2020

# Fraud in Nonprofit Organizations

Haylee Walker

# Fraud in Nonprofit Organizations

An Honors Thesis submitted in partial fulfillment of the requirements for Honors in Accounting

By
Haylee Walker

Under the mentorship of Dr. Thomas Buckhoff

ABSTRACT

This study focuses on the impact that occupational fraud has on the nonprofit sector and how nonprofit organizations react to fraud occurrences. Specifically, it focuses on how often nonprofits choose to prosecute fraudsters and publicize fraud occurrences. It also explores how the negative publicity surrounding a fraud incident in a nonprofit might affect the subsequent amount of charitable donations that nonprofit will receive. Finally, this study will explore whether or not nonprofits have a fiduciary duty to their stakeholders to prosecute fraudsters and publicize fraud incidents.

November 2020
Accounting
University Honors Program
**Georgia Southern University**

## INTRODUCTION

Nonprofit organizations (hereafter: nonprofits) mistakenly believe that no one would steal from them because of their charitable mandate. Similarly, the public perceives nonprofits as trustworthy and morally sound which creates the illusion that nonprofits are not susceptible to fraud. For example, on the surface it may seem like no one would steal from organizations such as churches or the Make-A-Wish Foundation because of their noble mandates. However, a nonprofit's mandate does not deter fraud. In fact, nonprofits are more vulnerable to fraudulent activity than for-profits for the following reasons:

- Increased trust in employees decreases the perceived need for internal controls.
- Fewer internal controls increases opportunities for fraud.
- Increased opportunity for fraud increases the occurrence of fraud.

Nonprofits also face the following repercussions when fraud does occur:

- Stolen assets can no longer be applied to the nonprofit's mandate.
- Fraud incidents can damage the nonprofit's reputation.
- Damaged reputations can cause a decrease in donations to the nonprofit.

Because of these repercussions, nonprofits might hesitate to prosecute after being victimized by a fraud. Nonprofits should be motivated to create better controls to safeguard their donations. This will ensure that donations are being used to accomplish the nonprofit's mandate and that nonprofits are making the best decisions regarding the following:

- Conducting background checks before hiring new employees
- Creating and enforcing a system of strong internal controls
- Prosecuting fraudsters when fraud does occur

## EXISTING KNOWLEDGE

### Concerns for Fraud in Nonprofits

The nonprofit sector is made up of organizations that relate to causes such as education, culture, arts, religion, medical and scientific research, and humanitarianism (Gilkeson, 2006). Because of its broad reach, the sector should be held to a high standard when it comes to fraud prevention and detection. While fraudulent activities result in negative consequences in all organizations, nonprofits face the following additional concerns regarding fraud.

- The fraud could reduce the amount of funds available for the nonprofit's mandate.
- The publicity of the fraud could damage the nonprofit's reputation.
- The publicity of the fraud could reduce the amount that donors are willing to contribute.

Nonprofits depend on the trust of donors. If donors do not trust a nonprofit's reputation, they may be less willing to contribute to that nonprofit. For example, after a 2001 fraud, the United Way of the National Capital Area received more than $30 million dollars less in private contributions. This caused overall revenue to decrease by 30% from the prior year (Gilkeson, 2006). Nonprofits have to build up donor trust and will likely hesitate to reveal fraud when it does occur in an attempt to protect their reputation and that sense of trust (Holtfreter, 2008).

**Relating the Fraud Triangle to Nonprofits**

The fraud triangle, created by Donald Cressey, posits that the following elements must be present for a fraud to occur:

- *Opportunity*: the perception that the fraudster can solve his or her financial problem without getting caught
    - Lack of internal controls increase opportunity.
- *Pressure*: a non-shareable financial need
    - Vices (e.g. drug addictions or gambling problems) are the most common pressures.
- *Rationalization*: the way the fraudster internally justifies the fraudulent act

Cressey (1971) refers to fraudsters as "trust-violators" because fraudsters have to be trusted in their position in order for the opportunity for fraud to be present. Committing fraud, therefore, violates this trust. These three elements combined create the condition under which this violation of trust, or fraud, occurs. The risk of fraud would be highest when there is high opportunity, high pressure, and low integrity. Integrity is inversely related to rationalization, so low integrity means the ability to rationalize is high. The greater the financial pressure, the lower the opportunity and rationalization have to be for a fraud to occur. Likewise, the greater the opportunity, the lower the financial pressure and rationalization have to be for a fraud to occur.

Removing just one of the elements from a situation will prevent fraud from occurring (Cressey, 1971). However, anyone can experience financial pressure, and everyone has the ability to rationalize their behavior. Therefore, the only element missing from the fraud triangle at any point in time is opportunity.

**Why Fraud is Easier to Perpetrate in Nonprofits**

Fraud is easier to perpetrate in nonprofits than in for-profits for three reasons.

- The atmosphere of trust that exists in nonprofits
- The lack of strong internal controls
- The lack of business and/or finance experience

Because nonprofits generally represent values, ethics, and good intentions, "it is shocking when trust is betrayed by occupational fraud[1]" (Holtfreter, 2008). However, trust is a prerequisite to fraud. Nonprofits mistakenly believe their charitable mandate serves as a deterrent to fraud, and they use this to justify having weaker internal controls. This increases the opportunity for fraud to occur. This increased opportunity makes nonprofits more susceptible to fraud. Nonprofits often do not have the means to implement strong internal controls. Either they do not have enough employees and volunteers to segregate duties, or they cannot afford the expense that comes with controls. Additionally, because nonprofits are largely run by volunteers, they often lack business and/or finance experience. Although it may not be intentional, this lack of experience contributes to fraud incidents. Nonprofits try to save money by hiring people with fewer qualifications, but saving this money will not matter if they lose it to either fraud or incompetence (Gilkeson, 2006).

**The Importance of Internal Controls**

Legal strategies used to fight fraud, such as the Sarbanes-Oxley Act, tend to ignore nonprofits (Holtfreter, 2008). Because of this, nonprofits do not always have a reliable system of internal controls in place to help prevent and/or detect fraud. However, a 2008 study of 215 nonprofits indicated that many nonprofits had already established procedures or were planning to establish procedures similar to the requirements of the Sarbanes-Oxley Act (Iyer & Watkins,

[1] The ACFE defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets."

2008). Internal controls help to provide reasonable assurance that an organization is operating effectively and efficiently and complying with laws and regulations. Controls also help ensure the organization's financial reporting is reliable (Petrovits, Shakespeare, & Shih, 2011). According to the 2018 *Report to the Nations*[2], weak internal controls caused nearly half of the 2,690 fraud cases included in the Report. When internal controls were present, they helped to reduce the median loss by up to 56% and reduce the duration of the fraud by up to 58% (Association of Certified Fraud Examiners, 2018). Donors do not have unlimited resources, so they have to choose which nonprofits to support. Weak internal controls in one nonprofit could motivate donors to contribute to a different nonprofit where the funds are used more effectively. Implementing and improving internal controls reduce the risk of fraud occurrences. Nonprofits may even attract more funding because donors will feel more comfortable contributing to an organization with sound controls. This additional funding will further increase the nonprofit's ability to perform charitable services effectively (Petrovits, Shakespeare, & Shih, 2011).

**The Effects of Fraud on Nonprofits**

The ACFE's 2020 *Report to the Nations* provides information regarding 2,504 total cases of occupational fraud. Out of these cases, 191 occurred in nonprofits. Nonprofits suffered an average loss of $639,000 and a median loss of $75,000. The ACFE uses the median loss in the majority of its calculations because it provides a more conservative, and typically a more accurate, understanding of the impact of fraud. This is because the median is not as influenced by outliers as the average (Association of Certified Fraud Examiners, 2020). The median loss for nonprofits is lower than the median loss of other types of organizations (e.g. government organizations or public companies). However, nonprofits still feel the ramifications of this loss because they have limited resources (Association of Certified Fraud Examiners, 2020). Fraud tends to have a greater negative impact on small nonprofits, so these organizations have to take extra care to ensure that they have proper fraud prevention and detection policies and procedures in place even when it is difficult (McNeal & Michelman, 2006). Criminal laws relating to fraud and embezzlement do apply to nonprofit executives in the same way that they apply to for-profit executives. These laws can act as a deterrent for fraud because breaking them labels the

[2] The ACFE website describes the *Report to the Nations* as "the largest and most comprehensive study of occupational fraud to date." The report is based on actual cases of occupational fraud that occurred in the preceding two years.

perpetrator as a criminal and could result in jail time. Therefore, the prosecution process could limit future frauds, but it does not help discover current frauds (Gilkeson, 2006). Internal controls, however, can help discover current frauds. The ACFE lists the top 3 control weaknesses for nonprofits to be lack of internal controls, management review, and the overriding of existing internal controls (Association of Certified Fraud Examiners, 2020).

**How Organizations Respond to Fraud**

The ACFE's 2018 *Report to the Nations* illustrates that occupational fraud referrals to law enforcement for prosecution have declined by 16% over the past ten years. Of the organizations that did not refer fraud occurrences to law enforcement, 38% cited fear of bad publicity as the reason while 33% cited that internal discipline was sufficient, and 24% cited cost concerns (Association of Certified Fraud Examiners, 2018). In 2020, fear of bad publicity dropped to 32% while believing internal discipline was sufficient rose to 46%. Private settlements also increased from 21% in 2018 to 27% in 2020. This suggests that there may be a trend of organizations attempting to resolve fraud cases privately or internally instead of going through the criminal justice system (Association of Certified Fraud Examiners, 2020). Referring fraudsters to law enforcement sends the message that there are consequences to committing fraud. If people perceive that there are no consequences, or that the consequence are not severe, they may be more likely to commit fraud. Referring fraudsters for prosecution also reduces the likelihood that fraudsters will become repeat offenders. If unpunished, the fraudster will not have the fraud occurrence on their record, and future employers will be unaware of the risks associated with hiring them.

**How Fraud Can Affect Nonprofits' Tax-Exempt Status**

Nonprofits can achieve tax-exempt status if they have an approved purpose and operate only for that purpose. The nonprofit cannot distribute profits to executives, and it cannot exist to benefit insiders. This status allows nonprofits to save money because they will be exempt from paying federal income tax. This status also allows donors to receive a tax deduction for portions of their donations (Gilkeson, 2006). The potential for a tax deduction incentivizes donors to donate which can further increase a nonprofit's contributions. If a nonprofit lost its tax-exempt status, it would likely reduce the amount of contributions received. The nonprofit would also be required to pay federal income tax which would further reduce the resources that the nonprofit could put towards its charitable mandate. Achieving and maintaining the tax-exempt status incentivizes nonprofits to enforce proper internal controls to help ensure that donations are being used appropriately. This in turn, helps to reduce fraud (Gilkeson, 2006). Most nonprofits, with the exception of religious organizations, are required to file Internal Revenue Service Form 990. Nonprofits are required to report information regarding fraud occurrences on this form. A study of 115 incidents of fraud in U.S. nonprofits concluded that many organizations do not comply with this requirement (Archambeault, Webber, & Greenlee, 2015). The primary purpose of the Internal Revenue Service, however, is to collect revenue for the federal government. This means that unless a significant amount of tax revenue is in question, the IRS is unlikely to pursue cases against nonprofit fraud. The IRS also does not have the means to audit every tax return, so some organizations may publicize their Form 990s with incorrect information (Gilkeson, 2006).

**Fiduciary Duties in Nonprofits**

A fiduciary duty can be defined as a legal obligation of one party to act in the best interest of another. Officers, directors, and other high-level employees of nonprofits are considered fiduciaries because they are expected to conduct business affairs with skill, attention, and care (The Law Related to Fraud, 2010). This means that they are expected to exercise due diligence and care when acting on behalf of their organization, and they should put the interests of the organization above their personal interests (Nolo, 2014). The majority of states require directors of nonprofits to practice a duty of care which not only includes performing duties in good faith and putting the interests of the organization over personal interests, but it also includes reasonably inquiring about potential fraud occurrences (Gilkeson, 2006). Nonprofit officers and directors must also adhere to the fiduciary duty of loyalty because their duties involve complying with donor restrictions on pledges and ensuring funds are being used for their charitable mandate (Nolo, 2014). In the nonprofit sector, the attorney general’s office is the only means of enforcing fiduciary duties. Because of this, nonprofit fiduciary duties tend to be under-enforced (Gilkeson, 2006). The general public, especially donors, rightfully expects nonprofits to take preventive action against fraud. This includes creating and enforcing a strong system of internal controls as well as considering the control and behavior of management (Holtfreter, 2008). Nonprofits also require confidence from the public that they are properly managing monetary contributions and other resources. Therefore, these organizations are expected to keep internal and external stakeholders informed on the performance level and financial position of the company. However, "it is not necessarily about money but rather about the fiduciary responsibility to use donated funds in the manner intended" (Greenlee, Fischer, Gordon, & Keating, 2007).

## HYPOTHESES

### Hypothesis 1

1. The negative publicity surrounding a fraud incident at a nonprofit will negatively affect the amount of charitable donations received in subsequent years.

Nonprofits' reputations play a crucial role in guaranteeing contributions from donors. Donors want to know that their money is being managed responsibly and that it is actually going towards the cause to which they donated. The negative publicity surrounding the discovery of a fraud can damage a nonprofit's reputation. If donors no longer trust the nonprofit due to its damaged reputation, they may feel less motivated to contribute to that nonprofit.

### Hypothesis 2

2. More often than not, nonprofit organizations will choose to not prosecute fraudsters.

Nonprofits have to build up donor trust and then continue to maintain that trust. A large fraud or scandal could hurt the nonprofits reputation and therefore adversely affect donor trust. Additionally, prosecuting fraudsters could be costly, and nonprofits have limited resources. Litigation costs would take away from the amount of resources available to serve the nonprofits charitable mandate. This could further disincentive nonprofits from pursuing prosecution.

## METHODOLOGY

I created an anonymous survey in Qualtrics for nonprofit organizations that contained the following questions:

1. Has your organization been victimized by occupational fraud?
    a. The ACFE defines occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets."
2. How did you discover the fraud?

3. Did you punish the fraudster within the organization?
    a. Why or why not?
    b. If yes, what was the punishment?
4. Did you refer the fraudster to law enforcement for prosecution?
    a. Why or why not?
    b. If yes, what was the outcome of the criminal prosecution
5. Did you publicize the fraud to other volunteers, employees, and/or donors?
    a. Why or why not?
    b. If yes, did you notice a decrease in charitable donations that your organization received after you publicized the fraud?
    c. If yes, by what percentage did donations decrease?

I sent the survey via email to 144 nonprofit organizations. I only received 15 responses to the survey which resulted in about a 10.4% response rate. Out of the 15 responses I received, only two responses indicated that their nonprofit had experienced fraud. Out of those two, only one response included any details about the fraud. In that case, the fraud was discovered during cash reconciliation procedures. The nonprofit did not punish the fraudster internally because the fraudster had left the organization prior to the discovery. The nonprofit did refer the case to law enforcement for criminal prosecution; however, the fraudster had left the county and could not be located. The nonprofit disclosed the fraud in their financial statements and did not notice a decrease in any subsequent donations.

I understand that I did not have enough information to draw any meaningful conclusions. Because of this, I examined the ACFE's *2020 Report to The Nations* for data regarding nonprofits. Many statistics in the *Report* represent fraud cases against various types of organizations (i.e. governmental, for-profit, etc.). Thus, I contacted the ACFE to request data from only nonprofit organizations for the statistics that were relevant to my research.

**RESULTS**

The ACFE's 2020 *Report to the Nations* was comprised of data from 2,504 cases of fraud. Out of those cases, 191 were committed in nonprofit organizations. The following data consists of information pertaining to the 191 frauds that occurred in nonprofits.

Table 1 shows how nonprofits reacted to fraud internally. The most common response to fraud was terminating the perpetrator. Some perpetrators could have received more than one of these punishments. For example, a nonprofit could choose to suspend the perpetrator while also coming to a settlement agreement that states the perpetrator must pay back part or all of the money lost to fraud.

Table 2 illustrates how often nonprofits refer fraud cases to law enforcement for criminal litigation. The majority of cases were referred to law enforcement. However, a large percentage of cases remain that are not referred to law enforcement. Table 3 illustrates the results of the criminal litigation for the cases that were referred.

Tables 4 and 5 illustrate, respectively, how often frauds in nonprofits resulted in civil litigation and the results of those civil cases.

Finally, Table 6 illustrates how often fraud losses are recovered either in part or in full.

Table 1:

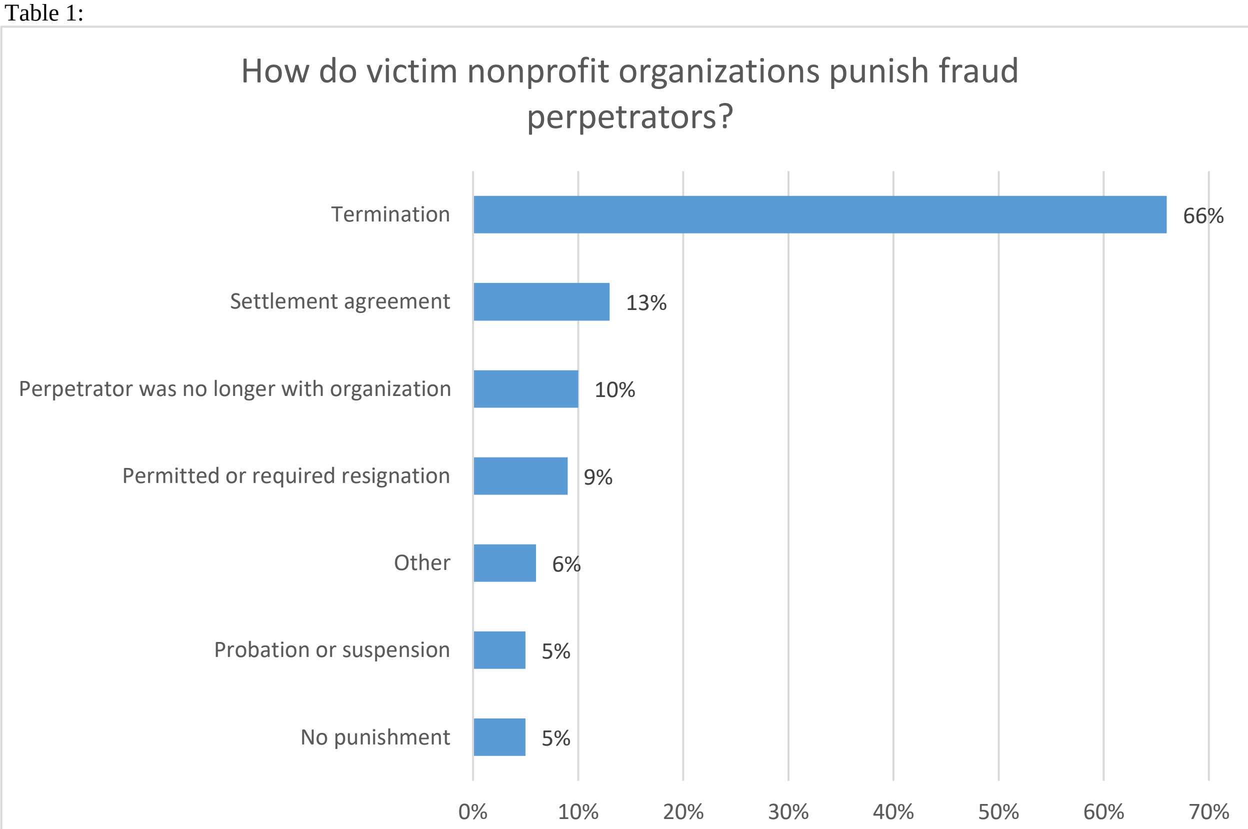


Table 2:

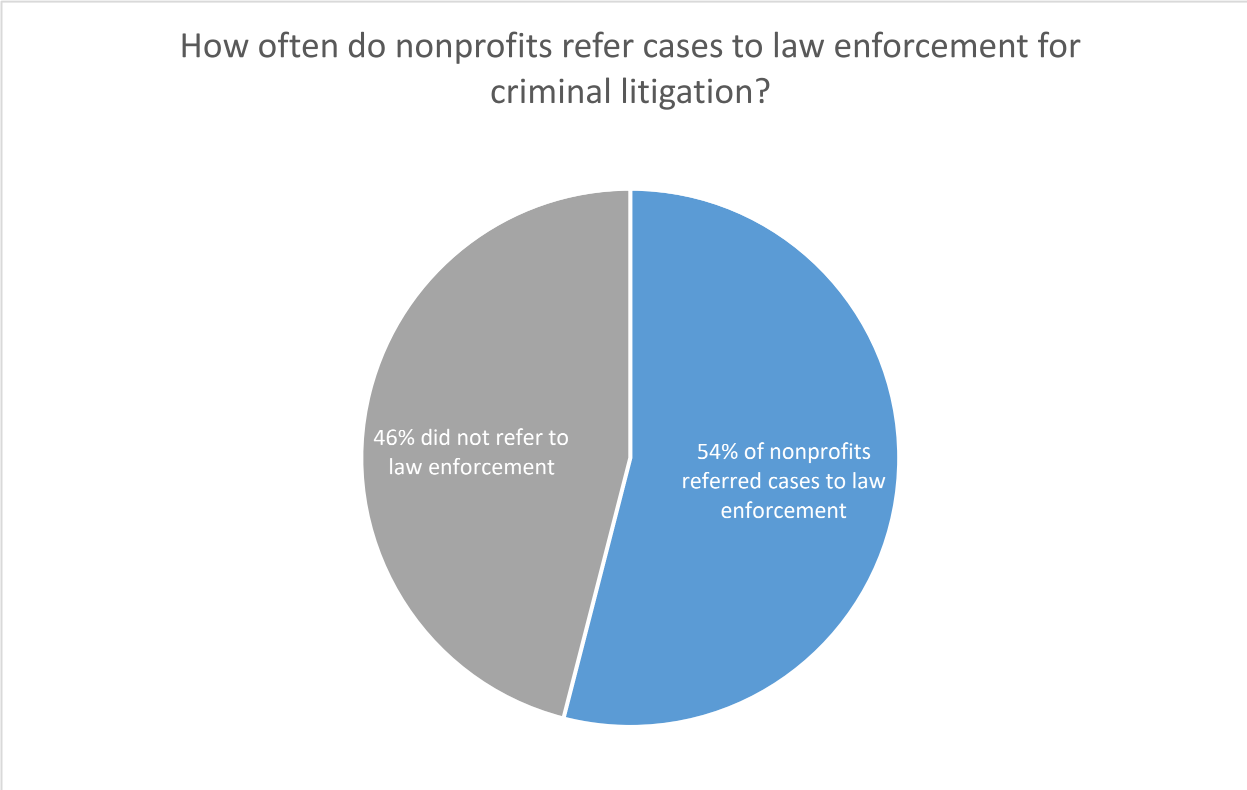



Table 3:

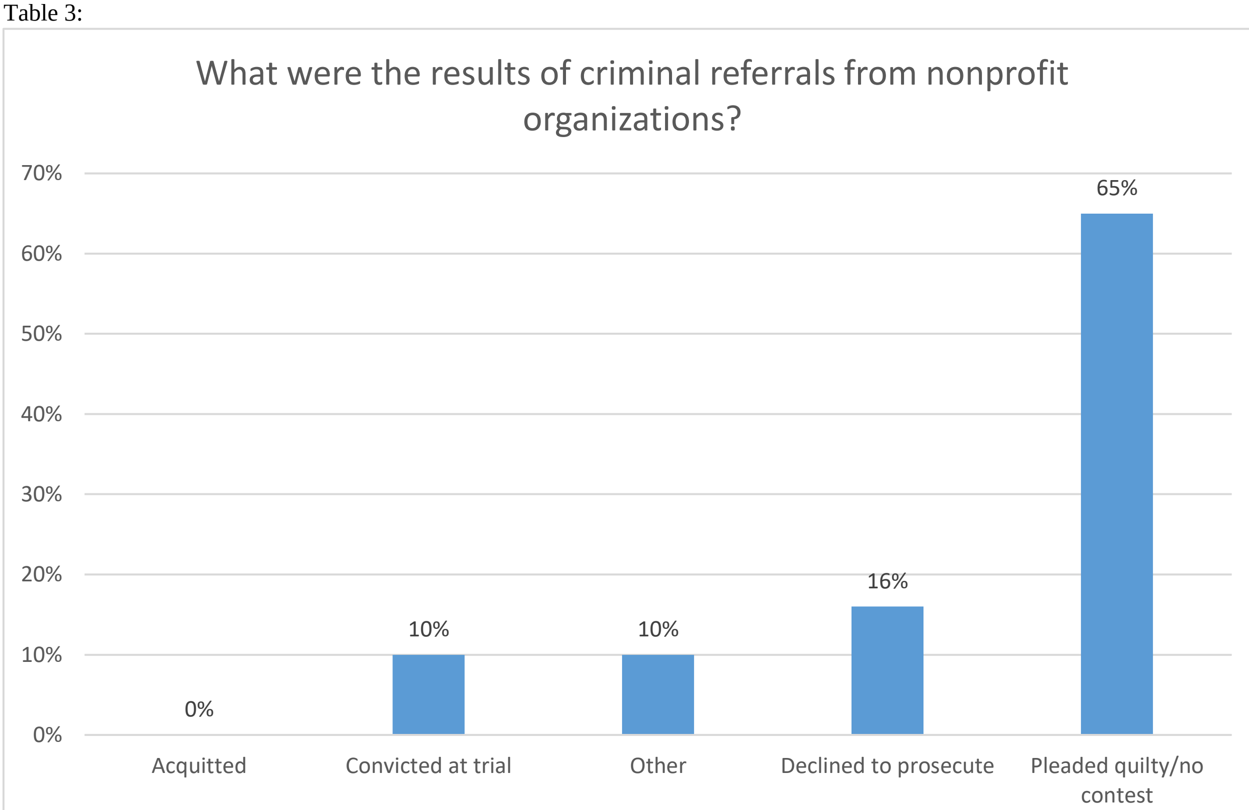


Table 4:

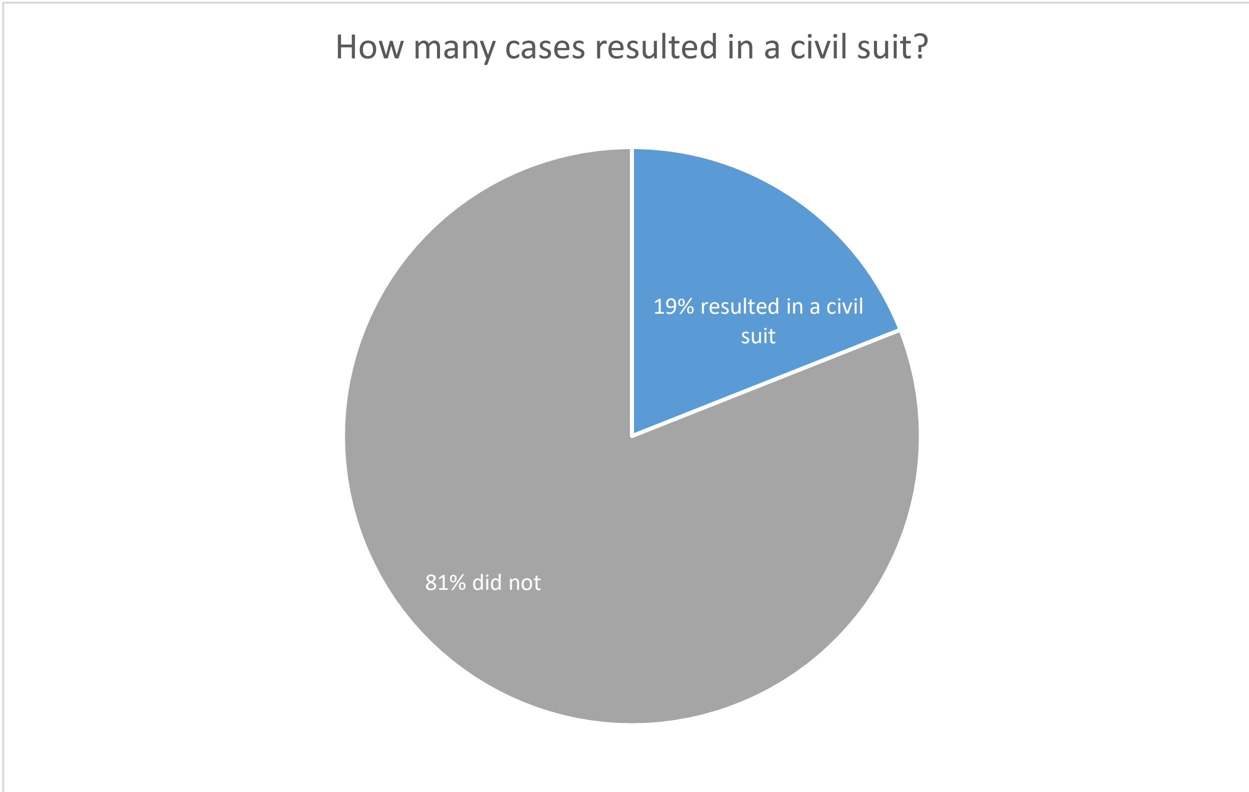



Table 5:

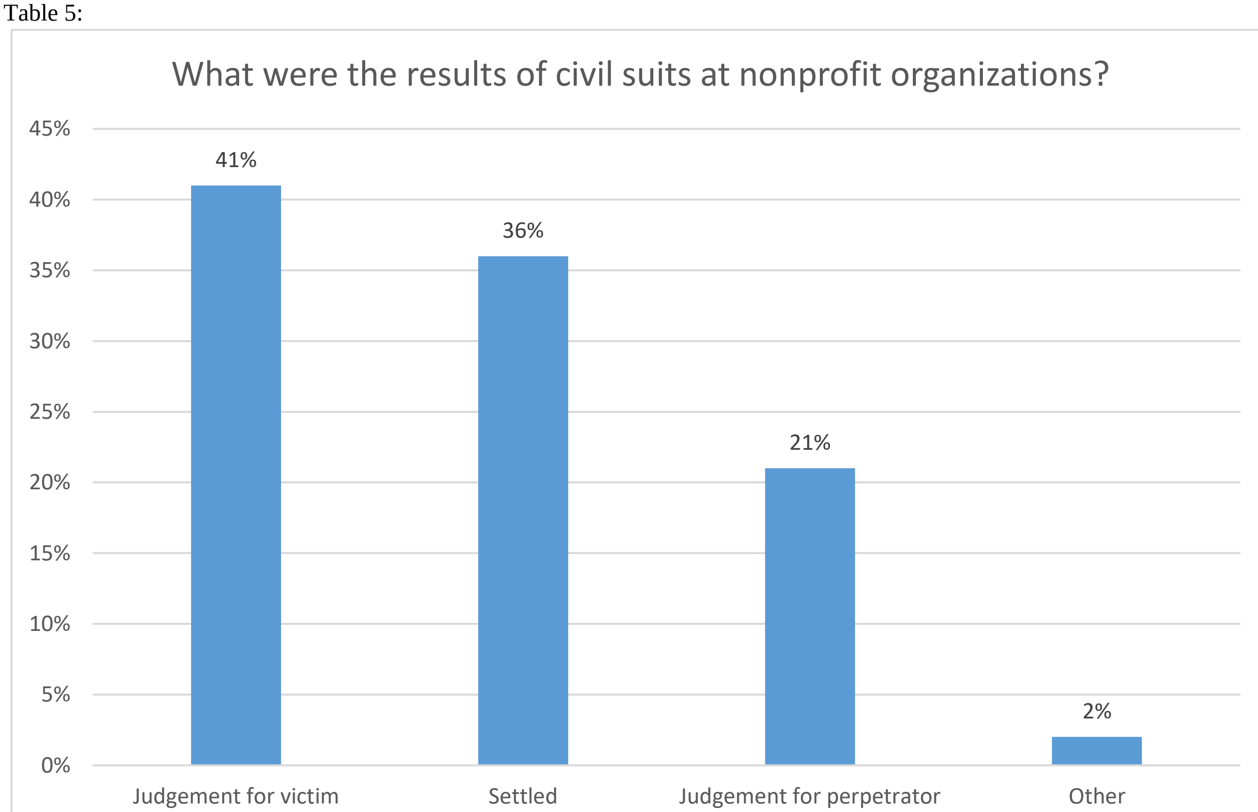
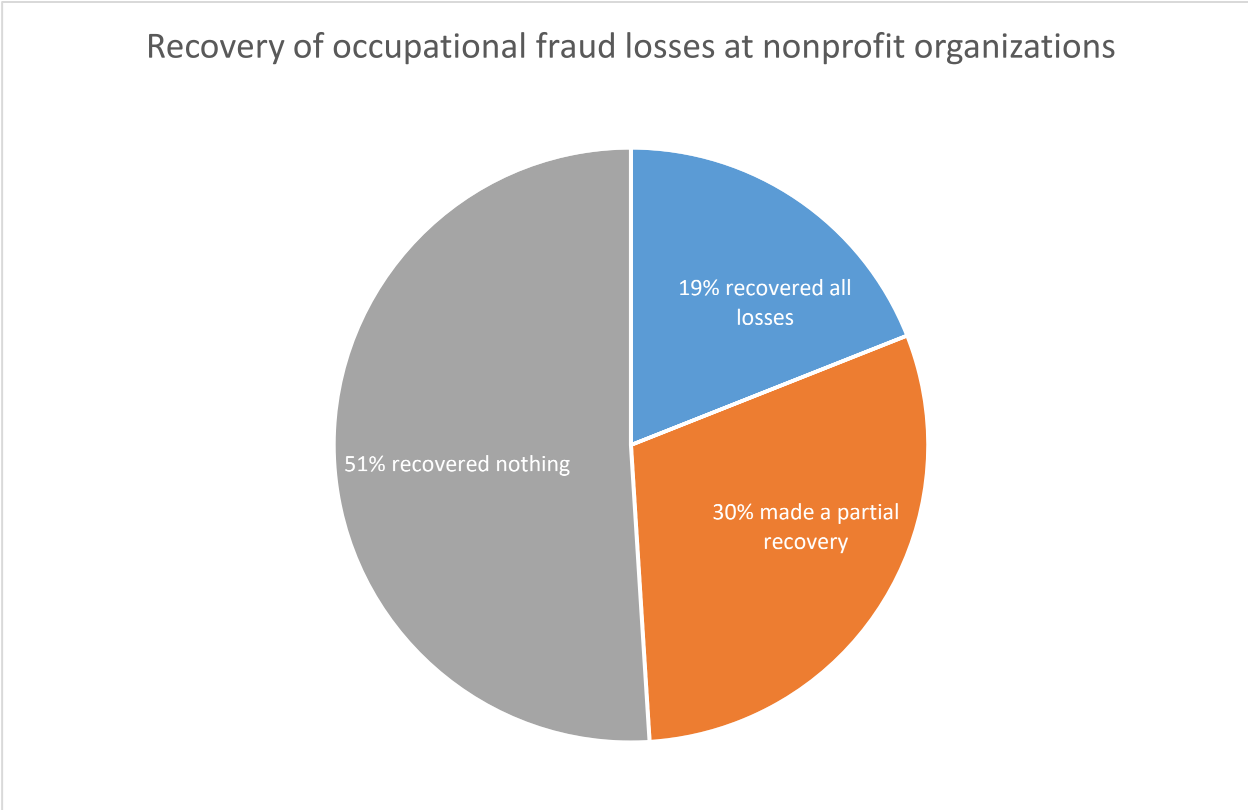


Table 6:




**Hypothesis 1: The negative publicity surrounding a fraud incident at a nonprofit will negatively affect the amount of charitable donations received in subsequent years.**

While fear of bad publicity remains a top reason for not referring cases to law enforcement, I was unable to collect enough data through my survey to show any confirmed relationship between bad publicity and the amount of charitable donations received in subsequent years.

**Hypothesis 2: More often than not, nonprofit organizations will choose to not prosecute fraudsters.**

Based on the information collected and provided by the ACFE, nonprofits referred fraud cases to law enforcement 54% of the time and did not refer cases to law enforcement 46% of the time (see Table 2). Thus, Hypothesis 2 is demonstrably false. In fact, nonprofits do choose to prosecute fraudsters more often than not.

## CONCLUSION

Ultimately, nonprofits do not have the same legal oversight as for-profit organizations, and nonprofits are more susceptible to fraud. However, there are ways that nonprofits can combat these issues. Implementing internal controls helps to prevent fraud from occurring and to catch fraud when it does occur. Conducting pre-employment background checks on new volunteers and employees can highlight any red flags that may exist. Finally, referring fraud cases to law enforcement not only acts as a deterrent against fraud in that organization, but it also will place the fraudulent activity on the perpetrator’s record. This allows other organizations to see the perpetrator’s fraudulent history when they run background checks and can prevent the perpetrator from becoming a repeat offender.

**Works Cited**


Archambeault, D. S., Webber, S., & Greenlee, J. (2015). Fraud and Corruption in U.S. Nonprofit Entities: A Summary of Press Reports 2008-2011. *Nonprofit and Voluntary Sector Quarterly*, *44*(6), 1194–1224.

Association of Certified Fraud Examiners (2018). *2018 Report to the Nations.* Retrieved from https://s3-us-west-2.amazonaws.com/acfepublic/2018-report-to-the-nations.pdf.

Association of Certified Fraud Examiners (2020). *2020 Report to the Nations.* Retrieved from https://acfepublic.s3-us-west-2.amazonaws.com/2020-Report-to-the-Nations.pdf

Cressey, D. R. (1971). *Other People's Money; a study in the social psychology of embezzlement*. Belmont, Calif., Wadsworth Pub. Co. [1971, ©1953].

Gilkeson, N. (2006). For-Profit Scandal in the Nonprofit World: Should States Force Sarbanes-Oxley Provisions onto Nonprofit Corporations. *Georgetown Law Journal*, (Issue 3), 831.

Greenlee, J., Fischer, M., Gordon, T., & Keating, E. (2007). An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents. *Nonprofit and Voluntary Sector Quarterly*, (Issue 4), 676.

Holtfreter, K. (2008). Determinants of fraud losses in nonprofit organizations. *Nonprofit Management & Leadership*, *19*(1), 45–63.

Iyer, V. M., & Watkins, A. L. (2008). Adoption of Sarbanes-Oxley Measures by Nonprofit Organizations:An Empirical Study. *Accounting Horizons*, *22*(3), 255–277.

McNeal, A., & Michelman, J. (2006). CPA's Role in Fighting Fraud in Nonprofit Organizations. *CPA Journal*, *76*(1), 60–63.

Nolo. (2014). Fiduciary Responsibility and Corporations. Retrieved November 18, 2020, from https://www.nolo.com/legal-encyclopedia/fiduciary-responsibility-corporations.html

Petrovits, C., Shakespeare, C., & Shih, A. (2011). The Causes and Consequences of Internal Control Problems in Nonprofit Organizations. *Accounting Review*, *86*(1), 325–357.

The Law Related to Fraud. (2010). In *Fraud Examiners Manual* (p. 2.212). Austin, TX: ACFE.