Internal fraud committed by employees of nonprofit organizations is, unfortunately, a more common occurrence than one might realize. Embezzlement happens most frequently to not for profit organizations (“nonprofits”) that have not taken active steps to prevent it. In addition, once any type of fraud or financial mismanagement is detected, many nonprofits do not handle the information properly or understand their responsibility; specifically, whether it is best to address the situation internally or report the fraud to the authorities.

The Association of Certified Fraud Examiners (“ACFE”), a nonprofit organization that conducts anti-fraud research and provides analysis of the costs, methodologies and the perpetrators of fraud within U.S. organizations, has found that the typical organization loses 5 percent of its annual revenue to fraud — translating to a total fraud loss in this country of more than $2.9 trillion every year. Fraud tends to be carried on for an average of 18 months before being detected. And occupational fraud is much more likely to be detected by a tip from an employee than by any other means. Organizations that lack anti-fraud controls are the most vulnerable to being victimized by fraud. In order to encourage whistleblowing, it is critical for organizations to have procedures and policies in place that enable employees to anonymously provide information to the board that can help in the detection of fraud.

The ACFE has identified three primary categories of occupational fraud used by individuals to defraud their organizations: 1) asset misappropriations, by far the

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most frequent and least costly form of occupational fraud, are schemes in which the perpetrator steals or misuses an organization’s resources (embezzlement by stealing cash receipts, falsifying expense reports, and forging corporate checks); 2) corruption schemes, which involve an insider’s use of his or her influence in business transactions in a way that violates his or her duty of loyalty for the purpose of obtaining a private benefit (e.g., bribery, extortion, interested party transactions, conflicts of interest); and 3) financial statement fraud schemes, which are those involving the intentional misstatement or omission of information in the organization’s financial reports.

The following examples of fraud among nonprofits were reported within the past year:

I. The Global Fund to Fight AIDS, Tuberculosis and Malaria: Misuse of $34 Million in Grants

The Global Fund to Fight AIDS, Tuberculosis and Malaria (“the Global Fund”) began operations in January 2002 and was created to dramatically increase global financing for interventions against three of the world’s most devastating infectious and communicable illnesses that claim nearly 6 million lives every year. Reportedly, it is the largest international donor agency to combat AIDS, malaria and tuberculosis. It provides 20 percent of all international funding to combat HIV/AIDS. To date, the Global Fund has committed $21.7 billion in 150 countries to support large-scale prevention, treatment and care programs against the three diseases.

In January 2011, the Associated Press reported vast corruption in programs financed by the Global Fund, highlighting that the majority of funds held in some of the Global Fund’s grant accounts, in the amount of $34 million, were “eaten up by corruption . . . Much of the money is accounted for with forged documents or improper bookkeeping, indicating it was pocketed.” The fallout from this article caused the organization to undertake damage control, and on January 24, 2011 the Global Fund outlined aggressive steps that the organization was taking to recover the funds that were mismanaged and prevent future corruption. Plans included the suspension and/or termination of certain funds, the implementation of safeguards subjecting funds to close scrutiny and restrictions, and the appointment of additional staff to oversee funds going to higher risk countries.

In damage control mode, the Global Fund issued a press release, which stated in part, “The Global Fund has zero tolerance for corruption and actively seeks to uncover any evidence of misuse of its funds. It deploys some of the most rigorous procedures to detect fraud and fight corruption of any organization financing development. The vast majority of funds disbursed by the Global Fund is untainted by corruption and is delivering dramatic results in the fight against the three diseases.” According to the Executive Director, “Transparency is a guiding principle behind the work of the Global Fund and we expect to be held to the highest standards of accountability.” A statement like that is akin to trying to put toothpaste back in the tube. Although efforts were undertaken after detection of the fraud, the organization may have been better served spending its time and resources on the front end in preventing fraud from ever occurring in the first place.
2. Educational Housing Services (EHS): Embezzling Millions From Within

Educational Housing Services provides affordable housing and lodging to students located in New York City. However, millions of dollars that could have been spent on securing suitable housing and summer jobs for students has instead allegedly been used for years to personally benefit the executive staff and board of directors of this non-profit.

Nonprofit Imperative blogger, Gary Snyder, details the rampant fraud that has been going on within this organization writing, “Educational Housing Services, a nonprofit, controls more than 5,000 student rooms in Manhattan and Brooklyn. The company has certainly been charitable to its founder and president, George Scott, and his family. The non-profit has paid him an average of $1 million a year since 2007 and loaned him $55,000 to pay off personal expenses on his American Express card—a year he raked in $926,334—without a written agreement, filings show. The five-member board approved it and that board has done alright for itself, too. Three directors got consultant jobs, including one who was paid $143,000 for “financial consulting.” The company paid Scott’s wife’s firm $4.9 million in 2009 for cable, phone and Internet service to his dorms. His wife, Yun (Suki) Scott, sole owner of Student Services Inc., has reportedly reaped $15 million from her husband’s charity since 2003.”

State Attorney General Eric Schneiderman is looking at EHS’ finances in an inquiry that records show began last year. The Charities Bureau has ordered EHS to provide “clarification and documentation” on “various issues.” A spokesman for CUNY, which refers students from six colleges to EHS dorms, said the school was ‘deeply concerned about the allegations.’

3. Madonna’s Foundation—Raising Malawi: Misappropriation of Millions Intended to Aid Children

Raising Malawi was founded in 2006 for the stated purpose of bringing an end to the extreme poverty and hardship endured by Malawi’s 1.4 million orphans and vulnerable children. Raising Malawi claims that it supports community-based organizations that provide vulnerable children and caregivers with food, clothing, shelter, educational opportunities, medical and emotional care, and psychosocial support.5

The alleged fraudulent misuse of funds at the organization exemplifies the unfortunate outcome that can occur when a nonprofit does not have a strong, actively-involved board of directors and managerial structure to oversee and control the allocation of funds.

Because of Madonna’s involvement with this charity, the claims of fraud were well publicized. Newsweek reported that only $850,000 of the $3.8 million that was raised to benefit the children was actually spent in Malawi.6 The article details the relationship between the non-profit organization and its parent company, the Kabbalah Center in L.A, which itself is currently under investigation by the IRS. Here is a case where fraud has been detected in not one, but two affiliated organizations. The article expands on the current claims against the Center, its misspending, possible tax evasion, and Ponzi scheme profiteering.
The *New York Times* reported that Raising Malawi abandoned its original goal of building a $15 million school for girls in the impoverished country. The Executive Director of the project stepped down over allegations of cost overruns and general mismanagement. There were reportedly “outlandish expenditures on salaries, cars, office space and a golf course membership, free housing and a car and driver for the school’s director.” As a result, the board of directors was ousted and replaced with a caretaker board to address the shortfalls and shift the foundation’s strategies.

Again, after the “genie” was out of the bottle, Madonna released a statement affirming her commitment to the organization and the community, and stating her intent to continue utilizing the foundation to help improve education in the nation. This is but another example where ample funding, best intent, real need, and even celebrity backing can collapse if the board of directors and senior management are not actively engaged and there is a general lack of managerial oversight.

**Limiting Liability and the Legal Responsibility of the Board of Directors**

Board members of New York state nonprofit organizations must discharge their duties in good faith, in a manner the board reasonably believes to be in the best interests of the organization, and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances. Directors have a fiduciary duty to protect, preserve, invest and manage the corporation’s property and to do so consistent with donor restrictions and legal requirements. Instituting strong defined internal financial controls can help reduce the likelihood that a nonprofit organization will be victimized by fraud.

It is the board’s responsibility to protect the charitable assets under its control by ensuring good governance. It is also the board’s responsibility to make reasonable efforts to prevent fraud. Boards should empower their audit committees to establish: 1) training for staff members, 2) protocols to ensure adequate checks and balances, and 3) an ongoing education process for employees. In dealing with fraud, the tone is set at the top; therefore, the board must set the proper example by designing and enforcing policies and procedures for management to implement and employees to follow. However, the board’s responsibilities are much greater, since it is its responsibility to make certain that the auditor’s recommendations are in fact implemented and that adequate systems are in place. Where an organization has retained an auditor, it is a prudent practice for the audit committee to meet with the auditor privately, without the presence of senior management.

The board can limit its liability by actively undertaking the following fraud-reducing activities:

1. **Conducting an External Audit.** Undertaking an audit by an external, independent certified public accountant, which in many cases is required by law, should be a regular and ongoing annual process for all except the smallest organizations. Although it is not technically an auditor’s job to detect fraud, knowing there is an annual audit can act as a deterrent to fraudulent activity.
2. **Conducting an Internal Audit.** Undertaking periodic internal audits conducted by the organization’s Audit Committee should again be a consistent practice.

3. **Creating a Compliant Environment.** Developing a culture of compliance with the law and high ethics, to be documented in the enactment of a code of ethics, helps to minimize the conditions where fraud may exist. In addition, management should make sure that the organization keeps accurate records. Further, instituting proper internal financial controls (i.e. fiscal checks and balances) will aid in the protection of assets and the prevention of fraud.

4. **Educating Responsible Parties on the Opportunities and Consequences of Fraud.** Conducting fraud training for the board, officers and corporate executives should be mandatory and internal records of such training efforts should be kept current and accurate.

5. **Putting in Place an Anti-Fraud Policy.** Developing and enacting an Anti-Fraud Policy, including whistleblower confidentiality, will help increase an individual’s propensity to report potentially fraudulent activities. Management must communicate the principles in this policy, and the responsibility to comply with it, to subordinate personnel and volunteers. Finally, an organization should profess, in its policies and procedures, zero tolerance for actions constituting fraud.

6. **Reviewing and Maintaining Accurate Books and Records.** Board members should familiarize themselves with, and have knowledge of, the financial books and records of the organization as well as its general operations. At the very least, the board should be aware of what the financial records disclose.

**Investigating Fraud Within an Organization**

As discussed, an organization that has a culture, backed up by education and effective corporate policies requiring accurate reporting to the board, audit committee or similar body within the organization when fraud is reasonably suspected, has an opportunity to prevent fraud before it occurs. However, if the Board has evidence of the occurrence of fraud the board, having a “responsibility to ensure that the organization is accountable for its . . . finances” should conduct a fair and thorough investigation. This investigation should respect the privacy of both the accused and the tipster. In some situations, as discussed below, the board may have to report misconduct to the appropriate authorities, such as the police or the Attorney General. When in doubt, a director or delegated audit committee should consult with the organization’s attorney, accountant, or other professionals, for guidance.

A non-profit’s management team should take responsibility for establishing the cultural environment, training employees and volunteers, assessing fraud risks, implementing internal controls and monitoring activities designed to prevent and detect misappropriation of the organization’s assets, and intentional material misrepresentation of the organization’s financial or other data and any other actions constituting fraud.
1. Reporting Responsibilities

Every director, employee or volunteer should be required to report, preferably in writing, any discovered or suspected unethical or fraudulent activity immediately to the audit committee or chair of the board. Reporting parties should know that if they make such a report in good faith, they will not suffer retaliation or other adverse consequences. Any person who retaliates against the party who reported such a matter in good faith should be subject to discipline up to and including termination of employment. Additionally, no director, employee or volunteer should be adversely affected because they refuse to carry out a directive which constitutes fraud or is a violation of state or federal law. Conversely, any allegation that was made maliciously or known to be false should be viewed as a serious disciplinary offense.

The board must gain as much information as possible with a measured approach at fact finding, which should include: 1) confronting the accused and 2) providing the accused with an opportunity to defend his/her actions. When the board has sufficient evidence showing that fraud has occurred, then inaction is not an option: corrective action must be undertaken.

2. Confidentiality

Discovered or suspected bad acts should be allowed to be reported anonymously, on a confidential basis. Anonymous allegations should be investigated with consideration given to the seriousness of the issue, its credibility, and the likelihood of confirming the allegation from other reliable sources. In the case of allegations made on a confidential basis, every effort should be made to keep the identity of the reporting party secret, consistent with the need to conduct an adequate and fair investigations. Allegations should not be discussed with anyone other than those who have a legitimate need to know. It is important to protect the rights of the person or persons accused, to avoid damaging their reputation should they be found innocent, and to protect the organization from potential liability.

3. Investigation procedures

The chair of the board or his/her delegate should investigate all allegations on a timely basis. When it is within the scope of the investigation, investigative actions may include, without limitation, examining, copying and/or removing all or a portion of the contents of files, desks, cabinets and other facilities of the organization without prior knowledge or consent of any individual who may use or have custody of such items or facilities. The reporting party should not attempt to personally conduct investigations, interviews or interrogations related to the alleged fraudulent activity.

Resolving Fraud Within an Organization

Fraudulent activity often involves front line personnel. For example, the specific wrong-doing may involve personnel related expenses such as travel, wages, and fringe benefits, payroll manipulation, false printing and mailing expenses as well as other vendor related expenses. Employees may be disgruntled and view their fraud as retribution for wrongs they believe the organization has inflicted upon them. They may be
staff members who believe they deserve higher compensation, or they may be attempting to help others in financial distress or in need, such as friends or family members. The process for this type of fraud, although not as potentially financially devastating, should nonetheless be investigated along the same guidelines as other types of suspected fraud.

The results of the investigation should be reported to the board of directors. Actions taken against the perpetrator of alleged fraud should be determined by the board in consultation with legal counsel.

**Reporting Fraud to the Authorities**

When an instance of fraud has been detected by an organization following a board investigation, a decision has to be made as to whether the corporation will handle the matter internally or report the criminal activity to the authorities. It is the natural inclination of many directors to undertake damage control and avoid bad publicity. However, as we have seen played out publicly in many instances, the cover up is often worse than the crime. Given their duty of care, boards must be sensitive to the need to alert law enforcement agencies once they have conducted a thorough investigation and determined that fraud has occurred and been perpetrated by someone within the organization. Thus, once an internal investigation is complete, where there is evidence of criminal activity, the board should report its findings to local police as well as to state regulatory bodies that prosecute fraud. In most cases, this would be the office of the Attorney General. Going public should not be viewed as a no win situation for the charity. Bad publicity has to be managed, but if the board is proactive, it can send a message that it is actively taking steps to detect and eliminate fraud when it occurs.

**Board Delegated Audit Committees**

The role of the auditor in detecting fraud and any potential liability for undetected fraud are core questions. The Statement of Auditing Standards (SAS) provides guidance on the auditor’s responsibilities in this regard. According to SAS, although external auditors have some responsibility for the detection of both errors and frauds that are material, this responsibility is not absolute. Auditors give reasonable assurance that material misstatements have been uncovered but not total assurance. It should be remembered that the auditing certified public accountant (CPA) is not held legally responsible or accountable for failing to detect fraud. Therefore, the audit committee must work with external auditors to gather information about the financial operations of their organization and to conduct additional fact finding where there is reason to believe fraud is occurring.

**Conclusion**

As stated above, every organization is vulnerable to fraud, and the ones that take steps to root out fraud should not be reticent to make this public. Acknowledging problems can result in added confidence to the public when you can show that such actions are being aggressively dealt with and remediated.

At a time when non profit organizations are rapidly proliferating and the need for
accountability and scrutiny is increasing, fraud and embezzlement persist as major problems in the not-for-profit sector. The impact upon charitable organizations is of special concern, given the fact that charities operate on such tight budgets and cannot always meet the needs they are organized to address. With more vigilant governing boards and more effective internal controls, these are problems that most organizations ought to be able to control. Preventing fraud is preferable to confronting the consequences of fraud, and it is only those organizations that seriously consider fraud risks and take proactive steps to create the right kind of climate to reduce its occurrence that have success in preventing fraud and controlling the risk of board liability.

**SAMPLE ANTI-FRAUD POLICY**

It is the policy of this Corporation for the Board of Directors to prevent, detect, and investigate any element of fraud and, if fraud is discovered, to ensure that it is corrected. The purpose of this policy is to establish guidelines and assign responsibility for the development of controls and procedures relating to investigation of fraud against the Corporation.

**Definition of Fraud:** “Fraud” as used in this policy is defined broadly to mean intentional deception, false representation or concealment of any material fact, misappropriation of resources, or manipulation of data for the benefit of any person and/or to the detriment of the Corporation.

Examples of fraud include:

- Forgery or alteration of a check or any financial document;
- Theft, misappropriation or other diversion of funds including donor contributions and/or other Corporation revenues and receivables;
- Misuse of the Corporation’s non-monetary resources, including but not limited to proprietary information, technology, donor lists and personally identifiable information, data, and trade secrets;
- Any dishonest act or unethical behavior;
- Impropriety in the handling of money or financial transactions;
- Any violation of Federal, State, or local laws related to fraud or dishonest activities;
- Abuse of power or authority;
- A dangerous practice likely to cause harm or damage to any person or property;
- Deliberate error in the preparation, evaluation, review, or audit of any financial statement of the Corporation;
- Deliberate error in the recording and maintaining of financial records of the Corporation;
- Deficiencies in or noncompliance with the Corporation’s internal accounting controls;
- Deviations from full and fair reporting of the Corporation’s financial condition.

The Corporation’s management and Board of Directors are collectively responsible for creating a culture of compliance with laws and establishing high ethical standards in connection with the conduct of the organization’s business. The Corporation’s management and Board of Directors are similarly responsible for preventing and detecting fraud and misappropriations ensuring the accuracy of the Corporation’s reported financial statements and tax filings.
Internal Financial Controls

It is the policy of this Corporation for the Board of Directors to oversee and ensure that the following procedures are followed:

• The Treasurer shall ensure that an annual income and expense budget is prepared and presented to the Board each year at the annual meeting.

• The Treasurer shall prepare and distribute written reports to the Board on a quarterly basis, comparing actual receipts and expenditures to the budget with explanations.

• All funds received by the Corporation shall be deposited in the Corporation’s bank account within 5 days after receipt and shall be recorded in the organization’s books immediately by the Treasurer.

• Every check written by the Corporation for an amount greater than $3,000 shall require two signatures, by any of the officers: President, Vice President, Treasurer and/or Secretary.

• The Secretary shall be responsible for ensuring that accountings required as a condition of any grant received by the Corporation are completed and that the Corporation’s CPA firm is advised of any restrictions on the use of donated funds in a timely fashion.

• The President shall be responsible for making sure that the Corporation’s bills are paid on time and that other necessary disbursements are made and authorized.

• The Treasurer shall be responsible for reviewing bank statements and reconciling the books and records each month.

• The Secretary shall be responsible for maintaining the integrity of the Corporation’s information, including electronic records.

• The Board of Directors, through its delegated Audit Committee, is responsible for overseeing the audit process and for hiring and monitoring the activities of the firm’s independent auditors, if any. This includes reviewing and responding to all management letters, and reviewing and approving financial statements, and informational tax returns prior to filing.

• Any director who becomes aware of possible wrongdoing or fraud shall report such activity to the Corporation’s audit firm and to the Board.

• The Board is responsible for ensuring that the Corporation complies with all governing laws and regulations and that all state and federal filings are prepared and filed in an accurate and timely fashion.

• The Board is responsible for complying with the bylaws, including but not limited to the conflicts of interest policy. At the annual meeting each year, each director shall fill out and provide to the Secretary a Conflict of Interest Form disclosing any known conflicts of interest or stating that he/she knows of no conflicts of interest. If any conflict arises during the year, such conflicts must be disclosed to the Board in accordance with the conflicts of interest policy set forth in the bylaws.

• The Board is responsible for ensuring that any contract is negotiated at arms’ length in good faith and is for fair market value. When practical, competitive bids should be obtained for any contract with a value greater than $500.

• The Board is responsible for making sure that the assets of the Corporation are invested prudently and sufficiently diversified.

• The Board is responsible for periodically (not less than once every 2 years) reviewing insurance coverage and determining its adequacy.

• Records shall be properly retained and turned over to an investigating government agency when appropriate or required. No records that are the subject of an investigation shall be destroyed.
Organizational documents including the Certificate of Incorporation, bylaws, 1023 application, current financial statements going back three years and current Form 990s going back three years, shall be maintained at the office of the Corporation.

The Board is responsible for ensuring that no solicitation to the public is misleading or fraudulent in any way.

REPORTING FRAUDULENT ACTIVITIES: WHISTLEBLOWER PROTECTIONS

The Board has adopted the following policies and procedures for: (i) the receipt, retention, and treatment of complaints received by the Corporation and (ii) the confidential, anonymous submission by employees, Officers, Directors, agents or committee members of the Corporation ("Covered Persons") of concerns regarding questionable practices involving unethical or illegal conduct.

A. Reporting of Concerns or Complaints

Taking action to prevent fraud is part of the Corporation’s culture. If a Covered Person observes possible unethical or illegal conduct, he/she is encouraged to report his/her concerns. Covered Persons must come forward with any such information, without regard to the identity or position of the suspected offender, by contacting or sending either a signed or anonymous written report to the Audit Committee at the contact information below:

__________________
__________________
__________________

B. Confidentiality

The Corporation will treat all communications under this policy in a confidential manner, except to the extent necessary to conduct a complete and fair investigation.

C. Treatment of Complaint; Non-Retaliation

Complaints received pursuant to this policy will be reviewed under the direction and oversight of the Audit Committee and by outside counsel, internal auditors or such other person(s) as the Audit Committee determines to be appropriate.

Prompt and appropriate corrective action will be taken as warranted in the judgment of the Audit Committee.

Any individual who, in good faith, reports any concerns pursuant to this policy, even if the report is mistaken, or who assists in the investigation of a reported complaint, will be protected by the Corporation. Retaliation in any form against these individuals will not be tolerated. Any act of retaliation should be reported immediately and will be disciplined appropriately.

Specifically, the Corporation will not discharge, demote, suspend, threaten, harass or in any other manner discriminate or retaliate against any Covered Person because of any lawful act done by that Covered Person to either (i) provide information, cause information to be provided or otherwise assist in any investigation regarding any conduct which the Covered Person reasonably believes constitutes unethical conduct or a violation, of any law, rule, or regulation, or (ii) file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or, to the Covered Person’s knowledge, about to be filed relating to unethical conduct or an alleged violation of any such law, rule, or regulation.

D. Reporting and Retention of Complaints and Investigations

The Corporation will maintain a log of all complaints, tracking their receipt, investigation, and resolution and shall prepare a periodic summary report thereof for the Audit Committee. Copies of complaints and such log will be maintained for as long as necessary.
Where an investigation reveals that there are reasonable grounds for suspicion to facilitate the ongoing investigation, the suspected wrongdoer may be suspended during period in which investigation is being conducted.

E. Corrective Action.

The Corporation will take the necessary steps, including legal action and notification to law enforcement authorities, to recover any losses arising from fraud or attempted fraud. This may include action against third parties involved in the fraud whose negligence contributed to the fraud. Management is responsible for taking the appropriate corrective action to ensure adequate controls exist to detect and prevent recurrence of fraudulent activities.

Employees found to have acted fraudulently against the Corporation will be subject to disciplinary action, up to and including, termination and legal prosecution in accordance with Company policies, applicable laws and regulations. If an investigation results in a recommendation by the Audit Committee to terminate one or more individuals, the recommendation will be reviewed by the Board of Directors and outside legal counsel before any such action is taken.

Endnotes

8. Id.
11. See Sample Anti-Fraud Policy in this article.