

Strategies for Preventing Fraud, Theft, and Embezzlement in Nonprofit Organizations

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Venable LLP recently published a [two-part series](#) on fraud, theft, and embezzlement in nonprofit organizations, issued in light of the New York Attorney General's ongoing, high-profile litigation against the National Rifle Association for misuse of charitable funds. Considering a [2020 report](#) finding that 74% of nonprofit fraud stemmed from the actions of individuals in management and officer positions, CAAs must be aware of the key risk factors that open the door to fraud at nonprofit organizations. According to the report, the top reasons for fraud all relate to internal controls—the lack of such controls, failure to review existing controls, and management overriding internal controls.

In [Part 1](#), Venable discusses measures that organizations can take to prevent organizational fraud, theft, and embezzlement before it occurs. These measures include:

- Requiring double signatures/authorizations, back-up documentation, and otherwise requiring multiple levels of approval for organization transactions and transfers;
- Segregating financial duties such that no single person is responsible for reconciling organizational finances while also receiving, depositing, and recording organization funds;
- Conducting fixed asset inventories, if the organization maintains an inventory of goods;
- Implementing automated controls that can alert managers and officers to bank account activity, balance thresholds, positive pay exceptions, wire transactions, and other indicators of potential fraud;
- Establishing audits and board-level oversight, or, where that is not feasible, including a CPA or other financially knowledgeable individual on the board of directors to advise the board in an anti-fraud oversight role;
- Encouraging whistleblowers;
- Constructing a strong compliance program consisting of comprehensive policies and procedures that set and enforce the organization's expectations for ethical conduct;
- Communicating with donors and other funding sources to maintain awareness of abnormalities that may indicate fraud or other wrongdoing, including checks being cashed without corresponding records or donor contributions that aren't properly acknowledged or recorded; and
- Acquiring insurance coverage.

See CAPLAW's resource, [Do the Right Thing: How CAAs Can Cultivate a Culture of Compliance and High Ethical Standards](#) for Community Action-specific compliance and ethics examples in the context of steps CAAs can take to increase accountability.

Investigating Fraud Allegations

Part 2 outlines an approach that organizations may take to investigating and addressing suspected organizational fraud. Specifically, Venable provides insight into a number of factors to consider when developing an approach, which include:

- **Working with outside counsel.** Depending on the circumstances of the suspected fraud, it may be necessary to retain outside counsel for investigative purposes, to defend the organization from legal actions stemming from the fraud, and/or to initiate an action against the individual(s) who committed the fraud.
- **Being aware of applicable employment laws.** Identifying and subsequently dealing with instances of fraud may require adverse employment action against the perpetrator or perpetrators, often including termination. Organizations considering this course of action should ensure that their employment policies for termination and other adverse employment actions are compliant with state and federal employment laws to safeguard against potential legal issues brought by the affected employee(s).
- **Identifying and maintaining pertinent records and files.** Accurate records of all transactions and actions related to suspected fraud are both a vital investigative tool, and an important defense against accusations of organizational fraud.
- **Retrieving stolen funds or assets.** If possible, organizations should have a plan and procedure for recovering funds or assets stolen or otherwise misappropriated as part of the fraud in question.
- **Assessing whether to involve law enforcement.** Cases of criminal fraud beyond the scope of the organization's investigative abilities should be referred to the relevant law enforcement authorities.
- **Coordinating with care public and internal disclosure.** Controlling information known by the public and members of the organization can directly impact the success of investigations of fraud in addition to maintaining public trust in the organization's mission and operation.

As board members develop anti-fraud approaches, they must keep in mind the fiduciary duties they owe to their organization, which require board members to (1) exercise independent and informed judgment, (2) act in the organization's best interests, and (3) exercise due diligence to ensure the adequacy and clarity of any information used to make a decision. Board members may satisfy their fiduciary duties by relying on information and opinions prepared or presented by others whom the director reasonably believes are reliable and competent with respect to the matters presented. This could include entrusting investigative tasks to a small subcommittee, an individual, or an attorney or auditor experienced in handling internal investigations. For sophisticated or long-standing embezzlement schemes, organizations may consider contacting a forensic accountant or certified fraud examiner to aid in the investigation.

When investigating potential fraud and embezzlement, organizations should pay particular attention to IRS reporting and enforcement requirements. A tax-exempt organization must disclose on its Form 990 any significant diversions of assets (defined as the lesser of (i) 5% of the organization's gross receipts for its tax year, (ii) 5% of the organization's total assets as of the end of its tax year, or (iii) \$250,000). Such disclosures require additional explanation of the circumstances and actions taken to rectify the fraud.

Further, under the IRS's rules prohibiting excess benefit transactions, certain officers and directors could be personally liable for allowing it the transaction to happen. While the organization that is the victim of fraud or embezzlement will not owe a tax in connection with the embezzlement, any officers or directors who willfully participated in an excess benefit

transaction, knowing that it was an excess benefit transaction, may be personally liable for an excise tax equal to 10% of the excess benefit transaction, up to a total of \$20,000 per transaction.

Because fraud attracts the attention of other regulators and enforcement entities at both the federal and state level – all of whom have a number of resources available to respond to fraud – the resulting enforcement actions can carry penalties that extend beyond the individual perpetrators and affect the organization as a whole. Recipients of federal funding may also be subject to added scrutiny as a result of federal fraud investigations. For these reasons, organizations – and CAAs in particular – should carefully consider their strategies for investigating and addressing allegations of fraud, theft, and embezzlement, as well as staying vigilant and, when in doubt, seek the advice of auditors, attorneys, and investigators throughout the process.

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