Diversion of Assets- What You Need to Know!

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Welcome

We are pleased to welcome you to today's webcast.

In order to qualify for your CPE Certificate, you will need to:

- Remain logged on for at least 50 minutes
- Respond to the 4 polling questions that will be presented

We would appreciate if you would complete the evaluation survey following the event. A link to the survey will be emailed to you automatically within the hour following the webinar.

You may submit questions and we will try to address them during the program. However, if time does not permit us to answer a question posed during the webcast, it will be answered offline after the event.

For those who meet the above criteria a CPE certificate will be emailed to you or deposited into your Checkpoint Learning account. To apply for a complimentary Checkpoint Learning account visit the Executive College page at www.eisneramper.com.

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Objectives

- Discuss the nature of a significant diversion, as defined by the IRS
- Learn how best to disclose this on the federal Form 990
- Understand the types of internal controls that can mitigate the possibility of a significant diversion
- Apply these concepts to your own organization

Background:

- Washington Post (October 2013) article highlighting “Diversions of Assets” at nonprofits

Background (continued):

- The article identifies over 1,000 organizations reporting *millions* of assets “diverted” since 2008
- Information obtained through Guidestar.org’s database for all “yes” answers to Form 990 part VI-A line 5
- Now a searchable database exists, created by The Post, of all organizations that answered “yes”

Background (continued):

- Most Prevalent Types of Frauds Identified by The Post:
  - ❖ Investment Fraud (Madoff)
  - ❖ Unsubstantiated Spending
  - ❖ Theft of Assets
  - ❖ Unapproved Compensation
  - ❖ False Vendors

Core Form 990: Part VI Line 5

Form 990 (2013) Page **6**

Part VI **Governance, Management, and Disclosure** *For each "Yes" response to lines 2 through 7b below, and for a "No" response to line 8a, 8b, or 10b below, describe the circumstances, processes, or changes in Schedule O. See instructions.*

Check if Schedule O contains a response or note to any line in this Part VI . . . . ☐

Section A. Governing Body and Management

			Yes	No
1a	Enter the number of voting members of the governing body at the end of the tax year . . **1a**			
	If there are material differences in voting rights among members of the governing body, or if the governing body delegated broad authority to an executive committee or similar committee, explain in Schedule O.			
b	Enter the number of voting members included in line 1a, above, who are independent . **1b**			
2	Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee?	**2**		
3	Did the organization delegate control over management duties customarily performed by or under the direct supervision of officers, directors, or trustees, or key employees to a management company or other person? .	**3**		
4	Did the organization make any significant changes to its governing documents since the prior Form 990 was filed?	**4**		
5	Did the organization become aware during the year of a significant diversion of the organization's assets? .	**5**		
6	Did the organization have members or stockholders?	**6**		
7a	Did the organization have members, stockholders, or other persons who had the power to elect or appoint one or more members of the governing body?	**7a**		

Form 990: Part VI Line 5 Instructions

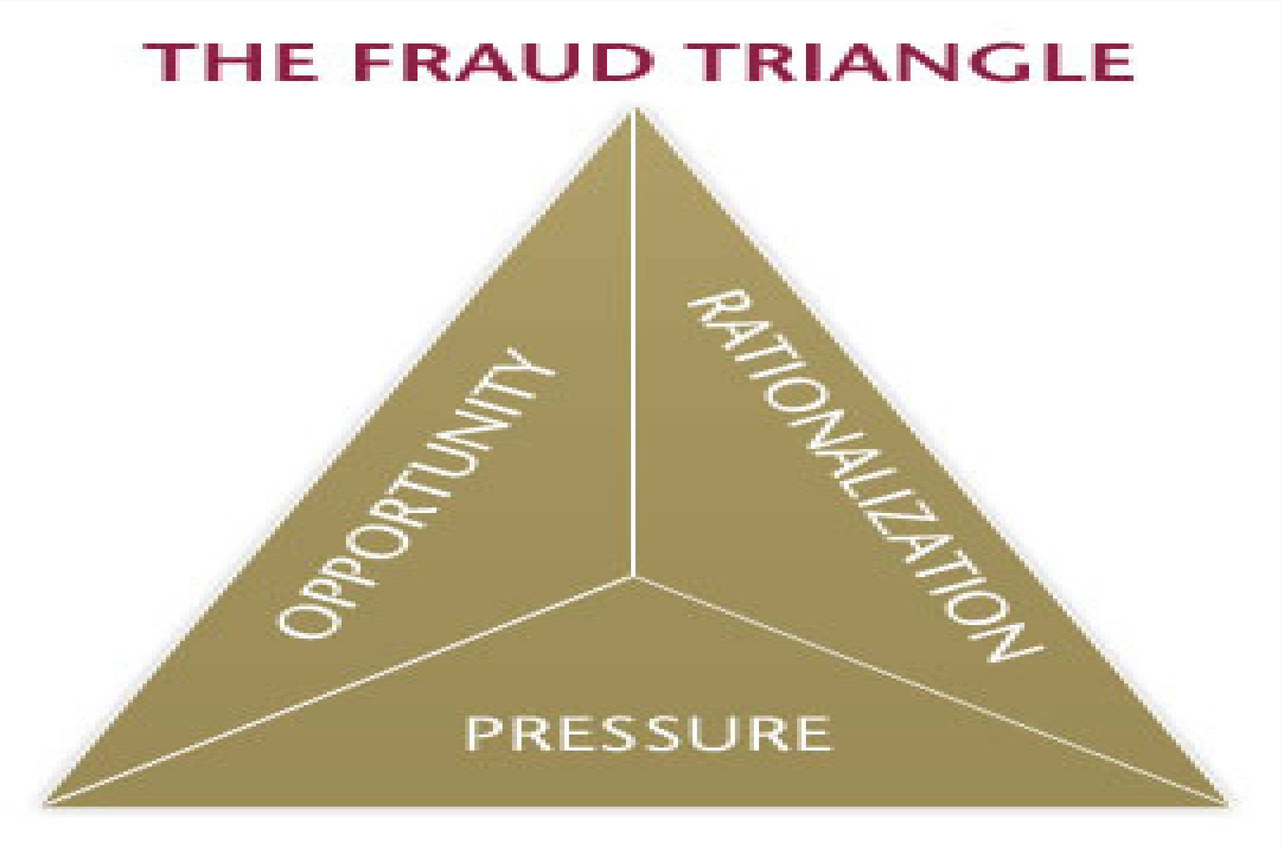
Line 5. Answer "Yes," if the organization became aware during the organization's **tax year** of a significant diversion of its assets, whether or not the diversion occurred during the year. If "Yes," explain the nature of the diversion, dollar amounts and/or other property involved, corrective actions taken to address the matter, and pertinent circumstances on Schedule O (Form 990 or 990-EZ), although the person or persons who diverted the assets should not be identified by name.

A *diversion of assets* includes any unauthorized conversion or use of the organization's assets other than for the organization's authorized purposes, including but not limited to embezzlement or theft. Report diversions by the organization's **officers**, **directors**, **trustees**, **employees**, **volunteers**, **independent contractors**, grantees (diverting grant funds), or any other person, even if not associated with the organization other than by the diversion. A diversion of assets does not include an authorized transfer of assets for **FMV** consideration, such as to a **joint venture** or for-profit subsidiary in exchange for an interest in the joint venture or subsidiary. For this purpose, a diversion is considered significant if the gross value of all diversions (not taking into account restitution, insurance, or similar recoveries) discovered during the organization's tax year exceeds the lesser of (1) 5% of the organization's gross receipts for its tax year, (2) 5% of the organization's total assets as of the end of its tax year, or (3) $250,000.

Put in Context:

- Question asks if organization became *aware* during the year of a significant diversion…
  - Not necessarily *occurred* during the year
  - Not necessarily indicative of a failure of controls
  - Includes “external” diversions (such as stolen checks from the mail)
  - Is exclusive of insurance reimbursements
  - Can be viewed as a lack of oversight (as article indicates) but can also be viewed as a positive – these diversions were **caught**!!

How Fraud Happens



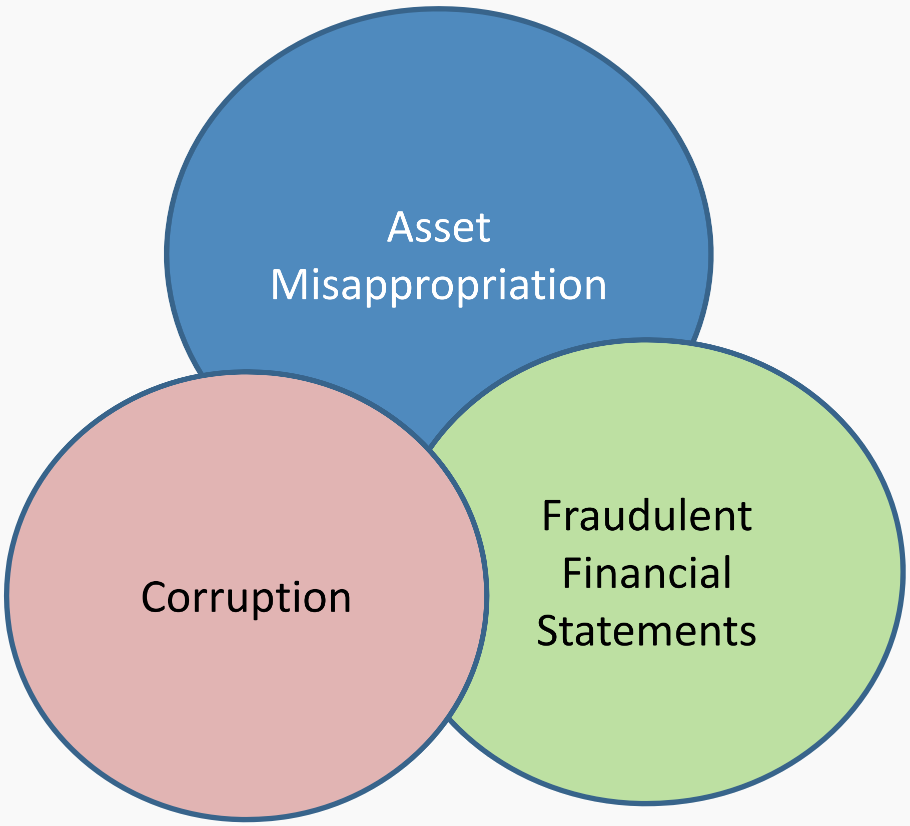
How Fraud Happens

- **Opportunity** – the ability to do something wrong (i.e. the control structure is insufficient)

- **Pressure** – an incentive to carry it out (the need for money or prestige)

- **Rationalization** – the self-deception to believe it is actually okay (I’m underpaid, everyone else does it)

Types of Fraud



Polling Question 1

Have you heard about a fraud within a non-profit organization in the past:

- Week
- Month
- Year
- None of the Above

More Common Types of Frauds

Internal	External
Kickbacks	Stolen Checks
Phony vendors	Hacking of database – identity theft
Theft of physical assets	Theft of physical assets
Stealing of petty cash	
Collusion / override of controls	
Travel/entertainment abuse by senior management	

Committee of Sponsoring Organizations of the Treadway Commission ("COSO")

- **Control Environment** – board, committees, policies
- **Control Activities** – segregation of duty
- **Information Processing** – financial reporting
- **Risk Assessments** – identification of risks the organization is facing
- **Monitoring** – are policies/controls still current/relevant

Case Study # 1

Internal Diversion - Segregation of duties involving non-finance personnel.

In order to achieve segregation of duty, the organization uses non-finance personnel as part of the control structure (good idea in terms of cost savings). BUT the organization doesn't train these employees or explain why they are serving in this role. As a result, it is easier to violate the segregation of duty procedures that have been set up.

Case Study # 1

Internal Diversion - Segregation of duties involving non-finance personnel (continued)

Example – the organization asks the grant manager to perform the monthly reconciliation of the bank account from which the grants are paid. This person does not have a finance background and may not understand why they are performing this task or the risks they should be concerned with.

Lesson Learned: Explain, train, and segregate duties!!

Case Study # 2

External Diversion – Check fraud occurring outside the organization.

In this example the organization mails a check to a vendor which gets intercepted by an outside party who manipulates the check to either change payee or check amount.

The organization, through no fault of their own, is the victim of a fraud. However, there are steps that can be taken to lessen the chances of this happening!

Lesson – Be proactive, don't let this happen to your organization!

Case Study # 2

Steps to Take to Avoid External Check Fraud:

- Make sure you are using sequenced checks and try to get check stock with a watermark, making it more difficult to replicate
- Banks now offer a service called “Positive Pay”. The customer sends the bank images of the cut checks prior to mailing them out. When a check is then presented at the bank to be cashed, the bank compares all the fields to the original image in the system and if they don’t match, the bank refuses to honor the check and calls customer
- An organization’s check signers should be real signatures, not stamps or electronic images of signatures, those are much easier to copy or steal.
- Timely reconciliation of bank statements – the faster you notice a check clearing out of sequence, the better off you will be!!

Strengthening Controls Without Weakening Your Wallet

The controls that help you get the biggest bang for your buck!

- Dual check signers (can even be a board member)
- Positive Pay – a feature offered by banks that can identify potential fraud
- Use of 3rd party vendors (such as a payroll service, an investment custodian, a pension record-keeper)
- Pay attention to check sequencing – an out of sequence check can tip you off to fraud
- Surprise procedural reviews
- Encryption
- Password protection

Polling Question 2

True or False – fraud is less of a concern at nonprofit organizations than in commercial entities?

- True
- False

Detecting Fraud – Pay Attention!

Fraud can take many forms and can involve collusion, which is harder to discover. If controls are sound, then it may require someone to "look the other way" in order to perpetrate a fraud, therefore pay attention to the following things:

- If part of the control structure is being circumvented, changed, or manipulated, **ask why!**
- Keep an eye on travel and expenses; does it match the budgeted amount? Is there spousal travel? Are people using credit cards for personal use? Are approvals required?
- Do expenses seem reasonable for what the organization does?

Detecting Fraud – Pay Attention!

(Continued)

Fraud can take many forms and can involve collusion, which is harder to discover. If controls are sound, then it may require someone to “look the other way” in order to perpetrate a fraud, therefore pay attention to the following things (continued):

- Think about vendor selection; is there a bidding process? Conflict of interest procedures? Kickbacks?
- Look at what is included in fringe benefits; are they taxable? Non-taxable? Legitimate business expenses?
- Too much authority given to one person – lack of segregation of duties, domineering personalities – can be dangerous

Lessons Learned

Do you have Internal Controls in Place to Prevent/Minimize Fraud?

- Perform background checks (consult with employment law counsel when creating such policies)
- Is staff competent/knowledgeable, encouraged to seek out training, and evaluated on their competence
- Who hires / interviews potential staff
- Secrecy or dominance by one individual could be a red flag
- Do expenses make sense for what organization does
- Is budget based on prior year or on actual contemplated costs? Is it monitored to actual expenses on an on-going basis?

Lessons Learned

Do you have Internal Controls in Place to Prevent/Minimize Fraud?

- Does the Board have a financial background, are budgets and cash flow statements being scrutinized
- Is financial information presented timely and accurately and generated from the general ledger system, not spreadsheets?
- Do random counts of petty cash and never leave cash undeposited!
- Is there a fraud risk management process – identification by Board of areas of potential risk on an ongoing basis?

Lessons Learned

Do you have Internal Controls in Place to Prevent/Minimize Fraud?

- Having a dual check signer policy is one of the easiest/inexpensive ways to enhance the control structure. Set a threshold, and if possible have a board member be the second signature (can use thresholds). Do not make the second signature a rubber stamp – that defeats the whole purpose!
- Make sure the person approving invoices understand accounting and what is being approved (likewise the first/second signatory of checks)

Lessons Learned

Do you have Internal Controls in Place to Prevent/Minimize Fraud?

- Have whistleblower policies (report directly to someone on the Board). Follow-through with training and concerns raised.
- D&O insurance important for protection
- Keep documents (bank recs, blank checks, invoices, personnel files, etc.) in appropriate areas with appropriate controls
- If employee goes on vacation, does someone else perform their job? Mandatory vacations?
- Conflict-of-interest policy is critical!

Lessons Learned

Do you have Internal Controls in Place to Prevent/Minimize Fraud?

- What is the “tone at the top” – board/ management
- Are program expenses really looked at? Verification that services are really being provided? Costs analyzed?

Frequency of Anti-Fraud Control

Based on the Certified Fraud Examiners 2012 Survey:

- More than 65% of nonprofits in the survey have the following anti-fraud controls in place:
  - Internal audit department
  - A Code of Conduct policy distributed regularly to staff
  - External Audit of the financial statements
- However, less than 40% of nonprofits in the survey have the following anti-fraud controls in place:
  - Formal fraud risk assessment
  - Surprise procedural reviews
  - Job rotation/mandatory vacation

Polling Question 3

True or False – Most governance policies are just suggestions and should be used when convenient:

- True
- False

What to Report on Line 5

- Identify whether diversion meets threshold for reporting first!!
- Make sure to disclose the appropriate information on Schedule O:
  - Nature of diversion
  - Dollar amounts
  - Circumstances of the diversion
  - Corrective actions taken/to take
- Don’t “overshare” but do be as complete as possible
- Be prepared for potential publicity – control the message and identify who will speak for the organization

Implications of Fraud on an Organization

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- Negative Press – scares away current and potential donors
- Litigation is expensive and damaging
- Resignation by valuable Board members can be a by-product
- Damage to an organization’s reputation is tough to fix
- Could impede ability to obtain government or other donor funding, also could result in having to return funding

Implications of Fraud on the Non-Profit Community

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- Attorney Generals are being more aggressive in prosecuting
- State and Federal agencies taking a closer look at executive compensation, fringe benefits, and travel, due to well publicized abuses
- New legislation is being implemented in various states to require tighter controls and more education on the Board level
- In an already difficult fundraising environment, negative press within the sector makes donors leery of giving significant gifts to the sector
- Inspiration for non-profits to have greater transparency, to restore confidence and highlight their programs

Polling Question 4

True or False – a well-governed organization will never have a fraud

- True
- False

In Summary

- **Fraud occurs when there aren't enough people paying attention**
- Look for the red flags (think about opportunities, pressure, and rationalizations)
- The control environment is constantly changing, make sure you assess the control structure regularly to make sure you are comfortable
- The entity should have a fraud risk management process in place to regularly evaluate and monitor risks
- If your business is becoming more internet-based, make sure you understand where the risks are within an online business model (identify theft, viruses, wire transfers)
- The best way to avoid negative press is to focus on transparency and building trust with your donors and the community you serve
- With better awareness, hopefully the next headline we read will be about all the wonderful things that non-profits do to serve the community

Thank you

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