NONPROFITS: BOARD GOVERNANCE

What Should a Nonprofit Know About a Forensic Audit?

11.30.17 | Linda J. Rosenthal, JD

In *Conflicts of Interest Can Lead to Big Problems*, we discussed the significant troubles that have plagued the University of Louisville Foundation for several years.

"It's not uncommon," we explained, "for a major nonprofit institution like a university health care center to form a foundation to help raise funds and support the important work of the main organization. Many of these relationships proceed for decades with harmony and success, but there are sad exceptions."

The University of Louisville and its related Foundation is one of those exceptions, not least because of the ill-advised overlap of key members of the senior staff of the University and the Foundation. Finally, the University ordered a costly forensic audit and, in June 2017, released the resulting 269-page report. "The 'specific findings … are a simple statement of transactions and issues resulting in a complex and destructive situation.'"

Audit: What Does it Mean?

The term "audit" may be a fuzzy concept for many nonprofit board members and staff.

One meaning of the word refers to the situation where a government agency – the IRS, in particular – requests the honor of your presence at an official examination of your books and records, operations, and documents.

"Audit" also refers to the type of services provided by an accountant. A "normal audit" typically refers to a "financial audit, which seeks to offer assurance that the financial statements of an entity are materially accurate and in compliance with Generally Accepted Accounting Principles (GAAP)." In

certain circumstances, a nonprofit organization may be required to arrange for a certified audit by an independent accountant.

A "forensic audit, sometimes also called a "forensic accounting" or a "fraud audit" is different both in purpose *and* procedure: One has the goal of determining the material correctness of the financial statements, and the other has the goal of uncovering fraudulent activity.

What is a Forensic Audit?

A forensic audit is "specifically targeted at reviewing records for evidence of fraudulent activity."

> *A fraud audit is a separate engagement from a financial statement audit. In a fraud audit, there typically is an allegation of fraud or a fraud has already been discovered; the accountant is called in to gather evidence or to act as an expert witness in connection with legal proceedings relating to the fraud. He or she is not asked to give an opinion on the financial statements as a whole.*

A forensic audit may be done to uncover a variety of types of fraud including, for instance: corruption, asset misappropriation, or financial statement fraud – or a combination of some or all.

- Corruption: While conducting the fraud investigation, the auditor would look for evidence of conflicts of interest, bribery, extortion, or similar unlawful or unethical behavior
- Asset Misappropriation: The auditor would investigate to uncover instances of theft of cash or property, directly or through devices like creating false invoices or making payments to nonexistent vendors, employees, or others.
- Financial Statement Fraud: The auditor would try to check financial statements to see if there are inaccuracies or changes made to cover up poor performance, including – for instance – "intentional forgery of accounting records; omitting transactions …; nondisclosures of relevant details from the financial statements; or not applying the requisite financial reporting standards."

How is a forensic audit conducted?

A forensic auditor must have specialist training combining accounting expertise with knowledge of legal and evidence issues.

The techniques used for evidence collection range from the ordinary review of documents to applying computer-aided audit techniques to interviews of suspected wrongdoers.

At the end of this process, a report is generated to present findings to the client. Since the investigation may result in either civil or criminal court proceedings, the auditor may have a role in that phase as well.

Conclusion

Most nonprofits will never need a forensic audit. There are – unfortunately – enough reports of wrongdoing in the philanthropy sector that directors and staff should know about this particular investigative technique. See, for instance: "Charities in the Courtroom, Part 6: Audacious Embezzlement"; "Charities and Embezzlement"; and "Charity Fraud: Secret Billing Schemes."