



Fraud: Welcome to Your Worst Nightmare

Fraud: It can happen to you

A Not-For-Profit Fraud Survey conducted by BDO in 2014 highlighted the following facts concerning fraud in Australia & New Zealand among 436 respondents:

Key findings from the survey included:

- Fraud totalling \$3,229,400 was reported, with the average fraud being \$22,904
- 55% of respondents have a code of conduct while 18% have a fraud control plan

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A Not-For-Profit Fraud Survey conducted by BDO in 2014 highlighted the following facts concerning fraud in Australia & New Zealand among 436 respondents:

Key findings from the survey included (continued):

- The typical fraudster was aged over 50 and was a paid employee in a non-accounting role
- Collusion was present in 30% of the largest frauds reported, with a Board Member involved in 31% of cases

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A Not-For-Profit Fraud Survey conducted by BDO in 2014 highlighted the following facts concerning fraud in Australia & New Zealand among 436 respondents:

Key findings from the survey included (continued):

- Of the largest frauds reported, the most common fraud suffered by respondents was cash theft
- 54% of respondents do not report fraud to Police because of concerns relating to the impact of future funding opportunities and damage to the organisation's reputation

What is Fraud?

There are various types of Fraud:

- (a) fraudulent financial reporting;
- (b) misappropriation of assets; and
- (c) bribery or corruption.

What is Fraud?

There are three conditions generally present when material misstatements in financial statements due to fraud occur:

- (a) incentives/pressures,
- (b) opportunities, and
- (c) attitudes/rationalisations.

What is Fraud?

What is fraudulent financial reporting?

Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in the financial report to deceive financial report users.

It can be caused by the efforts of management to manage earnings in order to deceive financial report users by influencing their perceptions as to the entity's performance and profitability.

What is Fraud?

What is misappropriation of assets?

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts.

However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

What is Fraud?

What is bribery or corruption?

The overcharging of suppliers

The receipt of bribes by employee, such as kickbacks from suppliers (procurement fraud).

Conditions for Fraud: #1

Incentive or pressure to commit fraudulent financial reporting may exist when management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target or financial outcome – particularly since the consequences to management for failing to meet financial goals can be significant.

Similarly, individuals may have an incentive to misappropriate assets, for example, because the individuals are living beyond their means.

Conditions for Fraud: #2

A **perceived opportunity** to commit fraud may exist when an individual believes internal control can be overridden, for example, because the individual is in a position of trust or has knowledge of specific deficiencies in internal control.

Conditions for Fraud: #3

Individuals may be able to **rationalise** committing a fraudulent act.

Some individuals possess an **attitude**, character or set of ethical values that allow them knowingly and intentionally to commit a dishonest act.

However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.

Common Types of NFP Fraud

The most common types of fraud due to asset misappropriations in NFP's are:

- Fraudulent disbursement of cash
- Cash theft
- Theft or misuse of non-cash assets
- Revenue fraud

Disbursement of Cash: Billing/ Invoices

Any fraudulent act in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services and/or inflated invoices.

- Employee creates a shell or fake company and bills the NFP for services not actually rendered. Such invoice authorised by the Employee.
- Employee uses related party to collude in inflating invoice prices or falsifying purchases and shares with the related party in the excess profits.
- Employee uses NFP vendor for work performed on personal home and the vendor invoices the NFP. The employee approves the bill for payment.

Disbursement of Cash: Billing/ Invoices

Any fraudulent act in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services and/or inflated invoices. (Continued)

- Employee uses NFP vendor for work performed on personal home and the vendor does not charge on the basis that the vendor retains the work for the NFP. The employee approves the vendor.
- Employee re-uses invoices that have already been paid/ claimed.

Disbursement of Cash: Expense Reimbursements

Any fraudulent act in which an employee makes a claim for reimbursement of fictitious or inflated business expenses.

- Employee files fraudulent expense report, claiming personal travel, non-existent meals or travel, personal meals etc.
- Employee incurs personal expenditure on the NFP's credit card.

Disbursement of Cash: Payment Tampering

Any fraudulent act in which a person steals his or her employer's funds by intercepting, forging or altering a cheque drawn or EFT payment, on one of the organisation's bank account.

- Employee changing EFT payment files prior to the release of money (manipulation in between systems).
- Employee obtaining unauthorised access to a second electronic signatory (and/or token device) for payment approvals.

Disbursement of Cash: Payroll

Any fraudulent act in which an employee causes his or her employer to issue a payment by making false claims for compensation.

- Employee adds ghost / fictitious employees to the payroll.
- Departed employees maintained on payroll reports for a period of time with payments diverted to a different bank account.
- Employees collude to inflate hours worked for casual staff.
- Employee claims overtime for hours not worked.
- Employees conducting their own business during NFP work hours.

Theft of Cash

Any fraudulent act in which:

- Cash is stolen from an organisation before it is recorded on the organisation.
- Cash is stolen from an organisation's books and records.
- An employee makes false entries on a cash register to conceal the fraudulent removal of cash.
- The perpetrator misappropriates cash kept on hand at the victim organisation's premises.

Theft of Cash

For NFPs, cash theft scenarios have occurred in the high- cash areas such as canteens, uniform stores, coffee stores, swim centres, and the front office. The typical cash theft scenarios are:

- Employee accepts payment from a customer/ parent / student but does not record the sale and instead pockets the money.
- Employee steals cash from daily receipts before it can be deposited in the bank.
- Employee fraudulently voids a sale or processes refund on their cash register and steals the cash.
- Employee steals cash from safe or cash tin.

Theft of Non-Cash Assets

Any fraudulent act in which an employee steals or misuses non-cash assets of the organisation.

- Employee steals computers/laptops/tablets from the NFP.
- Employee steals inventory and or supplies from a storeroom.
- Assets are stolen and written off as damaged and or fully depreciated.
- Colluding with a competitor by disclosing technological data in return for payment.

Revenue Fraud

Any fraudulent act in which:

- An employee steals his or her employer's funds by misstating discounts and adjustments and making false claims.
- An employee overinflate the NFP's revenue entitlements from government funding sources, i.e. Employee intentionally inflates student numbers and/ or types of students to obtain higher Government Funding.



Fraud: How to Prevent & Detect



Why does Fraud Occur?

Research has shown that the greatest continual threat to any organisation from potential fraudsters (whether internal and/or external parties) is through the overriding of internal controls that are in place and/or through the complete lack of adequate internal controls.

“Quis Custodiet ipsos Custodes?” - “Who Watches the Watchmen?”

from the graphic novel, Watchmen by Alan Moore & David Gibbons

This section will discuss ways by which Fraud can be prevented before it happens or detected after it happened.

Early Indicators of Fraud

Responding to early indicators of fraud is absolutely critical to detecting fraud and lessening its impact. It is important therefore to understand the nature of early indicators or “red flags” and having an appropriate set of mechanisms to deal with early warnings.

- Signs of recent and/or excessive wealth and/or spending by employees.
- Gambling habits and/or addictions.
- Unusually close relationships with particular customers or suppliers.
- Failing to declare potential conflicts of interest or gifts.
- Request for system access not commensurate with employees’ duties.

Early Indicators of Fraud (Cont.)

Responding to early indicators of fraud is absolutely critical to detecting fraud and lessening its impact. It is important therefore to understand the nature of early indicators or “red flags” and having an appropriate set of mechanisms to deal with early warnings.

- Staff not taking holidays.
- Bypassing established procurement processes when purchasing goods, supplies and/or services.
- Lack of supporting documentation (including originals) for transactions.
- Lack of reconciliation of bank and cash accounts.

Early Indicators of Fraud (Cont.)

Responding to early indicators of fraud is absolutely critical to detecting fraud and lessening its impact. It is important therefore to understand the nature of early indicators or “red flags” and having an appropriate set of mechanisms to deal with early warnings.

- Lack of reconciliation of key control accounts, including debtors and creditors.
- Lack of reconciliation of clearing and suspense accounts.
- Failure to follow up reconciling items identified in reconciliations on a timely basis.
- Inconsistent financial data.

Given the high cost to organisations of fraud, prevention thereof should be a key priority.

Fraud Prevention Methods

Prevention methods can include the following:

- Pre-employment screening of future employees.
- Reviewing and improving internal controls.
- Developing a corporate code of ethics and conduct.
- Establishing clearly documented whistle blowing policies and procedures.
- Preparing a statement of the organisation's attitude to fraud.

Fraud Prevention Methods (Cont.)

Prevention methods can include the following:

- Enforced leave and job rotations.
- Developing a fraud control strategy.
- Conducting and/or attending fraud awareness training.
- Conducting due diligence on suppliers and establishing a list of authorised suppliers.

Anti-Fraud Controls

Common anti-fraud controls include the following:

- Strong whistle blowing policies understood by all employees.
- Employees taking leave as it falls due and on a regular basis.
- Rotation of employee's duties. This provides back up for key functions.
- Independent reviews and authorisation of key accounting processes and functions.

Anti-Fraud Controls (Cont.)

Common anti-fraud controls include the following:

- Adequate segregation of duties.
- Controls over the use and authorisation of credit cards.
- Control over the purchasing and receipting functions.
- Minimum of 2 authorisations and passwords for all payments.
- Periodical review of and matching of critical master files data, including payroll, accounts payable and banking.

Anti-Fraud Controls (Cont.)

Common anti-fraud controls include the following:

- Use and independent review of edit reports; for example payroll exceptions and master file changes.
- Use of purchase orders.
- Requirements for original invoices to be presented.
- Establishment of a list of authorised suppliers.

Anti-Fraud Controls (Cont.)

Common anti-fraud controls include the following:

- Comprehensive and timely reconciliations processes, with timely follow up of all variances and reconciliations.
- Strong controls over the use and location of assets.
- Stocktakes of assets and authorisation of asset write-offs.
- Review of the journal entries, which may indicate management override.

Financial Internal Controls

For complete financial management of the organisation, good financial controls should be present.

A financial control is a procedure that is implemented to detect and prevent errors, theft or fraud, or policy non-compliance in a financial transaction process.

Financial control procedures can be implemented by either an individual or as part of an automated process within a financial system.

Financial Internal Controls (Cont.)

Each **financial internal control procedure** is designed to fulfil at least one of these seven criteria:

1. **Completeness** – ensures that all records and transactions are included in the reports of the organisation
2. **Accuracy** – ensures that the right amounts are recorded in the correct accounts
3. **Authorisation** – ensures that the correct authorisations are in place to cover such things as approval, payments, data entry and computer access
4. **Validity** – ensures that the invoice is for work performed or products received and the organisation has incurred the liability properly

Financial Internal Controls (Cont.)

Each **financial internal control procedure** is designed to fulfil at least one of these seven criteria:

5. **Existence** – ensures the existence of assets and liabilities. Has a purchase been recorded for goods or services that have not yet been received? Do all assets on the books actually exist? Is there correct documentation to support the item?

6. **Handling errors** – ensures that procedures are in place to ensure that errors in the system have been identified and corrected

7. **Segregation of duties** – ensures that certain functions are separated. For example, the person taking cash receipts does not do the banking

Conclusion

Ultimately a key preventative measure to stop fraud remains the Board and Management's commitment to a strong internal control system with appropriate checks and balances in place.

Organisations should regularly review their control systems to ensure that they remain effective and current.

An auditor can play an important role in assisting Management with maintaining effective internal controls.

Conclusion (Cont.)

Fraud can happen to you – be alert and prepared!



Questions





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