



Fraud: Prevention better than cure

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Fraud is not rife in the not for profit sector. However, having worked on a number of fraud investigations over the years, my experience is that it is naïve to believe that people would not sink to defrauding a charity. The very nature of many not for profit organisation's operating environment often means that there is possibility and scope for fraud.

What is fraud?

Until the passing of the Fraud Act 2006, 'fraud' was not defined in UK statute and the courts determined when dishonest conduct becomes fraud. Most of the relevant legislation was found in the Theft Act 1968.

The rationale behind creating the Fraud Act (the Act) was to simplify the law in this area by creating separate free-standing fraud offences. The old crimes of dishonesty have been revoked by the Act and, accordingly, the need to categorise perceived dishonest behaviour as one of the crimes of deception/dishonesty referred to above has been removed. Three main fraud offences are created by the Act.

Fraud by false representation (section 2) is designed to cater for situations where the offender knows they are making a representation which is false or misleading, or that may be false or misleading. Importantly, the victim of the false representation need not necessarily rely upon or be deceived by it. The law requires that the person making the representation does so with the intention of making a gain or causing loss or risk of loss to another. The gain or loss does not actually have to take place. The same requirement applies to conduct criminalised by sections 3 and 4 (see below).

A representation is defined as false if it is untrue or misleading and the person making it knows that it is, or might be, untrue or misleading. There is no limitation on the way in which the representation is made. So it could be oral or written representation or posted on a website.

Fraud by failing to disclose information (section 3). This applies where there is a legal duty to disclose. This could include a statutory, fiduciary or contractual duty.

A person commits an offence if they:

- dishonestly fail to disclose to another person information which they are under legal duty to disclose, and
- intend, by failing to disclose the information, to make a gain for themselves or another or to cause a loss to another or to expose another to a risk of loss.

Fraud by abusing a position of trust (section 4) focuses on the nature of the relationship between victim and defendant at the time of the alleged fraud. A fraud offence is committed by dishonestly abusing one's position. It applies in situations where a person has been put in a privileged position, and by virtue of this position is expected to safeguard another's financial interests or not act against those interests.

The recipe for fraud

Areas to consider are:

- Opportunity: how easy is it (does the fraudster have access to the systems, ledgers, assets etc? Are there controls?
- Incentive: is it worthwhile?
- Detection: will the fraud be discovered?
- Sanction: what is the likelihood of real sanction – for example, prosecution?
- Motive: lifestyle, commitments of employees and also morale are important here.
- Rationalisation: can the individual rationalise the action?
- Business ethic: in some locations the business ethic almost accepts that corruption/bribery and fraud is an acceptable form of behaviour.

It is also important to be alert to fraud indicators and weaknesses in methods of prevention and detection. Bear in mind the risk of management override of controls.

Tone at the top

The Charity Commission has published *Compliance Toolkit: Protecting Charities from Harm*, Chapter three deals with fraud and financial crime. This states: “Trustees have a legal duty and responsibility under charity law to protect the funds and other property of their charity so that it can be applied for its intended beneficiaries. They must also comply with the general law (and overseas law where applicable) including in relation to the prevention of fraud, money laundering and terrorist financing.”

“Fraud will flourish in an environment of weak governance and poor financial management. So this means that the protection of charity funds begins with having robust financial control systems within a framework of strong and effective governance.”

In summary, the Trustees, and through them management, are responsible for establishing and maintaining adequate financial and other records and internal control systems. In fulfilling that responsibility, they must assess the expected benefits and related cost of management information and of control procedures. It is not enough to work on trust and this must be accepted throughout the organisation.

The objective is to provide a high level of, but not absolute, assurance that assets are safeguarded against loss from unauthorised use or disposition. To do this, operations and controls need to be properly monitored and evaluated, transactions need to be executed in accordance with established procedures and recorded properly. Because of inherent limitations in any accounting and internal control system, errors or irregularities may nevertheless occur and not be detected. Also, projection or 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.

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It is not enough to design good controls. It is important that there is buy-in to the need for the controls so that the controls are understood, complied with and observed. It is also necessary for procedures to ensure that controls are not being overridden.

In the charity sector there is sometimes a culture that assumes that individuals always do what they should do, when they should do it and in the right way without supervisory and monitoring controls.

Trustees and management may have faith in a control and it may be believed that the residual risk is low, but without knowing that the control is operating consistently there will be a degree of false comfort. It is therefore important that regular reviews are undertaken to ensure that there is evidence that the control is in operation.

Empowerment and accountability

Many charities try to foster a culture of empowerment with staff, partners and those they support. In practice, this is only effective when those individuals are able to rely on realistic policies to set the parameters and framework for decision making. This means that often the charity needs to focus on capacity building and support as a means to true empowerment.

True empowerment requires an enabling environment and this means that the charity must ensure that those it is trying to empower have the aptitude, core competencies, values and skill base to properly use tools, methodologies and policies to support both accountability and devolved decision making.

True empowerment is only possible when suitably experienced individuals take decisions within their competence and within an agreed framework that does not require constant reference to others for prior approval.

Charities are often reluctant to properly address performance issues and simply move people and problems around in a way that contributes to decline.

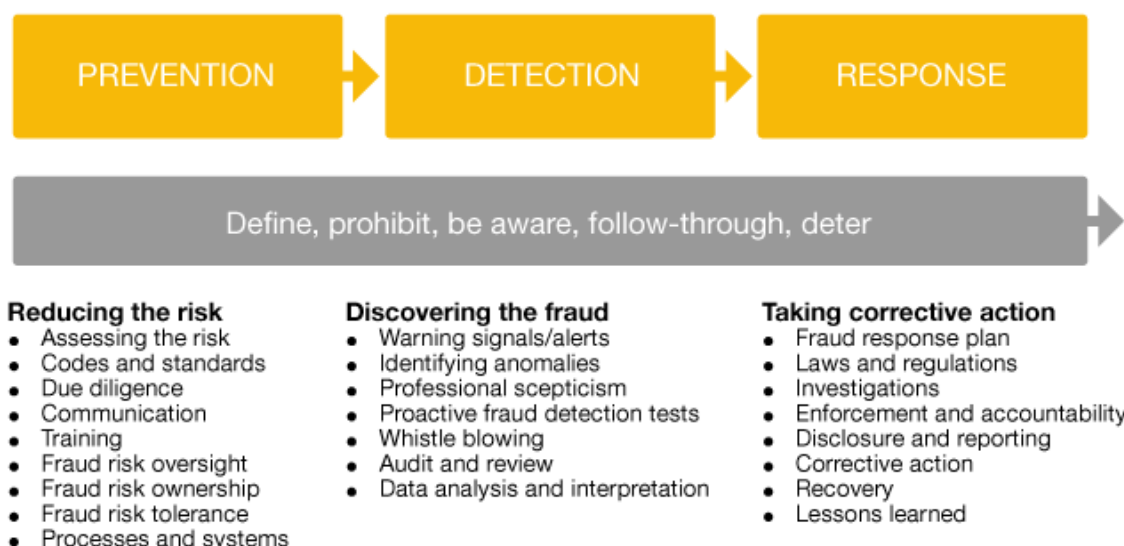
True and effective empowerment needs three components: responsibility, authority, and accountability. Whenever a process, activity or task is being transferred to a team or an individual, all three components need to be considered. The correct balance will be achieved only when individuals or teams have a clear

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understanding of responsibilities, the authority necessary to fulfil these responsibilities, and the accountability for the consequences of what they have done or failed to do.

Fraud risk management

While there is no one sized fit all approach, it is important to have a framework to prevent, detect and respond to risk. An effective framework will act as a deterrence. A typical framework is depicted below.



For the framework to be effective, board and management must:

- deliver and reinforce an ethical tone at the top
- ensure that there are effective internal controls
- encourage proper whistle blowing
- prevent reprisals
- ensure that there is required training
- create the proper culture
- demand accountability.

False accounting and accounting bias

Fraudulent report is a common fraud risk in the private sector. It is driven by bottom line pressures to meet analysts' expectations, compensation incentives, goals and targets. These factors do not normally feature strongly in the charity sector.

Therefore, fraud in the charity sector is not usually carried out by falsifying the financial statements. Falsifying statutory accounts usually provides no benefit, as it would for a for profit company. There is normally no real benefit 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.

However, there may be particular issues where there are bonuses paid on the basis of results. It is important to note that this does not require consideration only of areas where the profit or surplus is increased. In some cases, the bonus threshold may have been reached and it may be advantageous to 'carry forward' credits by setting up provisions or deferring the recognition of income.

Types of Fraud

In the charity world, fraud is usually carried out through misappropriation or theft. Simplistically, this can be divided into three kinds.

1. 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. Not for 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 rates, sensible analytical review of fundraising and income generation activities have to be relied upon.

To consider this, it is important to understand where the income comes in, who it comes from and what it is for. In essence, both management and auditors need to understand the different income streams and how they are controlled before it is possible to consider fraud risk.

For example: there is little point in considering donation income as one figure if income is received through direct debit and standing order as it will have a different audit risk profile to income received by home based fundraisers, in a post room or at a fulfilment house.

2. Frauds of extraction

This is where income or assets in possession of the charity are misappropriated. These often 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.

Funds can also be extracted through mandate fraud. This is when someone gets the charity to change a direct debit, standing order or bank transfer mandate, by purporting to be an organisation that the charity makes regular payments to. These are often quite sophisticated scams which on the face of it appear credible. In other cases payments staff may receive emails purportedly from senior management instructing them to make a payment.

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?

There is a greater inherent risk with charities as the expenditure may not be made for a quantifiable or easily identifiable exchange transaction. With a for profit company, it is usually possible to use gross margins, physical verification etc to confirm that expenditure is valid. With a charity, a payment may be by way of grant, or expenditure may be incurred to do 'good works'.

As with income, it is important to consider expenditure to understand where it goes out from and the system to monitor and control it. This is particularly important when expenditure is incurred at different locations, be they overseas or at branch offices. For example, the accounts may show a number for overseas expenditure but it is important to understand the different components. How much of the expenditure has actually been

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incurred in the UK? If the expenditure is incurred overseas, is it incurred by the charity's own staff or is it an onward payment made to partner organisations? This also requires an understanding of the payment controls at different locations.

If payments are made by way of grant, how does the charity ensure that the funds have reached the right place? Are there records of receipt, thank you letters etc? It is also important to understand the different payment mechanisms — for example, the controls over payments made by cheque, BACS and standing orders.

BACS can be a particular issue. The banks often require only one administrator who can override other segregation of duty controls. Charities should investigate who has the authority to set up new users and new passwords.

3. Backhanders and inducements

Charities often commission large contracts for work and this can lead to the risk of 'backhanders'. The best way to combat this is to have good tendering and purchasing procedures with adequate reviews and supervision. Most charities also take comfort from the fact that more than one individual take decisions on large tenders or commissioning of services.

Auditors' responsibilities

International Standards on Auditing (ISA) (UK & Ireland) 240 covers the auditor's responsibility to consider fraud in an audit of financial statements. Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial statements is intentional or unintentional. The term 'error' refers to an unintentional misstatement in financial statements including the omission of an amount or a disclosure, such as the following:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

Two types of intentional misstatements are relevant to an auditor, that is, misstatements resulting from fraudulent reporting and misstatements resulting from misappropriation of assets. Fraudulent financial reporting may be accomplished by:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documentation from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that may otherwise appear to be operating effectively. Fraud can be committed by management overriding controls using such techniques as:

- Recording fictitious journal entries particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- Inappropriately adjusting assumptions and changing judgements used to estimate account balances.

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- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period.
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

Internal controls

ISA (UK and Ireland) 315 explains that internal control is the process designed and effected by those charged with governance and management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

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.

The charity should have a procedure for identifying and responding to fraud. Lessons to be learnt need to be considered and whenever there is an incident of fraud. The thinking should be:

- What allowed this to happen?
- What is the extent of the risk?
- Could it still be happening elsewhere in the organisation?
- How was it detected?
- What procedures need to be implemented to prevent the risk of recurrence?

Matters to consider

- Does the charity have a fraud register?
- Does the charity have a fraud response plan?
- Are there whistle blowing guidelines?

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

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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.

Decentralised operations

There is often more to the charity than the head office location. Many charities have decentralised operations.

Empowerment is a popular concept in the voluntary sector and often much control is devolved to individuals who are trusted to do the right thing. It is important to ensure that there are adequate controls to detect if things are going wrong.

This means that there is a need to understand and document the operating environment. How many locations are there (branches, regional offices, project offices etc)? What is covered by external audit cover? What is covered by internal audit or other auditors? What satisfaction can be gained by relying on the work of others?

The fraud risk can be exacerbated when charities operate overseas.

Assurance framework and the three lines of defence

Many charities make a significant investment in 'assurance'. In addition to external and internal audit, there are other 'hidden' assurance costs and it is important that all this is coordinated to ensure maximum benefit. This entails understanding the level of assurance we see with most charities – in effect clarifying who does what, where, and when. There are many tasks, services and activities that typically provide assurance in the charity framework. These include:

- the oversight of Trustees and sub committees
 - external audit
 - internal audit
 - external audit at overseas offices
 - other review and extended assurance work
 - reviews by the staff (capacity building and review visits)
 - audits by and for funders (on an ad-hoc basis).
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In my experience, most charities have historically not been very good at understanding the different levels of assurance and properly identifying how all these should be coordinated to provide a joined up assurance framework.

Assurance for a charity has diverse aspects. In addition to the traditional areas of financial control, there is a need to factor in the specific issues that arise from the operating structure and local environment. A key question is: 'what assurance does the charity have that key controls to manage risk are in place and operating efficiently and effectively?'

This will require the building of an assurance framework and assurance maps. Assurance mapping is a mechanism for linking assurances from various sources to the risks that threaten the achievement of the charity's outcomes and objectives. They can be at various levels, dependent upon the scope of the mapping.

A concept for helping to identify and understand the different contributions the various sources can provide is the Three Lines of Defence model. By defining the sources of assurance in three broad categories, it helps to understand how each contributes to the overall level of assurance provided and how best they can be integrated and mutually supportive. For example, management assurances could be harnessed to provide coverage of routine operations, with internal audit activity targeted at riskier or more complex.

The Institute of Internal Auditors explains that in the Three Lines of Defence model, management control is the first line of defence in risk management, the various risk control and compliance oversight functions established by management are the second line of defence, and independent assurance is the third. Each of these three 'lines' plays a distinct role within the organisation's wider governance framework.

First line of defence

The first line of defence includes the 'front-line' or business operational areas. There are many arrangements established that can be used to derive assurance on how well objectives are being met and risks managed; for example, good policy and performance data, monitoring statistics, risk registers at country and central level, reports on the routine system controls and other management information. The assurance at this level comes direct from those responsible for delivering specific objectives or operation; it provides assurance that performance is monitored, risks identified and addressed and objectives are being achieved. While it may be that this type of assurance lacks independence and objectivity, its value lies in the fact that it comes from those who know the business, culture and day-to-day challenges.

Second line of defence

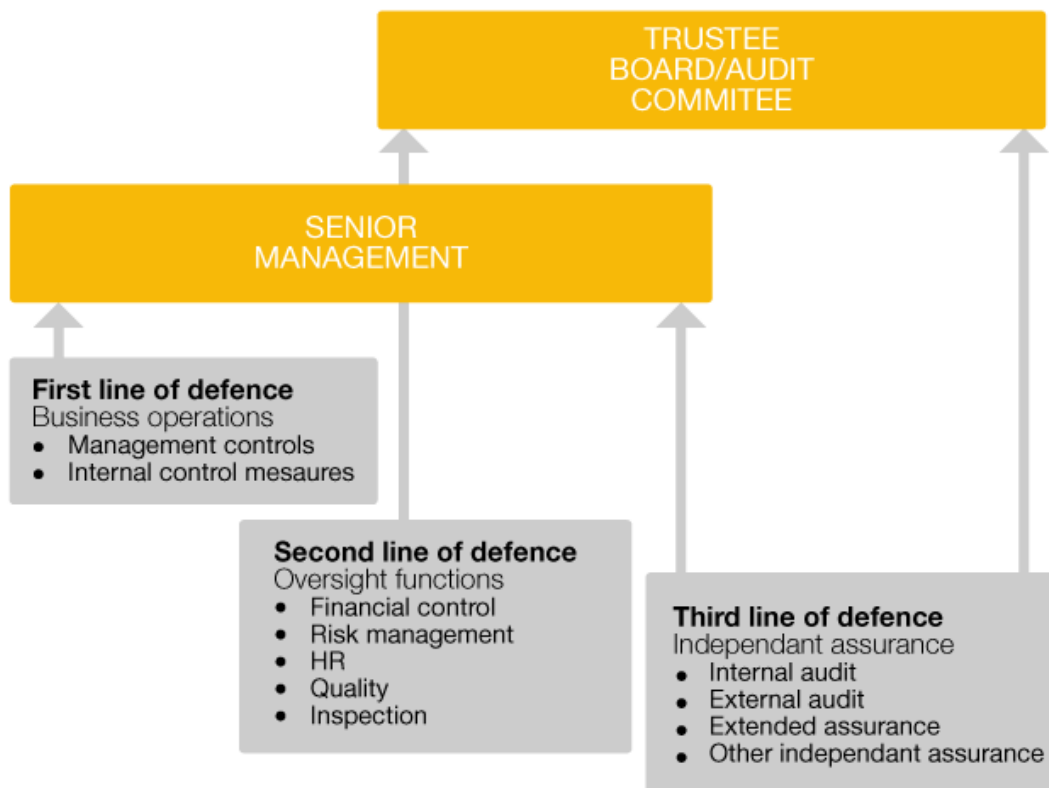
The second line of defence is associated with oversight of management activity. It is separate from those responsible for delivery, but not independent of the organisation's management chain. This could typically include compliance assessments or reviews carried out to determine that policy or quality arrangements are being met in line with expectations for specific areas of risk across the charity. This assurance provides valuable management insight into how well work is being carried out in line with set expectations and policy or regulatory considerations. It will be distinct from and more objective than first line assurance.

Third line of defence

The third line of defence relates to independent and more objective assurance and focuses on assurance to provide an independent and objective opinion on the framework of governance, risk management and control. Internal audit places reliance upon assurance mechanisms in the first and second lines of defence, where possible, to enable it to direct its resources most effectively, on areas of highest risk or where there are gaps or weaknesses in other assurance arrangements. It should also take assurance from other independent assurance providers operating in the third line, such as those provided by funder grant reviews, local external audits and work carried out as part of the external audit.

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Three lines of defence



Serious incident reporting

Linked to the area of fraud and error is the Charity Commission's regime on serious indecent reporting (SIR). We emphasise that the SIR duty does not exist only in the case of fraud but in many other areas. The Charity Commission has updated its guidance on SIR.

This duty requires the Trustees to evaluate for themselves the level of risk to the charity or any vulnerable beneficiaries in respect of each SIR situation or 'incident' arising, and themselves to blow the whistle to the Commission if and when regulatory intervention would be likely to result.

There is often the issue of an unconfirmed incident which may arise from an allegation or suspicion and the Commission's guidance to Trustees states: "You should still report this to us if you have received information that leads you to believe or suspect that a serious incident has happened and you have reasonable grounds for the suspicion. Trustees are responsible for taking appropriate action in response to a suspicion or allegation in order to protect their charity from harm, and we will expect to know what you have done. One of our statutory functions is to identify and investigate apparent misconduct or mismanagement in the administration of charities. We decide our regulatory response, if any, on the basis of evidence. If you are unsure whether an incident is serious or significant, we recommend you report it to us."

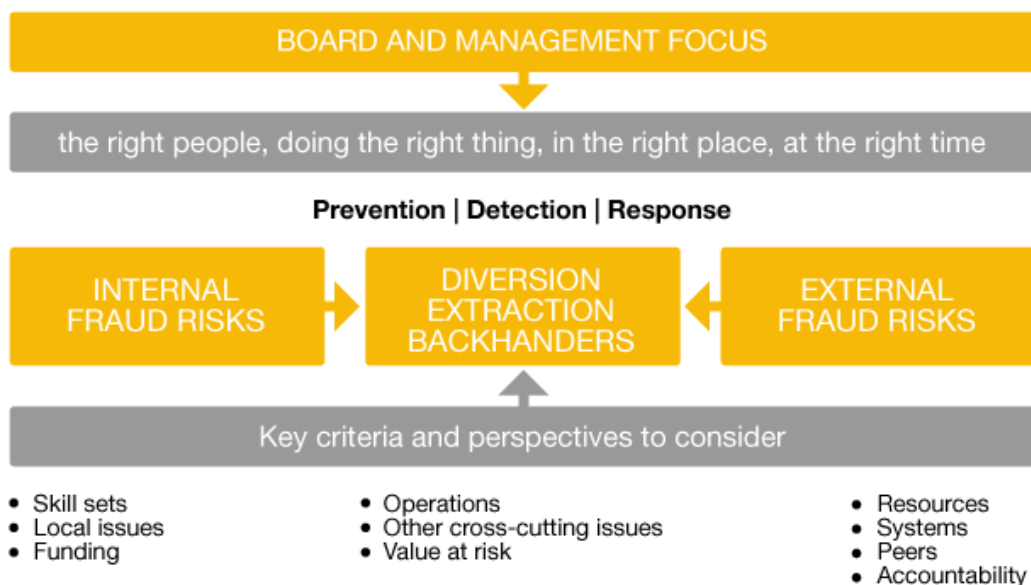
This means that all frauds need to be recorded and charities should have a risk register and a risk log.

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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.

The many factors to think about when considering fraud



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!'

Appendix 1: Examples of well-known charity frauds

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 fraud

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.

Controls over post opening are important and these should exist at all the locations where cash and cheques are received.

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 naïvely treated as, 'OK to write-off as it is all in the family'!)

BACS fraud

This charity used a manual 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's records and budget tied in with the project's 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 secondhand goods market. Once again, segregation of duties and proper tilling and checking procedures should have prevented this fraud.

Journal fraud

An employee in the finance department of the charity obtained cheques that were due to the charity and diverted them. He was aware that the income section were expecting the income so he used journals to record the income by way of credit entry but the debit entry was to different ledger accounts and not to the bank account.

The debit entries were often queried by account holders and he simply responded that it was a posting error and journaled them to another account. Controls over cheques and controls over journals were weak and this combination allowed the fraudster to steal over £90,000.

Diversion of income

The programme director of an overseas project was diverting sums of money that were being generated locally. This included the setting up of an 'internet café' on the charity's premises and local fundraised income. A separate bank account that was never on the books had been opened.

Appendix 2: Internal controls

Good practice suggests consideration of the following types of internal control.

Organisational: 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.

Segregation of duties: 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. Full segregation of duties may not be possible in all cases and this will require the use of other compensating control procedures.

Physical: 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.

Authorisation and approval: All transactions should require authorisation or approval by an appropriate responsible person. The limits for these authorisations should be specified by the Trustees/management.

Arithmetical and accounting: 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.

Personnel: 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.

Supervision: Any system of internal control should include the supervision by responsible officials of day to day transactions and recording.

Management: 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.



Start the conversation

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