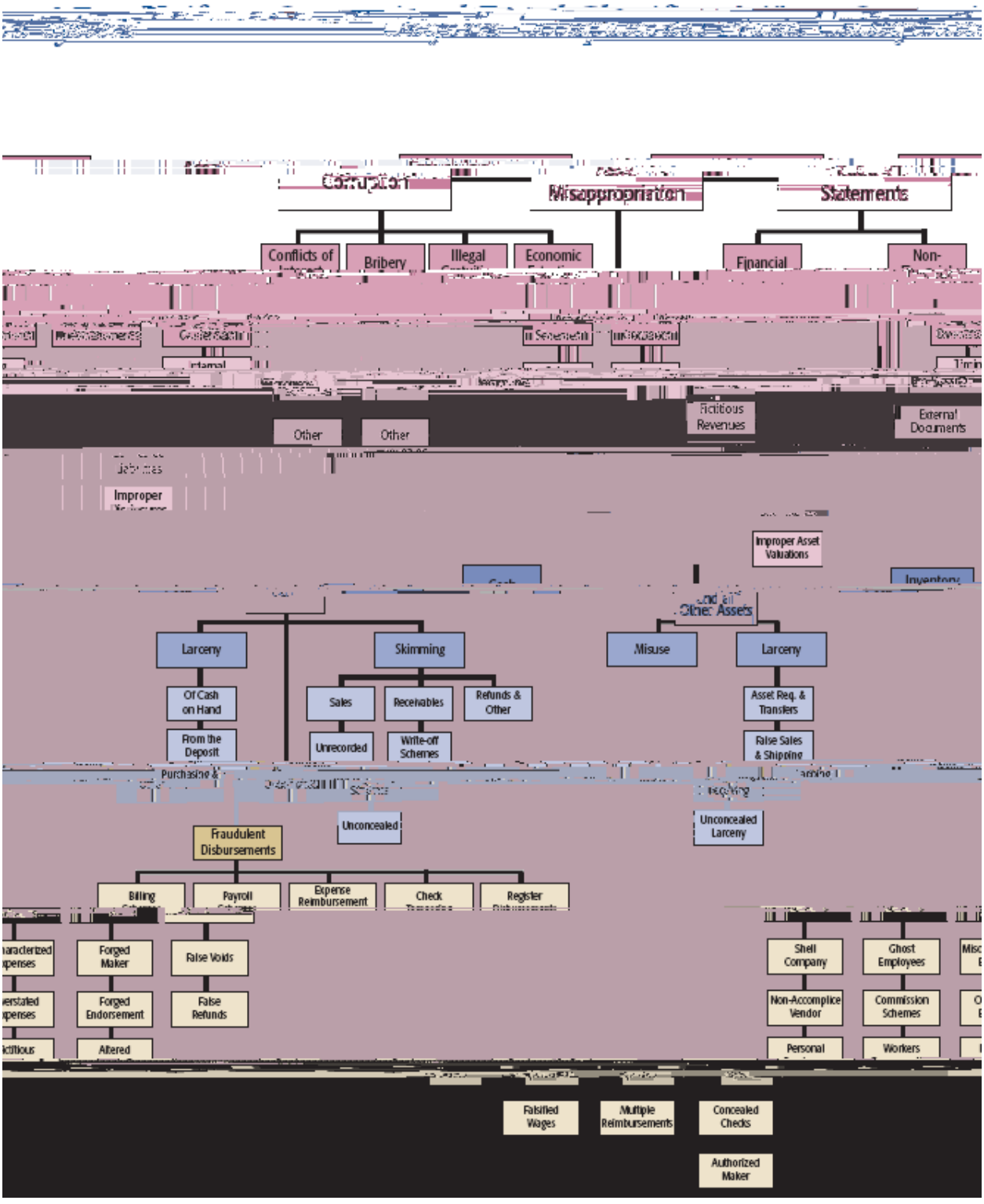
Figure 1



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

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

Panel A – Means & Distribution	**N**	**Mean**	**Median**	**Minimum**	**Maximum**
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)					

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

	Loss	Employees	Organization Age
Total Loss (natural log)	1.000	0.002	(0.049)
	56	56	54
Size of organization - total employees	0.088	1.000	0.682 ***

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 pe oo72 T(0	(0.022)	0.177 *	(0.042)	(0.147)	(0.108)	(0.177) *	(0.156)	1

Notes

1. Statistics on the size of the nonprofit sector were obtained from various documents available on June 26, 2006 at