

Internal Controls and Fraud Schemes in Not-For-Profit Organisations: A Guide for Good Practice

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Abstract

Fraud has become a cause of concern despite the nature and type of business being carried by an organisation. Not-for-profit entities cannot be neglected when considering good governance since the trustees are entrusted with public funds. The fraud schemes which occur in commercial and other trading organisations are also common in not-for-profit organisations. This presentation covers the general internal controls such as control environment, risk assessment, control activities, information and communication and monitoring. Mostly fraud perpetrators take advantage of slack internal controls which exist in an organisation.

Keywords: internal controls, fraud schemes, fraud perpetrators, not-for-profit entities.

1. Introduction

It has been a belief in so many minds of the business community and other related stakeholders, thinking that the issue of internal controls is for the public companies. There has been misconceiving of the aspect, since internal control issue shall wholly continue to exist in each and every enterprise despite of its nature and type, thus including not-for-profit entities also.

The non-profit making sector has a crucial role to play in satisfying the desire of the social community whether it is religious, health, cultural and other human service organisations. These could be churches, health care centres, local chambers of commerce; not-for-profit entities make our communities look livable spheres. The non-profit making organisations differentiate themselves from profit oriented companies in that they exist to pursue missions that satisfy shortfalls of the society. Not-for-profit organisations come in a variety of sectors, such as religious, health, social services, commerce, education, sports clubs, cooperatives and the arts. Not-for-profits are not owned on a commercial basis and mostly rely on members' subscriptions and contributions, program incomes, grants which could be public or private, other fundraising events and income from such investments. These charitable organisations have a substantially immense contribution to the society through educating children, sick people care, art, and music for us and future generations, providing shelter to the homeless, environment conservation and much more. Management and preserving of such entities' resources is in the hands of the boards and officers.

Internal control is equally an important function to any organisation whether profit oriented or non-profit oriented. In non-profit organisations the internal control arm has a crucial role since they put their income reliance on donor funds, grants and fundraising of which before any support is rendered by the financiers they consider whether the organisation is capable of using the funds as is intended. It is the internal control function which defines whether the policies, procedures, and practices designed and approved by management and the board are in place and operating as desired. The internal control arm is designed to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of reporting and compliance with the applicable laws and regulations.

The going concern of the not-for-profit entities lies in good stewardship, transparency and accountability of the board and management. It is the duty of the board and officers to critically maintain public standby and ultimate future viability of the organisation. It is from such limited resources that stakeholders, donors or members expect the organisation to act wisely in resources utilization and maintain optimum allocation. The reputation of not-for-profit entity should be tightly guarded from illegal or improper behavior, not considering whether it has been incurred or not. Administrators of not-for-profits must constantly be vigilant on fraudulent actions. Such fraud in non-profit organisations includes cash theft, expense account fraud, misuse of organizations' intellectual property and inventory theft. Fraudulent activities are normally perpetrated by the unsuspected people and under conscientiously run operations. There are some critical procedures which should be followed despite the size of the entity, to the extent that even if the organisation only has a few employees, it is still possible to implement a system of checks and balances. The implemented policies and procedures are set to safeguard assets, produce accurate reports and improve administrative effectiveness.

Most of the not-for-profit organisations do not have strong internal controls and these organisations grow almost on daily basis and need to improve the controls. It is then the duty of the officers and other relevant staff to

monitor the controls such that fraud can be deterred and detected and establishment of a good code of conduct that will create a limpid understanding of what is expected of all employees. The designing of internal control system is impacted by the size and complexity of the organisation in that smaller organisation may be less structured but still having effective internal control system. In such organisations these internal control are reinforced if the duties of the members of the organisation are segregated in such a way that no one person handles all aspects of a transaction from beginning to the end. Although some times the complete separation of functions may not be feasible for the smaller organisation, a measure of effective control may be obtained by planning the assignment and performance of duties carefully.

In this modern setup of running entities there is no noticeable difference in how a profit and not-for-profit organisations are run, they are just the same. It is not necessary in concentrating on wanting to establish the similarities and differences in operations of these entities. Non-profits are all run by human beings regardless of their mission, people make them exist. It is the duty of the stakeholders and the society at large to appreciate and recognize that individual people are the foundation of all actions in the not-for-profit entity.

Most of the non-profits treat implementation of internal controls as too costly to the organisation and normally end up being overlooked or ignored but it is these policies and procedures that are designed to safeguard assets and provide assurance that activities are conducted in accordance with laid down controls. As a result most of the set missions are not accomplished due to inadequate funding. However, it is impossible for a non-profit organisation to have enough financial resources to achieve its mission.

The board and management should then recognize their employees and are not perfect executors of their duties – then internal controls will no longer appear as expensive luxury. The issue of internal control function prompts the look into fraud and embezzlement that occur in not-for-profit entities just as they do in every other sector of the economy. It is as a result of imperfect personnel in an entity's activities. It is then crucial to treat internal controls as measures taken to secure the long-term sustainability of the organisation.

As has been noted above, non-profits provide human and public service in various sectors. The funding of such services and programs is through soliciting and donor fund acceptance which might be through public or grants from government and foundations. It is then of great importance for a not-for-profit organisation to foster strong internal controls as its operations are based on public monies. The controls are there to prevent the probable fraud and misuse of funds and as well provide a significant role in the integrity and accurate financial reports. These normally help the entities to reach acceptable ratio between expenditures for any program activities and program support allocations.

Sometimes fraud can emanate from outside the organisation, but mostly it is perpetrated by the internal people. The organisation's image can be damaged by fraud related cases which can undermine the fulfilling of the financial mandate of the not-for-profit entity. So the not-for-profits should no devote most of their time and resources to advancing worthy causes. The loss of corporate image affects credibility status which can lead to longer-term funding shortfalls and other tangent challenges.

Therefore, there are a number of ways to minimize the potential for fraud and its effects on your organisation. Understanding different types of fraudulent activity and educating yourself and your associates about how it occurs and how to identify it is a good place to start. From there, you can incorporate procedures using the system of checks and balances, to help prevent fraudulent activity from occurring in the first place.

2. Context of Internal Controls

The context of internal controls is more than the rules and regulations laid down by the not-for-profits; they embody the organisation's principles, trust, values, norms and culture. It involves the standardization of entity's operations and processes and gives an outline on decision demonstration through applying the principles and documented assumptions and criteria.

Definition of Internal Controls

Internal controls can be defined as systems of policies and procedures that provide safeguard to an entity's assets and other resources usable by the organisation, accurate and reliable financial reporting assurance, rules or laws and regulations compliance promotion, and attainment of efficient and effective operations.

Not only the systems relating to accounting and reporting are being talked of, but also including communication process both internally and externally, management of employees and volunteers and handling of error.

Internal control function is a valuable tool in satisfying efficiency and effectiveness of the not-for-profit as a whole. It improves employee confidence, satisfies external reporting needs and there is value creation of the organisation through designing controls that address the entity's short and long-term shortfalls. Therefore internal controls is part of the governance journey that has the responsibility to assess, test, monitor, evaluate, and report on the status of implementing good governance in a not-for-profit environment.

Sound internal controls include procedures for:

- Safe custody of funds received and the subsequent expenditures.
- Financial reports are prepared timely as per the requirement by the board and senior management.
- Annual financial statements audit should be done.
- Organisation's overall performance assessment.
- Individual employees or staff appraisal and programs.
- Proper and good maintenance of inventory records of properties.
- Personnel and conflicts of interest policies should be implemented.

Therefore, the internal controls mostly focus on risk assessment, general oversight provision, and reporting on the not-for-profit entity's control position.

2.1 Significance of Internal Controls

A good and sound control system needs effective implementation that assist in ensuring that non-profit entity meets its goals of service provision to the society in good ethical practices. This entails resources utilization in an efficient way and reducing fraud risk, misuse and margin of error.

Good Internal controls therefore will:

- Assist in the alignment of performance of the entity with the corporate objective.
- Encourages controlling of the set targets with the actual achievements and such reports should be received by the management timely highlighting any variances and deviations.
- Provide assurance and evaluate reliability and proper financial reporting in line with the set standards.
- Provide protection to the entity's assets including physical, intellectual property and monetary assets from fraud, theft and errors.
- Provide detection and prevention of fraud and error, the system should quickly identify errors and fraud if and when they occur.
- Meditate exposure to risks.
- Provide the base for establishing parameters on power delegation and authority to guide and regulate economic activities. Supports the remediation effort by examining the limits of authority as defined.
- Test and report on compliance with those established parameters.

2.2 The Five Components

Normally people have a tendency of relating and limiting internal controls to bank reconciliations and dual signatures on cheques, The Committee of Sponsoring Organisations of the Treadway Commission (COSO) Framework (1992) identifies these as only one of the essential elements in an effective control system. The five components are:

- a) Control environment
- b) Risk assessment
- c) Control activities
- d) Information and communication
- e) Monitoring

2.2.1 Control Environment

Fundamental concepts associated with the control environment component are;

- Integrity and good professional values commitment are demonstrated by the not-for-profit organisation.
- Development and performing of internal controls are done through oversight management by the board of directors.
- In pursuit of organisation's overall objectives, board oversight, structures, hierarchy outlining authorities and responsibilities should be established.
- In alignment with the entity's mission, the not-for-profit organisation should attract, develop and keep most competent persons.
- Individuals should be held accountable for their internal control responsibilities.

Fundamentally, the control environment underlies the norms and values of an organisation and it broadly outlines the "tone" that should be set from the board and management to all the staff including volunteers and other stakeholders. It is the control environment which should highlight the eventual positive outcome of all the project programs within the organisation's culture including its honesty, integrity and professionalism. A control environment in which the staffs conceive their duties and roles, authority parameters, powers associated, expertise, and commitment is regarded as effective control environment. The employees should reveal their commitment through giving support to the culture and appreciate the laid down or implemented policies and procedures. The mission of the organisation is embraced in the set policies and procedures in the control environment.

Such policies and procedures should cover the following;

- The recruitment policies, job designs encompassing job descriptions, personnel development and training, appraisal on performance, reward management and disciplinary procedures. Overallly, it entails human resources function.
- Administratively and financially should take cognisance of line and staff relationships, job roles and responsibilities, segregation of duties, authority in financial operations and assets.
- Should encompass all the systems including hardware and software systems acquisition and maintenance, key activities procedures such as funds disbursements and purchasing, recovery on disasters and planning emergencies.

2.2.2 Risk Assessment

Entity's risk assessment is identifying and analysing of risks in the attainment of its overall objectives. Risk can be defined as anything that has the capacity of jeopardizing the achievement of any of the organisation's mission and key objectives. Therefore, risks should be identified and managed properly.

Fundamental concepts associated with the risk assessment component include;

- The entity's objectives should be clearly specified to allow the identification and evaluation of risks in relation to objectives.
- Analyzing of risks should be the basis for determination of how risks are managed and risk identification should be done across the whole organisation.
- Fraud should be considered when undertaking risk assessment to the achievement of objectives.
- Internal control system should be adaptive to significant changes which could have an impact on the overall goals of the organisation.

The major crux of effective internal control is the identification of areas in an organisation that need close monitoring and protection against possible risks, determination of probable risks associated and coming up with relevant controls to counter or manage those risks. Risk assessment can commence by evaluating the broad or overall objective of the not-for-profit organisation or the outlined strategic plan. Key areas of risk need to be identified and managed at the same time it is crucial to evaluate the possibility of an event happening, its impact level on the operations aligned to the overall plan of the entity.

For instance a check list can include the following:

- Check for any vulnerable issues that can exist in the organisation.
- Corporate reputation management checking.
- Identify organisational assets which require security and protection.
- Check for inevitability of fraudulent actions.
- Check for operations disturbances possibility.
- Check for the activity of the organisation that absorbs the highest portion of funds.
- Does the entity mostly rely on a single source of income or from a variety of sources?
- Check for the ways of revenue collection and billing.
- Identify the entity's regulated operations.
- Check for the organisation's greatest legal exposure.

Within the risk assessment early warning signs that internal controls may break down occur when there is no risk assessment program; when risks, however low, seem to be clustered around the same process or functional area; or when risks seem to occur at the same point within the process or financial cycle. Internal control representatives need to be especially vigilant when it comes to functions working in silos and not sharing information; low risks in one area may snowball as they progress down the line to where they become significant.

2.2.3 Control Activities

Control activities can be defined as the policies, procedures and processes which assist in ensuring that the management's commands are followed and executed. These consist of the controls over incomes, expenditures and the financial statement process.

Fundamental concepts associated with the control activities component;

- The not-for-profit entity chooses and develops the control activities that organisation selects and develops control activities that add to the reduction of risks to the attainment of goals to reasonable levels.
- General control activities are selected and developed in line with technology designed to meet the achievement of the overall goals.

- The control activities are planned as outlined in the policies stating the expectation and relevant procedures to effect the controls.

The controls can be identified as either detective or preventative, with preventative controls most preferred over detective. The difference between preventative and/or detective lies on the form of event and where/how the control is introduced.

- **Detection**
Detection refers to the validation of data after the transactional event has happened and is modelled pick errors, omission, fraud or misstatement. Detective controls are significant where preventative controls have not been designed because of feeble processes. Instances in which general controls are considered detective in form include comparing budget to actual results, comparing period-over-period results, monitoring performance indicators.
- **Prevention**
Prevention refers to control procedures modelled within and becoming part of the process. In nature, preventative controls are effected to counter errors, omissions, misstatements, or fraud from occurring before processing the activity. General controls considered preventative in nature include written policies and procedures, authority limitation, attachment of supporting documents, and questioning unusual items.

2.2.4 Information and Communication

Information and communication entails the provision of relevant information at all organisational stages, disseminating it timely in support of the entity's objectives. Identification, capturing and communication of such salient information allow employees to carry out their duties effectively, for instance a general ledger would produce accurate financial reports.

Fundamental concepts associated with the information and communication component;

- Generated or obtained pertinent and high quality information supports the operating of other internal control aspects.
- The objectives and responsibilities for internal control are communicated internally across the organisation to enhance the overall objectives of the non-profit entity.
- The organisation should communicate with other stakeholders most probably external parties regarding issues that would affect proper functioning of other components of internal control.

Information sharing and communication refers to a matrix flow of information from the top down, bottom up and across the organisation. The management should give provide conducive environment to the employees to feel free to contribute suggestions for the betterment of the organisation at large. All the relevant members, stakeholders, staff including volunteers should be kept well informed of the policies and procedures.

2.2.5 Monitor, Evaluate and Report

This is the consolidation and report stage on the findings and remediation efforts and to assess the effectiveness of the internal control program. This information is used to determination of the organisation's overall control position that is required within the governance submission. Management and supervisory roles are carried out to monitor, evaluate and improve the design, execution and effectiveness of internal controls. Internal audits, self assessments, audit committee periodic review, and spot checks are the other ways of monitoring internal controls. The changing of the strategic direction of the not-for-profit entity will be ensured by the continuing alignment of monitoring internal controls.

Fundamental concepts associated with the monitoring activities component;

- The presence and operating of other internal control components is ascertained by organisation's selection, development and performance of ongoing evaluations.
- After evaluations and communication by the organisation on the shortfalls on internal controls they are appropriately and timely conveyed to the senior management and the board of directors.

The external audits and internal reviews can give background for the validation of certain controls and picking the deficiencies which need redesigning.

3. Fraud

The Association of Certified Fraud Examiners (ACFE) reports that the average organisation loses six percent of its annual revenue to fraud and abuse. This alone has prompted a critical look on fraud prevention and detection. Before looking into fraud prevention it is of significant importance to first define what is fraud? and identifying various forms or schemes of fraud.

Fraud Definition

- Fraud refers to act of artifice (trickery or guile) to defraud or deceit encountered in misrepresentation which is normally intentional, or concealment of documents, or non-disclosure for the purpose of inducing another or to surrender a legal right or obtaining money or other properties through false pretences, representations or promises. This could also be the use of one's occupational position to enrich him/her via deliberate misuse or misapplication of organisation's resources.

However, there are a number of ways to minimize the potential for fraud and its effect on your organisation. Understanding different types of fraudulent activity and educating others about how it occurs and how to identify it is a good start up point.

3.1 Types of Frauds Committed Against and By Not-For-Profit Organisations

These can be split into internal, external forms, fraud committed by the entity and fraud committed by the management

3.1.1 Internal Frauds

3.1.1.1 Asset Misappropriations

a) Revenue and Cash Receipts

- Skimming
This is theft involving cash before it is captured into the books, an individual person would pocket the monies for personal use. The perpetrators could be the person who either collects the cash or who opens incoming mails, the person who logs in cash receipts, bank deposit preparer, or the actual person who takes the money to the bank.
- Theft of donated items/goods
Lack of proper records on donated merchandize by mostly not-for-profit organisations especially religious entities such as churches have exposed themselves to theft just as good as cash theft. It is via such slackened controls that the perpetrators take the advantage to prejudice the not-for-profit.

b) Purchasing and Cash Disbursement

- Credit card abuse
The use of organisations cards for personal use by the perpetrators and in some instances the players use the credit numbers of the donors and this is more detriment to the organisation.
- Ghost/Fictitious Vendors
This is a common occurrence in most non-profits where employees create a fake supplier company and submit fake invoices where a payment is subsequently generated.

c) Payroll padding and employee expense reporting

- Ghost employees
This is another common act in most non-profit organisations whereby creation of non-existing employees is done by either maintaining laid off employees on the payroll or setting up new employees on the payroll. The cheques would be made to these fake employees, which are subsequently cashed by the perpetrator.
- Fictitious expenditure
Fake invoices are created for later reimbursement.
- Working Hours Overstatement
The responsible employees claim more than the worked hours by their juniors and this are form of conniving between the supervisor and the junior.

3.1.1.2 Other Asset Misappropriations

- Personal use of organisation's assets and other resources, including use of organisation's computers, software, and printers for personal projects. Personal long-distance telephone calls, utilising the organisation's internet access and e-mail for personal use, photocopying personal documents on the organisation's photo copier.
- Physical Asset Conversion
This refers to outright theft of assets (property and equipment).

3.1.2 External Frauds

a) Vendor/Supplier Fraud

This refers to fraudulent billings by vendors on charging for goods not delivered or inflating prices, phony extra charges.

b) Kickbacks skimming and conflict of interest

The out sourced service organisations to the not-for-profit entity would charge for false transactions or to receive kickbacks from subcontracted vendors.

3.1.3 Frauds Committed by the Entity (Not-For-Profit Organisation)

Not-for-profit organisations also can and do commit frauds.

- a) The not-for profit entity would inflate or overstate fundraising costs to programs so as to overstate expense ratios.
- b) Failure by the donor funded entity to comply with the given requirements by the donor pertaining donor funds usage.
- c) Misrepresenting the portion of donations that will be used in charitable organisations.

3.1.4 Frauds Committed By Management

The management normally commits Fraudulent Financial Reporting intentionally by creating false assertions in relation to financial statements and these would include the following;

- Misleading of donors through expenses misclassification in regard to program funds usage.
- Misleading donors through restricted donations misclassification.
- Non-disclose of significant related party transactions.
- Revenue inflating through holding records opens beyond the period end.
- Understatement of expenses by failing to report trade payables in their rightful year of presentation.
- Failing to correctly value receivables, inventory, donated assets, and liabilities under split-interest or gift annuity obligations.

3.2 The Fraud Triangle

Most of the fraudulent acts are done by the loyal and a trusted person who are never suspected to be fraud perpetrators may be because of inadequate check and balances by employers. Some people have turned to perpetual criminals because perhaps they are not being prosecuted. The concept therefore that many frauds do share common traits in nature, which is there are three elements in very fraud:

- Motivation/Perceived Pressures/Incentive
Sometimes an employee can go under pressure or get incentivised, which lead to motivation of the employee to indulge in fraud. An employee can develop a belief of being underpaid and as such the financial. Some frauds are committed because the person just wants power or revenge.
- Opportunity
Inadequate management oversight, lack of sound controls and employee ethical standards also contribute to fraud commission.
- Rationalisation
Those involved in the fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some people possess an attitude, character or set of ethical values that allows them to knowingly and intentionally commit a dishonest act. For instance; “i am underpaid, and just balances things out more”, “they have plenty”, “i really needed the money for vacation”

4. Conclusion and Recommendations

4.1 Conclusion

Upon identification and evaluation of the key risk areas it is then equally crucial for the entity to develop a sound and effective internal control system to manage such risks. The key stakeholders then should readily access these controls which should act as prime source of reference for resolving any anomalies which may arise.

To that end, Good Internal Control System requires the following:

- The not-for-profit staff, volunteers and members should be competent.
- Policies should be well documented without any ambiguity.
- Assignment of responsibilities should be thoroughly done.
- Authorisation processes should be properly outlined.
- Employees and volunteers need a close supervision.
- Duties should be segregated that is, board governance from operations; operations from accounting; the custody of assets from accounting.
- Internal and external audits should be always undertaken and taking seriously the opinion and findings.
- Documents and records should be properly kept and safely kept.
- Electronic records need good monitoring.

While it is a common appreciation and acknowledgement that most of not-for-profits have limited resources ranging from financial to other physical resources to undertake and fulfil its mandate, it is the concerted effort from the employees and volunteers who get the work done. This then triggers some directors to get into the operation that is getting away from an oversight role to an operational one. All the roles then should clearly be defined even if one person holds a number of roles they should be pellucid roles.

One of the most serious threats to the success of any not-for-profit organisation is fraud. Misplaced trust, inadequate hiring and supervision policies, and failure to implement sound internal controls can then lead to an environment that is ripe for internal theft and fraud.

4.2 Recommendations

a) The not-for-profit control system should be visible to the key stakeholders of the entity such as the suppliers, donors, financiers, members and even recipients. This can be achieved via strong policies for example suppliers can be made aware of the procedure or policy that for every invoice it should have an official purchase order and such no invoice would be raised without such an official order.

b) Despite the size or mission of the not-for-profit organisation, policies and procedures to govern operations should be established. The board of directors and officers should be aware of their fiduciary duties; all the assets should be managed properly and the charitable objectives carried out perfectly. If in any case these are failed to be met it is then a breach of fiduciary duty and can result in financial and other liability on the part of the board and officers. The staff and volunteers should get guidance they need from the implemented policies by the board. Ultimately the employees and volunteers would watch the “tone” of the board and management in regard to the set policies and procedures.

c) Application of the COSO model

Quite often, most not-for-profit organisations are already doing this type of analysis, but may not realize it. By formally adopting the COSO model/framework, or at least putting a COSO-like environment in place, organisations have guideposts to follow. These guideposts can help management identify, structure, and implement changes that may seem overwhelming at first. COSO can also help reduce errors and increase efficiencies, as well as anticipate problems and provide guidance on how to respond. Moreover, it allows management and auditors to speak a common language. Finally, having internal controls correlate with the framework’s guidelines can help streamline the auditing process, and that may even lower audit costs to a certain degree.

d) Designing internal control system should cover the following aspects and functions;

- Finance and Accounting
Duties segregation to meditate room for concealing errors and irregularities commitment, proper recording of transactions and good duties assignment involving authorisation especially in purchasing and payments.
- Payroll and Human Resources
There should be clear and proper procedures for personnel records maintenance, payroll budgets and schedules and disbursements, hour and wage compliance.
- Budgeting process
The budgeting process should involve all the officers, management team and committees nominated to participate during budget preparations. There should be proper accountability; timing; planning procedures and justification of capital expenditure with authorization.
- Audit committee
Outside directors should comprise the audit committee which should do required meetings with auditors to review management’s adherence to policies and procedures.
- Annual External Audit
The selection of the auditor, scope of audit procedures and review of the management letter should be considered.
- Computers and data systems
There should be good management of passwords, back up and security procedures, retention and destruction of documentation, hardware and software acquisition and upgrade schedule.
- Month-on-month financials
An organisation should prepare financial reports on a monthly basis to allow reviews and explanation of variances.

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