NONPROFIT

Charity Fraud: Embezzlement, But Much More

02.22.17 | Linda J. Rosenthal, JD

According to a recent study by the Association of Certified Fraud Examiners, "the typical nonprofit organization loses an estimated 5 percent of its annual revenue to fraud."

While fraud in nonprofit organizations resulted, on average, in a smaller net loss than fraud in commercial enterprises, the nonprofits in the study reported a median loss of $100,000—an 11 percent increase from the previous study and a significant loss to any charitable organization. On top of the actual monetary losses from fraud, charities are at greater risk than commercial enterprises for a special type of additional damage; that is, reputational harm. While hard to quantify monetarily, it can – nonetheless – "have devastating consequences."

Public charities, in particular, depend heavily on donations from supporters, financial grants from government and foundations, and other public sources. In order to interest and maintain a money flow from these sources, an organization's reputation is among its most valued assets. Negative attention from media or government regulators can translate into a permanent dent in the organization's financial base.

The possibility of fraudulent activity should never be dismissed or discounted, especially because charitable organizations – for a variety of reasons – are "tempting targets" and present certain unique opportunities for wrongdoing.

In addition, the range of potential schemes is broad. We've already discussed embezzlement in charity situations; there are opportunities for this type of theft because of "large amounts of cash and checks coming in from various sources." But that's not the only fraud perpetrated against charitable organizations. According to experts, the most common form of charity fraud involves improper billing schemes.

Nonprofits are Tempting Targets for Fraud Schemes

Many charities have special vulnerability to fraudsters.

Trusting Atmosphere

Nonprofit organizations are populated – to a much greater extent than in commercial enterprises – with people who are good-hearted and particularly inclined to trust others. In that setting, it's difficult to believe that a co-worker or supporter of the mission would violate that trust or damage the organization and its ability to do its work.

That complacency may lead to skimping on proper checks and controls, and may account for overlooking "red flags" that might be more apparent in other settings.

In a recent case, a town's kindly librarian was eventually discovered to have embezzled hundreds of thousands of dollars from the town's little league team. Because of the small community's camaraderie and long-standing friendships, there were no controls at all on money coming into or out of the organization. This grandmother gladly volunteered to take care of everything. When the crime was discovered, there was more than money lost; community members felt a keen and lasting sense of betrayal.

Limited Resources

Small, and even mid-sized, nonprofits may operate on such thin margins they have little money for systems of internal controls to deter and detect fraud. This makes them vulnerable to anyone – especially an employee – who is in a position to recognize the lack of controls and exploit this vulnerability for personal gain.

Even with a system of adequate internal fraud-prevention controls, smaller organizations generally have high-turnover workforces without the training or commitment to monitor the anti-fraud features of the accounting system. Also, since one of the most effective fraud-prevention measures is the segregation of duties involved in money collection or disbursement, a small staff may make this feature impractical.

Similarly, the presence of volunteers – while helpful in other respects – may complicate plans for tight internal controls.

Wide Variety of Possible Fraud Schemes

"Fraud cannot occur unless an opportunity is present," according to the Center for Audit Quality. "Opportunity has two aspects: the inherent susceptibility of the [organization's] accounting to manipulation, and the conditions within the [organization] that may allow a fraud to occur."

There are special features of some charitable organizations that create opportunities for illegal or unauthorized activities. First, many nonprofits have significant amounts of cash and checks coming in from various sources, and in casual and sporadic spurts. This feature creates openings for skimming by employees or volunteers. Second, certain nonprofits distribute grants or scholarships and financial aid to other agencies or to individual recipients. This feature creates opportunities for misappropriation, misuse of funds, or other abuses.

"While nonprofit organizations present particular temptations to fraudsters, the actual fraud schemes they might face are common to all types of organizations"; for instance (in addition to embezzlement):

- Misappropriation of funds for personal use, including expenses fraud
- Vendor kickbacks or fictitious vendor schemes
- Ghost employees
- Check fraud
- Theft of physical equipment or assets
- Check fraud
- Fraudulent billing schemes

According to a 2012 survey of nonprofit organizations by the Association of Certified Fraud Experts (ACFE), among nonprofit organizations, "billing schemes were among the most common fraud methods" used by unscrupulous insiders.

For example, a rogue employee may set up a fake identity "that bills for goods or services the organization does not receive. In some instances, goods or services may be delivered but are marked up excessively, with the proceeds diverted to the employee." Or a worker may set up a "pay-and-return-scheme" that results in overpayments that are eventually embezzled by the employee.

Conclusion

In a later post, we'll discuss the ways that nonprofits can deter or detect fraudulent billing schemes.