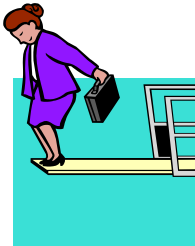


Financial Vulnerability & Fraud in Nonprofit Organizations



Prepared for the 2010 MOWAA Annual Conference
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Financial Vulnerability in Nonprofit Organizations



Topics

- z Financial statements
- z Disclosure requirements
- z Measure financial vulnerability
- z Predict financial vulnerability

Basic review of financial statements – Articulated

- z Statement of Revenues & Expenses
- z Statement of Fund Balance
- z Balance Sheet
- z Statement of Cash Flows
- z Statement of Functional Expenses



Statement of Revenues & Expenses

$$\text{y Revenues} - \text{Expenses} = \text{Surplus (Loss)}$$



Statement of Fund Balance

$$\text{y Beginning Fund Balance} + \text{Surplus/(Loss)} \pm \text{other items} = \text{Ending Fund Balance}$$



Balance Sheet

y Assets = Liabilities + Ending Fund Balance

y Restrictions

- x Permanently
- x Temporarily
- x Unrestricted



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Statement of Cash Flows

y Cash in(out)flows from operations

y + Cash in(out)flows from investing

y + Cash in(out)flows from financing

y = change in cash balance

y + beginning cash balance

y = ending cash balance (on Balance Sheet)

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Statement of Functional Expenses

y Program Expenses

y + Administrative Expenses

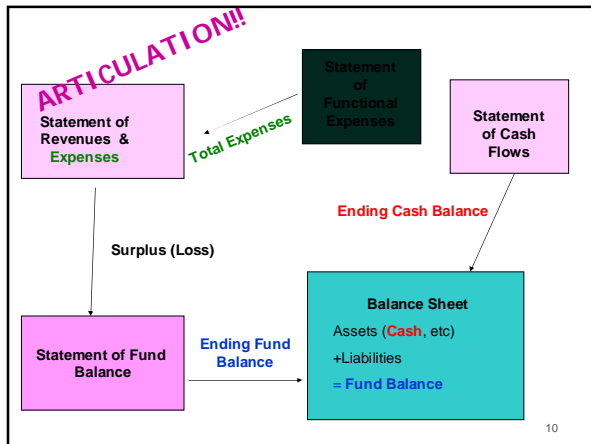
y + Fundraising Expenses

y = Total Expenses

- x on Statement of Revenues and Expenses



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A Few More Things


- z Revenue Recognition
 - y Cash vs. Accrual
 - y Matching
- z Materiality
- z Internal Control
 - y i.e., Sarbanes-Oxley



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Who sees these?

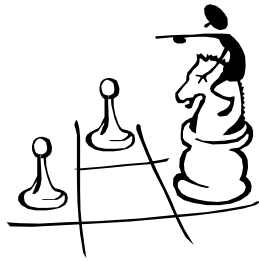
- z Auditors
- z Grantors/large donors
- z Creditors
- z Others – if YOU want



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Usefulness?

- z Strategic planning
- z Benchmarking
- z Analytical review
- z Monitoring
- z Allocation decisions



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Disclosure – Who gets to see what?

- z Annual Reports
 - z Audited (or not) Financial Statements
 - z Single Audit Act Reports
 - z **Form 990s**
 - z Reporting no fundraising expenses
- [y www.aicpa.org/download/acctstd/TIS6100_21_22.pdf](http://www.aicpa.org/download/acctstd/TIS6100_21_22.pdf)

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How can these financial statements be used to see how we're doing?

- z Comparison to others?
- z Comparison to previously?

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Financial Management

- z Problem: Bimodal distribution of nonprofits
- y Lots of very small
- y A few humongous

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One way to measure financial vulnerability

- z Focus on
 - y Expenses/Revenues
 - y Assets → Liabilities
 - y Accumulated surplus
 - y Organizational efficiency

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Another way to look at financial vulnerability

- z Market risk
- z Industry risk
- z Firm risk

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SO . . . What to do?

- z Ratios
- z Common size financial statements
 - y Horizontal
 - y Vertical
- z Prediction models

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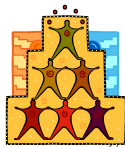
Typical Ratios

- z *Trend is what's important*
 - y Industry risk
 - y Firm risk
 - y See Handouts

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Prediction models

- z A system to predict relative financial condition of charities.
 - y Based on financial (accounting) indicators
 - y Includes broad sector comparisons
 - y Controls for the size of the organization



Financial Risk

- z The risk that financial problems will not allow an organization to continue to achieve its objectives (i.e., be "distressed")
- z Financial risk ratings in the proprietary sector
 - y Moody's
 - y S&P

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Methodologies

- z Accounting ratios as predictor variables
 - y Ratios measured one or more years prior to becoming distressed.
 - y Definitions of "distress"



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Methodology

- z Financial distress:
 - x "Significant" overall decrease in net assets (fund balance) over a consecutive 3 year period
 - 20%, 50%
 - x A switch from positive to negative net assets
 - $A-L > 0$ to $A-L < 0$
 - Aka "technical bankruptcy"



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Negative net assets

- x Tuckman & Chang (1991), Altman (1968), Ohlson (1980)
- x Include size & sector
- x Test for robustness

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Predicting Financial Distress

- z ½ sample used to develop model
- z Remaining: "holdout"
- z Logistic regression
 - y Yes or no



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What We Did (& are still)

- z National Center for Charitable Statistics
- z Sample: 311,977
- z Used *all* variables
- z Discrete Hazard Rate Regression
 - y Probability

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Nonprofit "DuPont" Model

- z As effective as larger model
- z Three variables
 - y NA/TR
 - y NA/TA
 - y Deficit in two previous years
 - y Controlled for size and sector

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Annual Total Expenses	NA/TR (5th percentile)	NA/TA (5th percentile)	% with Deficits in the Two Prior Years	Estimated Probability of Insolvency (5th percentile)
Very Small (\$100,000 to \$250,000)	7.26%	36.47%	10.05%	6.32%
Small (\$250,000 to \$1 Million)	5.29%	20.98%	13.04%	11.13%
Moderate (\$1 Million to \$50 Million)	4.69%	13.64%	12.30%	8.64%
Large (\$50 Million and Over)	5.18%	10.47%	8.71%	10.14%
Full sample	5.73%	21.00%	11.51%	8.50%

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Usefulness

- z Auditors, Government agencies, Prospective donors
 - y Predict probability of financial distress
 - y Rate financial health of nonprofit organizations



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Remaining Questions?

- z Might different variables work better?
- z Different models for different types of nonprofits?
- z Maybe MOW has a different model?



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Questions? Comments?

- z Carla Jutson – It can happen to you!!!
- z 15 minute break

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Fraud in Nonprofit Organizations



Introduction

- z What is Fraud?
- z Why Should We Care?
- z Nature of Fraud
- z Who Commits Fraud?
- z Red Flags to Watch Out For
- z Fraud Prevention

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What is Fraud?

What it is

Intentional
Trick or Deceive
Theft
Crime

What it isn't

Taken by physical force
Mistake/error
Victimless
Insignificant (no one got hurt)
Acceptable/Justifiable

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Elements of Fraud

- z Material
- z Knowledge
- z Reliance
- z Damages

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Occupational Fraud

- z The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets

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Why Should We care?

- z Increased visibility of the sector
- z Gresham's Law for nonprofits

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The Nature of Fraud



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How Serious is It?

Magnitude?

Size and Dollars?

Why is this difficult to know for sure?



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Estimated cost

- z \$400 Billion +
- z \$9.00 per day per employee
- z 6% of revenue lost
- z 6 cents on every revenue dollar stolen
- z \$40 Billion (nonprofits)

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Big Problem

- z Some things we know that we know
- z Some things we know that we don't know
- z However
 - y It's what we don't know that we don't know that can really mess us up.

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Fraud in Nonprofits

- z ACFE Study of Fraud
- z 508 cases; 58 were nonprofits
- z Losses?
 - y Similar to businesses; higher than governments
 - y Median: \$100,000
 - y Maximum: \$17,000,000

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The Three Components of Every Fraud

1. The Theft
2. Concealment
3. Conversion

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Two Major Types of Fraud

- z Fraud against an organization

- z Fraud on behalf of or for an organization

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Type of Fraud	Victim	Perpetrator
Employee embezzlement or occupational fraud	Employers	Employees
Management fraud	Donors, lenders, others who rely on Financial Statements	Top management
Investment scams	Investors	Individuals
Vendor fraud	Organizations that buy goods & services	Vendors
Customer	Organizations that sell goods and services	Customers/Clients

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Fraud Against Organizations

- z Clandestine
- z Violates employee's fiduciary duties
- z Benefits employee financially
- z Costs the organization assets, revenues, reserves, ability to provide services

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What does the fraudster look like?

- z Like you and me
- z No specific psychological profile
- z 70% male, while females make up 30%, females are 2% of property offenders
- z Older
- z More religious
- z Less substance abuse

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Who commits fraud?

Year of Employment

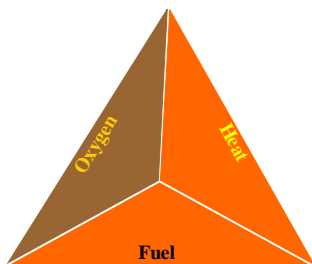


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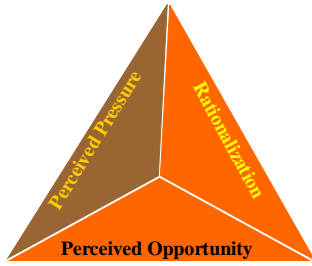
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The Fire Triangle



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The Fraud Triangle



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Implication??

- z Who has the three elements of the fraud triangle?
- z Put controls in place to prevent fraud.

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Factoids

30% Dishonest
30% Situationally
Honest
40% Honest All the
Time
Internal Audit
Detects 20% of
Detected Frauds

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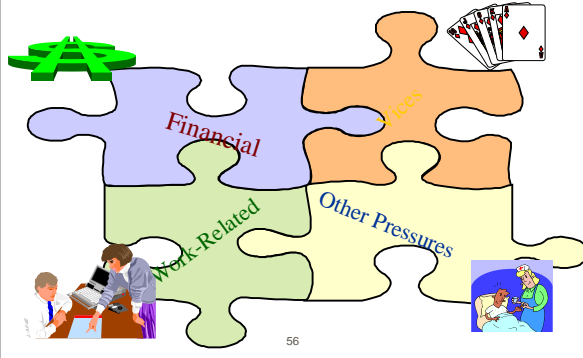
Importance of Personal Integrity

y More personal integrity = less propensity to commit fraud.

y More of the three fraud elements needed.

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Perceived Pressure



What lengths will people go to support their vices?



Vices

- **Gambler's Confessions**

- After I woke up from an appendectomy, I sneaked out of the hospital, cashed a bogus check, and headed for my bookie. I was still bleeding from the operation.

- **Drug User's Confessions**

- I was the branch manager of a large bank. But secretly I was shooting up in my office all day and stealing money from my employer to finance it.

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Perceived Opportunity

1. Commit
2. Conceal
3. Avoid



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Increased Opportunity

- z Get around internal controls
- z Inability to judge performance
- z Failure to discipline prior frauds
- z Lack of access to information
- z Ignorance, Apathy, Incapacity
- z Lack of an audit trail

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Decreased Opportunity

- z Modeling
- z Management communication
- z Appropriate Hiring
- z Clear Organizational Structure
- z Effective Prevention Programs
- z A good accounting system

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Primary Control Procedures

1. Segregation of Duties or Dual Custody
2. System of Authorizations
3. Independent Checks and Balances
4. Physical Safeguards
5. Documentation & Records

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Internal Control Structure

Control Environment	Accounting System	Control Activities and Procedures
1. Management philosophy & operating style, modeling	1. Valid transactions	1. Segregation of duties
2. Effective hiring	2. Properly authorized	2. Proper procedures for authorization
3. Clear organization structure	3. Completeness	3. Adequate documents & records
4. Effective internal audit	4. Proper classification	4. Physical control over assets & records
	5. Proper timing	5. Independent checks on performance
	6. Proper valuation	
	7. Correct summarization	

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Rationalization



- z Wife's dress
- z Mother-in-law's pie
- z Speeding
- z Income taxes
- z Kind of parent

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Common Rationalizations

- I need it worse than the company.
- Something has to be sacrificed, my reputation, prestige, or integrity...
- I'm only temporarily borrowing it.
- It's for a good purpose.
- To be somebody, I must be successful.



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Common Rationalizations

- The organization owes me.
- I am only borrowing the money and will pay it all back.
- Nobody will get hurt.



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How much is too much?

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Symptoms of Fraud



- z Document Irregularities
- z Accounting Irregularities
- z Internal Control Weaknesses
- z Extravagant Lifestyle
- z Unusual Behavior
- z Tips & Complaints

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Recognizing the Symptoms

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Symptoms: Document Irregularities

- z Missing Documents
- z "Stale Items" on Bank Reconciliation
- z Excessive Voids or Credits
- z Payee Names & Addresses = Customer Names & Addresses
- z Photocopied Documents
- z Payee Names & Addresses = Employee Names & Addresses
- z Past Due A/R 
- z Reconciling Items 
- z Altered Documents
- z Duplicate Payments
- z Second Endorsements on Checks

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Symptoms: Accounting Irregularities

- z Faulty journal entries
- z Inaccuracies in the ledgers
 - y Ledger doesn't balance
 - y Master or control accounts do not equal the sum of individual client or vendor accounts



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Examples of Anomalies

- z Unexplained Shortages or Adjustments
- z Excess Purchases
- z Too Many Debit or Credit Memos
- z Significant increase or decrease in account balances
- z Physical Anomalies
- z Cash Shortages or Overages
- z Excessive Late Charges
- z Unreasonable Expenses or Reimbursements

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More Anomalies

- z Increase in revenues with decrease in inventory
 - y Cash
 - y Receivables
- z Increase in inventory with decrease in
 - y Payables
 - y Warehousing costs
- z Increase in service volume with
 - y Increase in cost per unit of service
 - y Decrease in total cost of service

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Symptoms: Extravagant Lifestyles

- z Financial Pressure
- z Greed
- z Spend What They Steal
- z Significant Improvement in Lifestyle
- z Flaunt Their "Wealth"
- z Living Way Beyond Their Legal Means



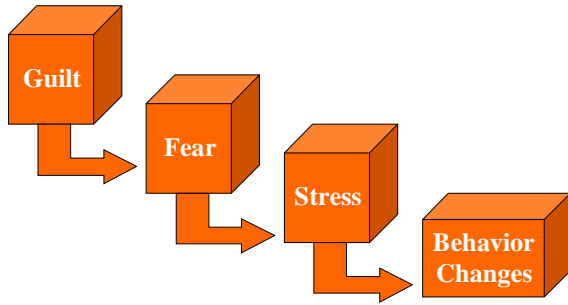
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Symptoms: Unusual Behaviors

- z Insomnia
- z Increase Drinking
- z Drug Abuse
- z Unusually Irritable & Suspicious
- z Unable to Relax
- z Lack of Pleasure in Former Pleasing Things
- z Inability to Look People in the Eyes
- z Unusually Belligerent
- z Working Standing Up
- z Sweating
- z Increased Smoking
- z Fear of Getting Caught

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What is the chain that leads to unusual behavior?



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Profile of an Embezzler

- z Tends to be a trusted employee
- z Works long hours
- z Dislikes mandatory vacation policy & cross training
- z Change in personality
- z Deceptive and usually quite good at lying.



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Embezzlement Insights

- z Begin small by "testing waters"
 - y Usually discovered at its highest level
- z Embezzlers
 - y Only quit when caught or no money
 - y Get bolder and sloppier
 - y Signs are usually there

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Fraud Vulnerabilities

- z Recent fraud with no/little discipline
- z Accounting anomalies
- z Frequent overdrafts
- z No timely bank reconciliations
- z Extravagant lifestyle
- z Unusual behavior of key employees

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Fraud Vulnerabilities

- z Rumors, tips, complaints from clients, suppliers, employees.
- z Management and/or employee circumvention of internal controls.
- z High employee turnover.
- z Poor morale

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Fraud Vulnerabilities

- z Downsizing
- z Frequent changes in management
- z Reluctance of key employees to take vacations
- z Something just doesn't "feel" right.

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Common Embezzlement Schemes

- z Skimming
- z Lapping
- z Wire transfers
- z Intercepting checks
- z Expense report
- z Overpayments to vendors
- z Ghost-employees

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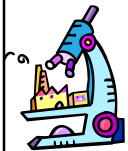
Common Embezzlement Schemes

- z Checks
 - y Changing amounts
 - y Cashing
 - y Forging
- z Fraudulent endorsements

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Why are more frauds discovered through tips & complaints?

- z Auditor Focus
- z Employee Focus



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Why do employees hesitate to come forward with fraud information?

1. Wrongly Accuse
2. Horror stories about whistle blowers
3. Intimidation
4. Squealing

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Hotlines

- z What are they?
- z How are they set up?
- z Do they work?

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