

## FRAUD - PREVENTION BETTER THAN CURE

At the outset I must clarify that fraud is not rife in the non profit sector. However, having worked on a number of fraud investigations over the years my experience is that it is naive to believe that people would not sink to defrauding a charity. The very nature of many non profit organisations operating environment often means that there is possibility and scope for fraud.

### What is fraud?

Fraud is not defined in statute and the courts determine when dishonest conduct becomes fraud. Most of the relevant legislation is found in the Theft Act 1968 (the 'Act'), this applies in England and Wales and in Scotland one has to have recourse to common law. In Northern Ireland the equivalent legislation is the Theft Act (Northern Ireland) 1969. Section 1 of the Act provides that:

- "a) a person is guilty of theft if he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it; and 'thief' and 'steal' shall be construed accordingly; and
- b) it is immaterial whether the appropriation is made with a view to gain or was made for the thief's own benefit."

Theft is an arrestable offence, and punishable on conviction on indictment by imprisonment.

In practice many prosecutions are brought under Section 15 of the Act which covers obtaining property, or pecuniary advantage through deception. A person who by any deception, dishonestly obtains property belonging to another with the intention of permanently depriving the other of it commits an arrestable offence. Obtaining property includes obtaining ownership, possession or control of it.

'Deception' means any deception deliberate or reckless by words or conduct as to fact or law including a deception as to the present intention of the person using the deception or any other person. Hence most of the prosecutions made against scam fundraisers who purportedly raise money for charity are often made under this section of the Act.

In January 1995 the Auditing Practices Board produced a Statement of Auditing Standard 'Fraud and Error' (SAS 110). In the SAS fraud comprises both the uses of deception to obtain an unjust or illegal financial advantage and intentional misrepresentation affecting the financial statements by one or more individuals amongst management, employees or third parties. Fraud therefore may include:

- (1) Falsification or alteration of accounting records or other documents;
- (2) Suppression or omission of the effects of transactions from records or documents;
- (3) Recording of transactions without substance;
- (4) Intentional misapplication of accounting policies;
- (5) Wilful misrepresentation of transaction or of the entity's state of affairs; or
- (6) Misappropriation of assets or theft.

### False accounting

False accounting is an arrestable offence under Section 17 of the Act and items 1 to 5 above would fall under this offence. In addition a person who makes or concurs in making an entry which is or may be misleading, false or deceptive or omits or concurs in omitting a material particular is also treated as falsifying the accounts or document.

Usually fraud in the charity sector is not carried out by falsifying the financial statements. Falsifying statutory accounts usually provides no benefit, as there would be for a for profit company, in showing a higher profit to avail of artificial share prices or unearned bonuses. However falsifying accounts can be used to permit a fraud or to avoid detection. As a generality the charity represented by its management and its trustees does not actively try to falsify accounts as there are not the same compelling incentives to do so. In the charity world fraud is usually carried out through misappropriation or theft. Simplistically this can be divided into two kinds.

## **Frauds of diversion**

This is where income or other assets due to the charity are diverted before they are entered into the accounting records or control data of the charity. Non profit organisations are usually more susceptible to this kind of fraud than other organisations. Essentially, with charities it is easy to check what is there but very difficult to establish that it is all there. Therefore ensuring the completeness of income or gifts in kind provided to a charity becomes difficult.

With trading organisations there are invoices, despatch notes, job sheets, stock controls, debtor ledgers, profit margin analysis etc which all support a control environment which assist in ensuring that all the income due to the organisation has been received.

Charities often receive voluntary income that cannot be monitored and controlled until it is received at the charity's premises. Therefore controls such as proper mail opening, recording and processing procedures, analysis of direct mail response notes, analytical review of fundraising and income generation activities have to be relied upon.

## **Frauds of extraction**

This is where income or assets in possession of the charity are misappropriated. These usually involve the management or employees since they require assets that are already in the possession of the charity being extracted fraudulently. This could be by false invoices, overcharging or making unauthorised grant payments. Essentially such frauds are carried out due to weaknesses in physical controls over assets and system weaknesses in the purchases, creditors and payments cycle. The cycle can be evaluated by considering questions such as who authorises incurring a liability and making a payment? On what evidence? Who records liabilities and payments? Who pays them and who checks them?

## **The recipe for fraud**

Areas to consider are:

- (1) Opportunity - how easy is it? are there controls?
- (2) Incentive - is it worthwhile?
- (3) Detection - will the fraud be discovered?
- (4) Sanction - what is the likelihood of prosecution?
- (5) Motive - lifestyle, commitments of employees and also morale are important here.

It is also important to be alert to fraud indicators and weaknesses in methods of prevention and detection.

## **Internal controls**

An internal control system is defined as being the whole system of controls, financial and otherwise, established by management in order to carry on the business of the enterprise in an orderly and efficient manner. It ensures adherence to management policies, safeguards the assets and secures as far as possible the completeness and accuracy of records.

It is a responsibility for management to decide the extent of the internal control systems appropriate to the enterprise. For charities, there will always be a cost versus benefit trade off, as well as the problem that it is often difficult to impose onerous controls on all areas. No internal control system can be itself guarantee efficient administration and completeness and accuracy of the records.

Large charities should have the internal controls appropriate to any large enterprise and the auditor should look for and encourage the charity to implement internal controls and reporting systems in keeping with the scale of operations. Controls should be both financial and operational.

Good practice suggests consideration of the following types of internal control

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| (i) <i>Organisational</i>              | The charity should have a plan of its organisation, defining and allocating responsibilities and identifying lines of reporting for all aspects of its operations, including the controls. The delegation of authority and responsibility should be clearly specified.  |
| (ii) <i>Segregation of duties</i>      | One of the prime means of control is the separation of those responsibilities or duties which would, if combined, enable one individual to record and process a complete transaction. Segregation of duties reduces the risk of internal manipulation or error and increases the element of checking. Functions which should be separated include those of soliciting income, receiving and opening mail, recording income, banking, authorisation, execution and custody. I recognise that full segregation of duties may not be possible in all cases and this will require the use of other compensating control procedures. |
| (iii) <i>Physical</i>                  | These are concerned mainly with the custody of assets and involve procedures and security measures designed to ensure that access to assets is limited to authorised personnel. This includes both direct access and indirect access via documentation. These controls assume importance in the case of valuable, portable, exchangeable or desirable assets.   |
| (iv) <i>Authorisation and approval</i> | All transactions should require authorisation or approval by an appropriate responsible person. The limits for these authorisations should be specified by the trustees/management.   |
| (v) <i>Arithmetical and accounting</i> | These are the controls within the recording function which check that the transactions to be recorded and processed have been authorised, that they are included and that they are correctly recorded and accurately processed. Such controls include checking the arithmetical accuracy of the records, the maintenance and checking of totals, reconciliations, control accounts and trial balances and accounting for documents.   |
| (vi) <i>Personnel</i>                  | There should be procedures to ensure that personnel have capabilities commensurate with their responsibilities. Inevitably, the proper functioning of any system depends on the competence and integrity of those operating it. the qualifications, selection and training as well as the innate personal characteristics of the personnel involved are important features to be considered in setting up any control system.   |
| (vii) <i>Supervision</i>               | Any system of internal control should include the supervision by responsible officials of day to day transactions and recording.  |
| (viii) <i>Management</i>               | These are the controls exercised by the trustees and management outside the day to day routine of the system. They include the overall supervisory controls exercised by trustees/management, the review of management accounts and comparison thereof with budgets, the internal audit function and any other special review procedures.   |

The trustees, and through them senior management, are responsible for establishing and maintaining adequate accounting and other records and internal control systems. In fulfilling that responsibility they must assess the expected benefits and related costs of management information and of control procedures. The objective is to provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorised use or disposition, that operations are properly monitored

and evaluated, that transactions are executed in accordance with established procedures and are recorded properly, and to enable the charity to conduct operations in a prudent manner.

Because of inherent limitations in any accounting and internal control system, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the systems to future periods is subject to the risk that management information and control procedures may become inadequate because of changes in conditions or that the degree of compliance with those procedures may deteriorate.

The examples below highlight some frauds in the charity sector. Readers will see that the use of internal controls would prevent and/or detect similar frauds.

### ***Bank account fraud***

This charity was in the midst of a major appeal. New donors were being solicited and there was very little trend analysis available. One individual was responsible for both soliciting and receiving donations. In addition, she was also responsible for banking the donations.

There were two bank accounts involved in the fraud, the main bank account of the charity and another, now dormant, bank account that had been opened some years previously for a special fund- raising event. The auditors were not aware of the existence of the second bank account.

The fraudster originally started by "borrowing" about £500 for a holiday. Apparently, the intention was to repay this, but of course, it never happened. The fraudster managed to use both frauds of diversion and of extraction defrauding the charity by about £2.5 million.

In essence, the fraud was quite simple. A number of the cheques were banked into the second account which no one knew anything about and the fraudster withdrew these for her own use. Her spending became so large that she then had to make transfers from the main bank account of the charity to cover it. She did this in two ways. In some cases, she transferred money directly from the first bank account to the second and in others she used the first bank account to make payments (through forged cheques) purportedly on behalf of the charity which were for her own extravagant lifestyle.

To allay the suspicions of her colleagues, she explained her "inheritance" and even made substantial donations to the charity. Surprisingly, she had been told by her superiors to close the second account and they were seemingly unaware that this had not been done.

The amount stolen was a significant percentage of the charity's income. However, since the charity was in the stage of early donor development, those involved with managing the charity internally and in auditing it did not notice that large amounts were being diverted. The whole system was flawed because there were no internal controls and it was based entirely on trust.

The main problem was the lack of segregation of duties on areas that should have been separated, such as soliciting the income, receiving and opening the mail, recording the income and banking. This was not a large charity and, therefore, full segregation of duties would not have been possible. However, it would have been important for the charity to have some compensating controls, segregating the main duties. In addition, there should have been some form of back-up checking through independent means with the donors.

### ***Security of cheques***

This large national charity was in a period where the amount of cheques received was greater than it could process in a timely manner. Consequently, these cheques were being "locked away" by the cashier.

The charity was commonly known by its initials and donors wrote cheques using those initials. The cashier was able to open a bank account in a name that, with a little amendment, incorporated the charity's initials. As a result he was able to divert over £800,000.

Many charities prevent subsequent diversion of their cheques by the use of a simple stamp across their cheques which states the charity's bank account number and its bank sort code, thus the cheques cannot be banked in any other bank account.

This also highlights the importance of prompt recording and banking of donations.

### ***Branch fraud***

This international charity operated through a number of fund-raising branches during a major international disaster. The branches were encouraged to carry out local fund-raising events and were supported by head office in their endeavours to do so. In the end, the branches were required to fill in a branch return to analyse their income and expenditure and, supposedly, tie in to the amounts being sent to head office.

The branch treasurer, knowing that the branch committee would be aware of the amounts raised by the branch produced a set of figures for them which did not, in fact, tie in with the branch return or the amounts she was remitting to head office. This fraud involved almost £20,000 and controls now in place would detect a similar occurrence.

The charity now has a Regional Manager who is closely involved with the activities of the branches and is aware of the amounts that should appear on the branch return. The branch return itself is required to be presented to the full branch committee who should notice any anomalies between the amounts that they would expect to see on it and the amounts that were included on it.

The charity is also closely matching amounts received by branches and amounts stated as being received on their branch return. (Surprisingly, a number of charities do not attempt to reconcile differences of transactions between the charity and the branch and they are naively treated as, "OK to write-off as it is all in the family"!)

### ***BACS fraud***

This charity filled in a BACS form for its payments. The form involved the name of the payee, the special BACS number and the amount. The form was prepared by the finance officer and usually signed-off by another individual, such as the Chief Executive. The finance officer used a number of ploys to extract over £100,000 from the charity. In some instances, he used fictitious invoices for budgeted expenditure, such as repairs, and simply inserted his own BACS transfer number against the payee details. Of course, the signatory was not checking that the numbers matched the payees. In other cases, the finance officer did not have to prepare fictitious invoices as he simply added on another name to the bottom of the form and was able to amend the total that had been authorised by the signatory.

Once again, a lack of segregation of duties and no independent checks of expenditure incurred allowed this fraud to occur.

### ***Legacies fraud***

The legacy officer of this charity wrote to the executors asking them to pay legacies directly into a bank account that had been opened by him and was not within the accounting records and controls of the charity. The executors were not aware of any problem and simply made the payments accepting 'receipt' from the legacy officer.

The opening of unauthorised bank accounts has become much harder as a result of an initiative between the Charity Finance Directors' Group, the Charity Commission and the British Bankers' Authority. Most banks will now refuse to open an account in the name of the charity unless they have the appropriate authority from the head office.

Notwithstanding, this system can be circumvented and charities should not rely on this control. They should have their own internal controls to prevent cheques from being misappropriated.

### ***Payments fraud***

This fraud involved collusion between a supplier and a charity employee. The supplier billed the charity employee for work that was never carried out. This work involved services that could easily not be verified. Thus the supplier was regularly billing the charity for de-duping mailing lists, sorting its mailing list, profiling donors, etc. The charity employee authorised the invoices and received a share.

In some cases, purchasing fraud is less blatant. Charity employees receive kickbacks, gifts and other incentives to use a particular supplier when the use of that supplier and its products is not in the best interest of the charity.

Standard controls over the purchase, creditors and payments cycle should help such frauds, but it is very difficult to cater for collusion.

### ***Grants fraud***

A charity applied for and received a grant for £50,000. This had been a head office initiative for a local project. The project manager subsequently approached the funder for a 'top up' grant of £10,000 that was received at the project and never used for the charity.

The head office records and budget tied in with the projects out figures and agreed with the original budget application. It was only direct confirmation sought by the auditors that identified that an additional £10,000 had been paid.

### ***Shops fraud***

The shop's manager "tilled up" an hour before the shop closed each evening. During this period, she worked alone and pocketed the takings. The earlier till readings matched taking records and cash banked. The fraud was discovered by random test purchase checks. Further investigation revealed that the fraudster was also stealing donated goods and selling them on a second hand good market.

Once again segregation of duties and proper tilling and checking procedures should have prevented this fraud.

### ***Internal controls***

Auditing Standards explain that the internal control system "comprises the control environment and control procedures. It includes all the policies and procedures (internal controls) adopted by the directors/trustees and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. Internal controls may be incorporated within computerised accounting systems. However, the internal control system extends beyond those matters which relate directly to the accounting system."

The standard goes on to explain the control environment and states that it is "the overall attitude, awareness and actions of directors and management regarding internal controls and their importance in the entity. The control environment encompasses the management style, and corporate culture and values shared by all employees. It provides the background against which the various other controls are operated. However, a strong control environment does not, by itself, ensure the effectiveness of the overall control system. Factors reflected in the control environment include:

- the philosophy and operating style of the directors/trustees and management;
- the entity's organisational structures and methods of assigning authority and responsibility (including segregation of duties and supervisory controls; *and*
- the directors/trustees' methods of imposing control, including the internal audit function, the functions of the board of directors and personnel policies and procedures."



### ***In conclusion***

The trustees, and through them senior management, are responsible for establishing and maintaining an adequate internal control systems. In fulfilling that responsibility they must assess the expected benefits and related costs of control procedures. The objective is to provide reasonable, but not absolute, assurance that assets are safeguarded against loss that operations are properly monitored and evaluated, that transactions are executed and recorded in accordance with established procedures.

Prevention is always better than cure and ensuring the likelihood of detection is an important prevention tool. Therefore it is important that management and internal/external auditors closely monitor and understand the business and investigate unusual variances. The culture should not permit management override and all staff should be aware of the risk of fraud and error.

A number of frauds are carried out by the 'trusted' individual and my experience of investigating these has made me a bit of a cynic. I now operate on the basis of "in God I trust - everyone else is subject to audit!"

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