Internal Controls and Fraud

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Agenda

- Part 1 - Internal control challenges faced by not-for-profit entities
- Part 2 - Core control areas and where they commonly break down
- Part 3 - Fraud schemes, red flags, and warning signs
- Part 4 - Auditor's responsibility and response

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Learning Objectives

- Understand why not-for-profit environments create distinctive control and fraud risks
- Identify the control areas that most most often affect financial reporting reporting and audit approach
- Recognize common fraud schemes, schemes, red flags, and management override risks
- Improve walkthroughs, documentation, testing, and communication of deficiencies

Part 1 – Challenges Faced by Not-for-Profit Organizations

- Staffing
- Mission over Margin
- Board Focus
- Grant Compliance
- Board Literacy
- Complexity

Part 1 – Challenges Faced by Not-for-Profit Organizations – Why Controls Matter

- Safeguard cash, investments, equipment, and donor resources
- Improve accuracy of financial reporting, grant reporting, and contribution accounting accounting
- Help leadership and auditors detect issues before they become larger problems problems
- Support continuity during growth, turnover, and system changes

Part 1 – Challenges Faced by Not-for-Profit Organizations – Why Controls Matter (con’t)

Weak controls create both mission risk and financial statement risk

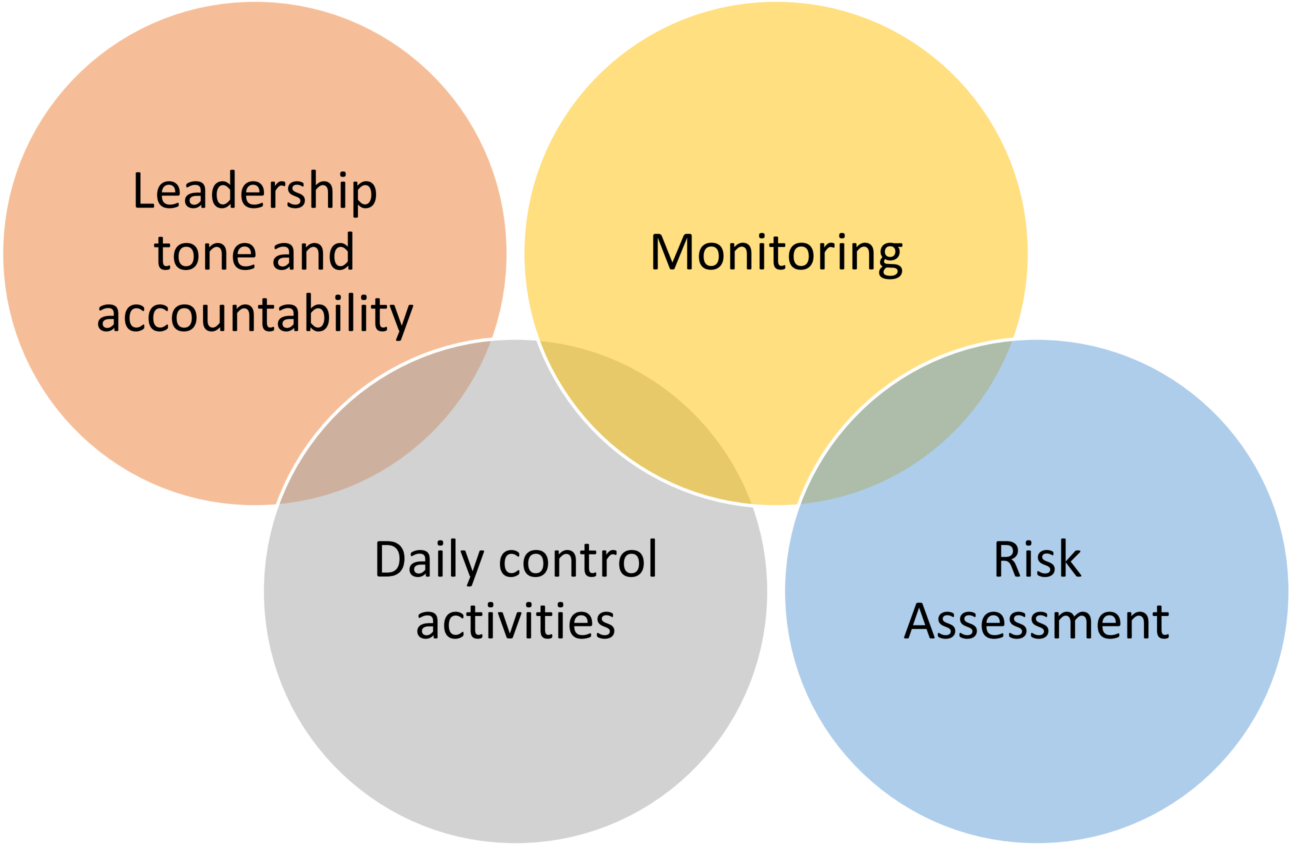
Loss of funds reduces resources available for programs and services

Fraud allegations can damage donor donor confidence and public reputation

Weak processes can lead to audit adjustments, repeat findings, and questioned costs

Control failures often point to broader governance or monitoring weaknesses

Part 1 – Challenges Faced by Not-for-Profit Organizations – System of Internal Control



Part 1 – Challenges Faced by Not-for-Profit Organizations – System of Internal Control - Governance

- Passive receipt of financial reports is not the same as active financial governance

Management

- Design
- Operation

Board

- Challenge
- Oversight and accountability

Audit/finance committee

- Compensating oversight

Part 1 – Challenges Faced by Not-for-Profit Organizations – Risk Assessment

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Transaction classes

- Identify significant receipt streams, disbursements paths, payroll change points, journal entry access

Segregation of duties

- Does one person have access to authorize, record, reconcile

Staffing Changes

- New hires, retirements/terminations, restructuring

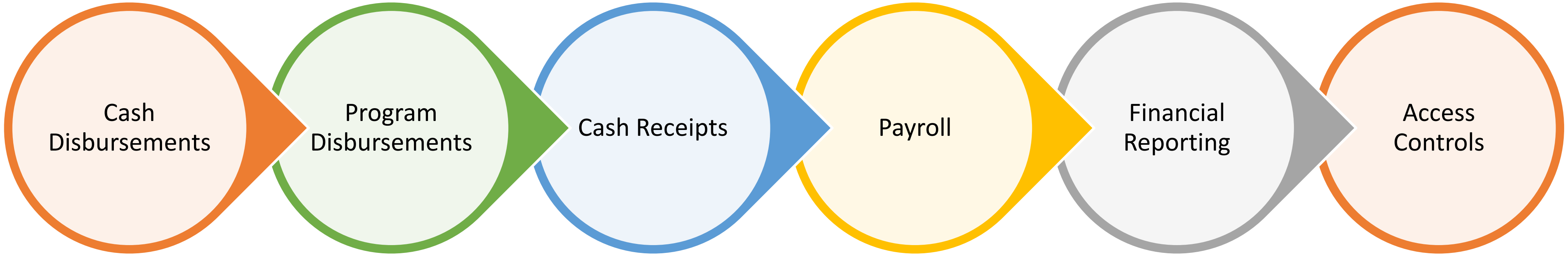
Part 1 – Challenges Faced by Not-for-Profit Organizations – Risk Assessment

Significant growth
- New programs, funding sources, expansion

System Changes
- New accounting software, banking transitions

Audit findings/recommendations
- Management letters or formal findings

Part 2 – Core Control Areas



Part 2 – Common Breakdowns

Authorization

Recording

Segregation of Duties

Custody

Reconciliation

Part 2 – Core Control Areas – Cash Receipts

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Risks

Multiple streams =multiple handoffs

Skimming, lapping, delayed deposits, diverted checks, unrecorded receipts

Controls

Prelisting, dual custody, timely deposits, independent reconciliations

Review – timely, documented, skeptical, informed

Part 2 – Core Control Areas - Disbursements

Risks

Fictitious vendors, altered payees, duplicate payments, and personal purchases

Setup and release of electronic payments combined

Controls

Vendor master creation, payment support and approval

Review of business purpose, receipt of goods, exception reports

Part 2 – Core Control Areas – Disbursements (Credit cards)

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Risks

- Split purchases, missing receipts
- Personal charges, vague business purpose

Controls

- Strict documentation and review policies
- Budget context

Part 2 – Core Control Areas – Program Disbursements

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Risks

- Matching requirements, allowability rules, and reimbursement terms create multiple failure points
- Funds may be improperly spent, classified, or released released from restriction

Controls

- Budgets, grant agreements, and reporting deadlines deadlines should be be embedded into workflows
- Subrecipient monitoring, time and effort documentation

Part 2 – Core Control Areas - Payroll

Risks

- Ghost employees and inflated hours
- Unauthorized rate changes and improper payouts

Controls

- Segregate HR and payroll (ideally payroll processing and payroll approval)
- Change reports for new hires, terminations, and pay-rate changes; review and agree payroll reconciliations

Part 2 – Core Control Areas – Financial Reporting – Journal Entries

Risks

- Manual entries posted late or outside normal workflows
- Unsupported reclasses or top side entries

Controls

- Limit access to post journal entries
- Independent review of entries, especially unusual entries

Part 2 – Core Control Areas – Financial Reporting

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Risks

- Unresolved differences
- Frequent post close adjustments

Controls

- Timely reconciliations
- Reviews of reconciliations and nature of review

Part 2 – Core Control Areas - Access Controls

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Risks	Controls
Security policies	Multi-factor authentication, password policies, phishing training, incident response plan
Access	Limit access to role requirements and review access, including removing access immediately upon termination

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Poll: What is the number one control weakness for not for profits?

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Poll: Which group of employees account for the highest percentage of fraud cases?

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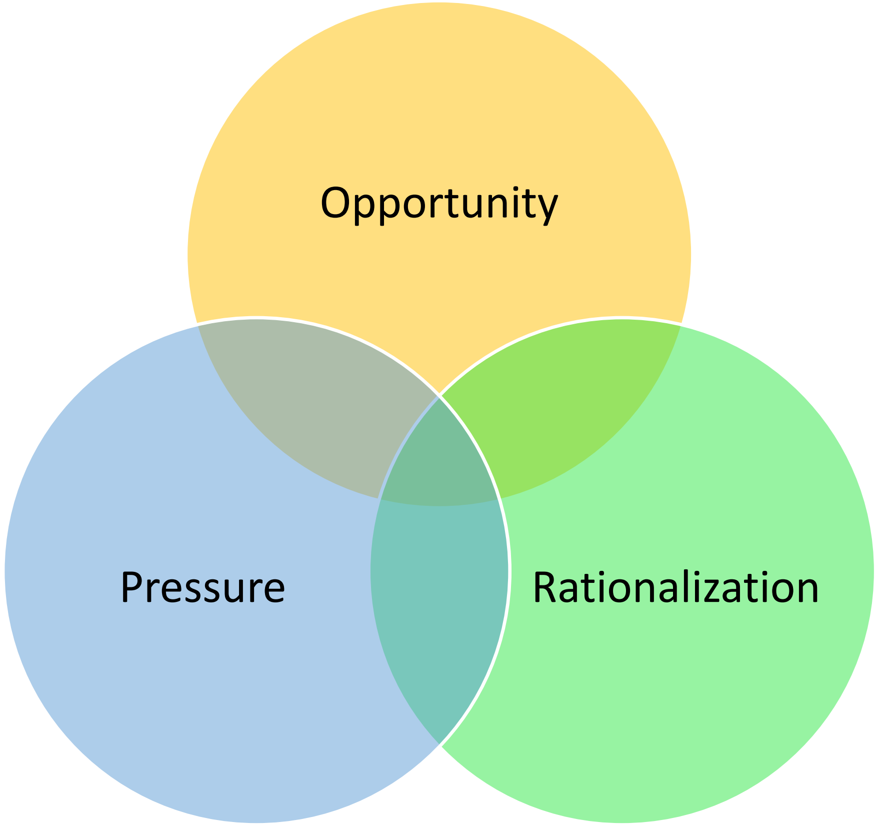
Poll: What is the median loss for manager/supervisor level employees who commit fraud?

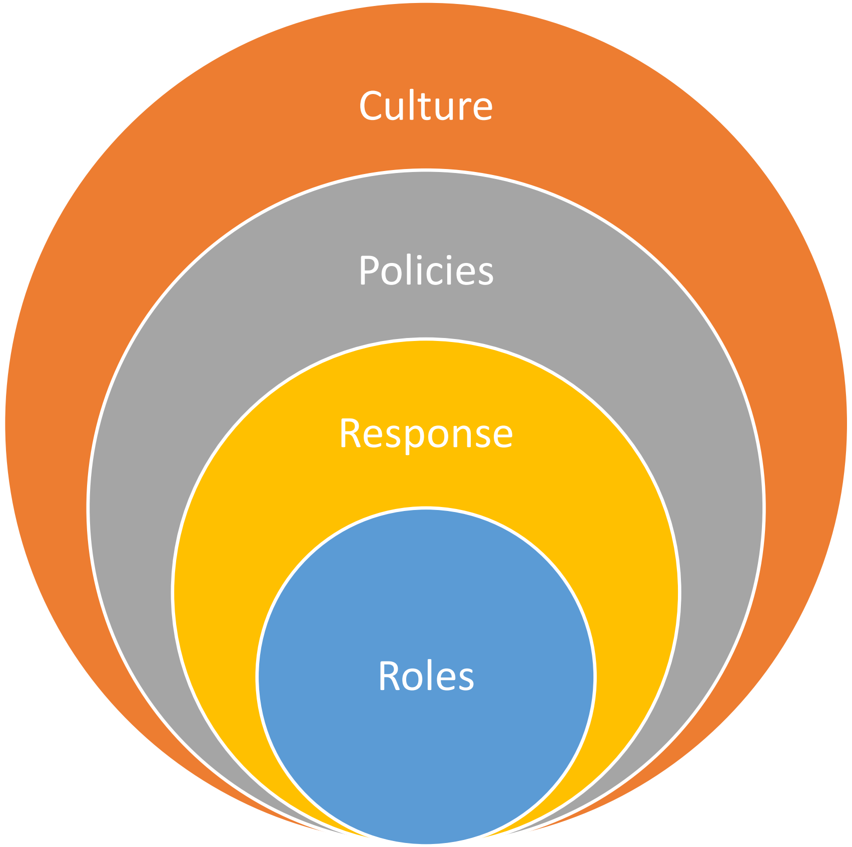
Part 3 – Fraud Schemes, Red Flags and Warning Signs



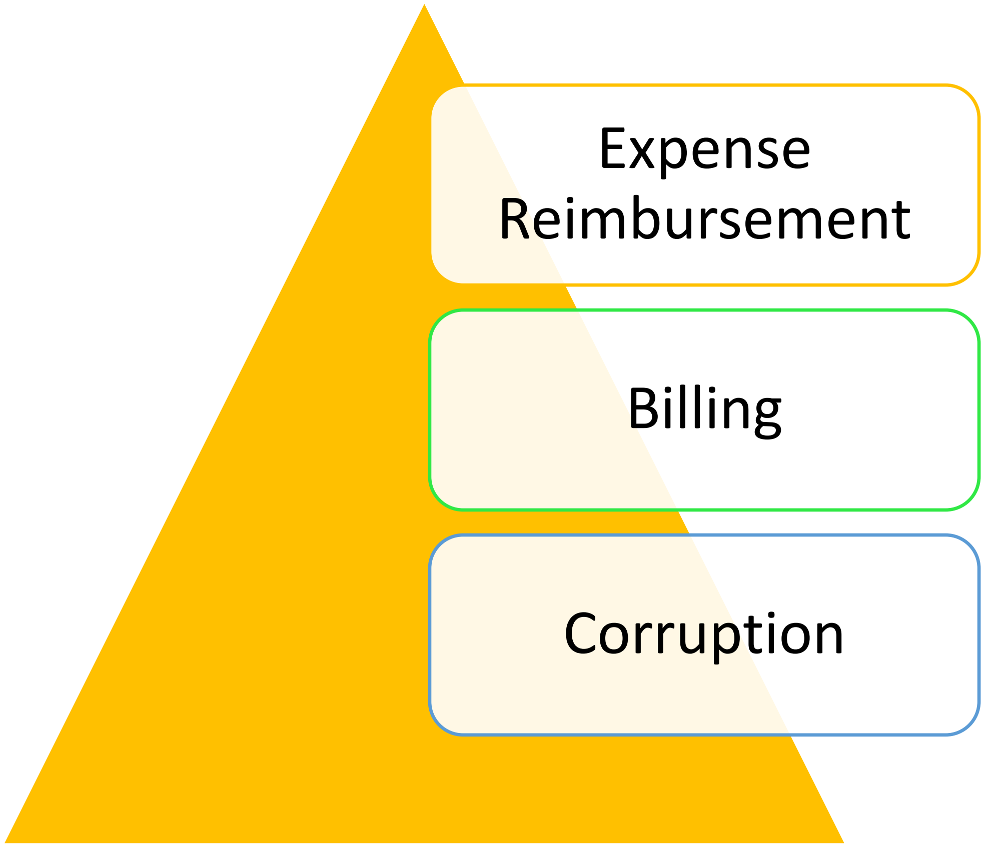
Part 3 – Fraud Schemes, Red Flags, and Warning Signs

- Resisting oversight
- Refusing vacation
- Round dollar entries, missing support, duplicate vendors
- Delayed reconciliations
- Patterns of errors

Part 3 – Fraud Schemes, Red Flags, and Warning Signs

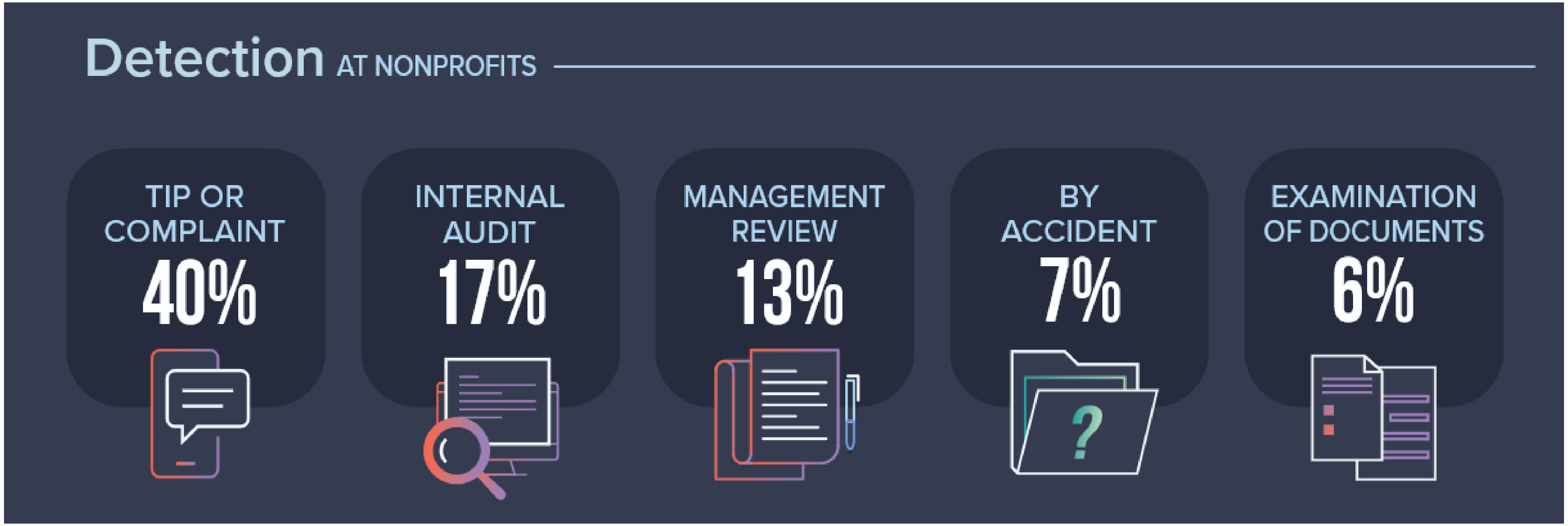


Part 3 – Fraud Schemes, Red Flags, and Warning Signs



Anti Fraud Controls

Detection


Detection AT NONPROFITS
TIP OR COMPLAINT
40%
INTERNAL AUDIT
17%
MANAGEMENT REVIEW
13%
BY ACCIDENT
7%
EXAMINATION OF DOCUMENTS
6%

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Poll: A clean audit opinion guarantees no fraud has occurred.

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Poll: A financial statement audit opinion includes assurance on internal controls.

Part 4 – Auditor’s Responsibility and Response

1. Gain understanding of controls
2. Inquire about management’s knowledge of fraud
3. Evaluate the design and implementation of internal controls
4. Report material weaknesses and significant deficiencies in writing

Part 4 – Auditor's Responsibility and Response – Gaining an Understanding of Internal Control

Narratives

Checklists

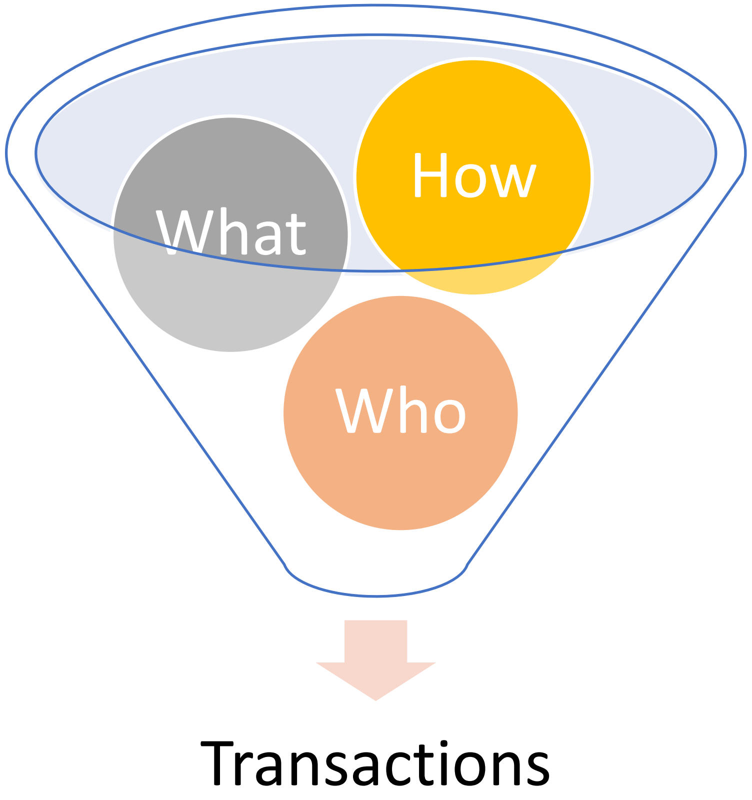
Flowcharts

Policies/ Procedures

Memos

Questionnaires

Part 4 – Auditor's Responsibility and Response – Gaining an Understanding of Internal Control



Part 4 – Auditor's Responsibility and Response – Gaining an Understanding of Internal Control

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Inquiry

Observation

Inspection

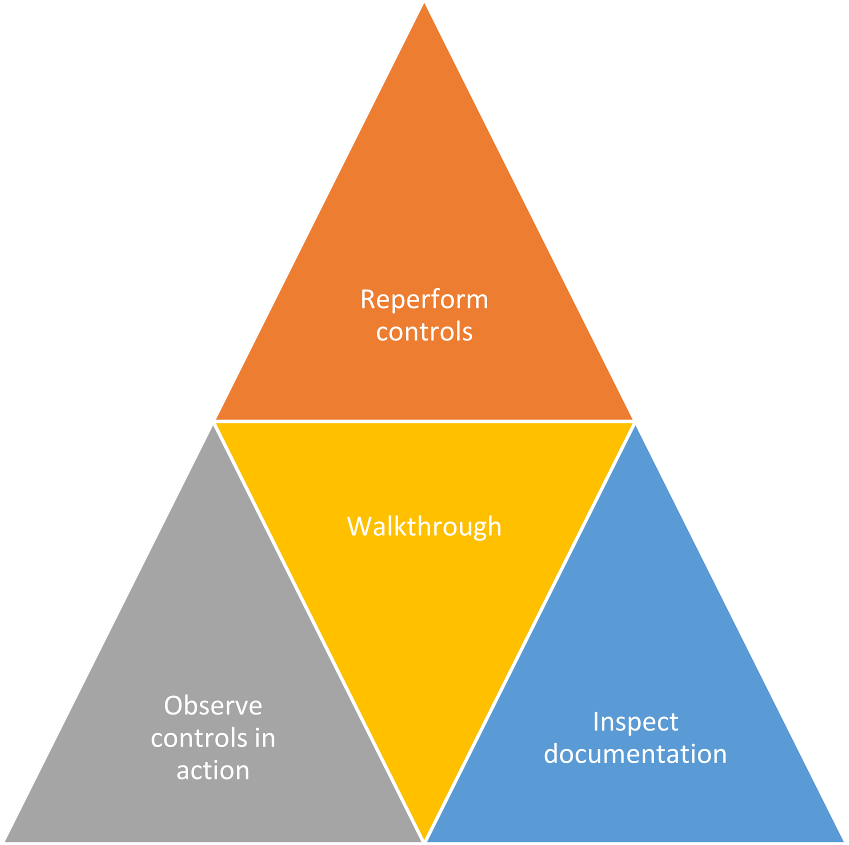
Reperformance

Corroborate

Part 4 – Auditor's Responsibility and Response – Evaluating the Design and Implementation

- Design
  - Is the control above to prevent, or detect and correct, material misstatements?
- Implementation
  - Does the control exist and is it actually being used by responsible personnel?
  - Auditor must obtain evidence that control owners understand the procedure and how to perform it
- Required even if the auditor does not plan to rely on internal controls.

Part 4 – Auditor’s Responsibility and Response – Evaluating the Design and Implementation



Part 4 – Auditor's Responsibility and Response – Evaluating the Design and Implementation

Design

Effectiveness

Testing

Sample inspection of transactions, approvals, and reconciliations

Re-performance – auditor performs the control themselves to verify

Part 4 – Auditor's Responsibility and Response – Reporting Deficiencies in Internal Control

- Likelihood of error or misstatement
- Repeated Reviewer non-performance more significant
- Patterns may point to broader issue and should be reported together
- Connect condition, cause, effect and recommendation
- Practical recommendations
- Impact on opinion

Case Study 1

- A development employee opens mail, prepares deposit, posts gifts, and reconciles donor records
- Deposits are sometimes delayed until event activity slows down
- Leadership reviews monthly totals but not underlying detail or timing differences
- The process gives one person control over custody, recording, and follow-up

Response

- Redesign process
  - Separate receipt listing, deposit preparation, posting, and reconciliation where possible
  - Use dual custody and compare donor records, bank deposits and ledger activity regularly
- Adjust audit approach
  - Reperform selected tracing from source support to deposit and recording
  - Does control gap change substantive procedures or result in deficiency communication?

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Case Study #2

- One finance employee can create vendors, enter invoices, and prepare prepare ACH files
- A controller reviews total disbursements but not vendor change activity or unusual patterns
- Electronic support exists, but invoice legitimacy is not independently challenged
- The process appears efficient while leaving vendor authenticity largely untested

Response

- Strengthen vendor validation
  - Restrict vendor create rights and require independent verification of new vendors
- Test approval substance
  - Review payment populations for duplicate addresses, round-dollar amounts, and off-cycle activity
  - Evaluate whether approvals reflect actual scrutiny or merely workflow completion
  - Communicate issue in terms of unauthorized payment risk and control exposure

Case Study #3

- ✓ A payroll administrator maintains employee records, enters rate changes, changes, and processes payroll
- ✓ Supervisory review focuses on total payroll expense rather than employee-level changes
- ✓ Vacation balances and termination payouts are adjusted manually without independent review
- ✓ Long tenure and low turnover reduce scrutiny over recurring payroll activity

Response

- Recurring review discipline
  - Review unusual fluctuations over time
  - Increase scrutiny over payroll review – detail level support vs analytical review
- Test change controls
  - Inspect new-hire, rate-change, and termination support for independent approval
  - Compare payroll changes to authorized personnel actions and board-approved compensation where relevant

Governance

Board and audit committees with active oversight

- Active oversight is control evidence
- Minutes may show follow-up on unusual activity, allegations, and policy exceptions
- Governance communication is stronger when tied to specific risk observations
- Questions can reveal whether oversight is engaged or ceremonial

Reporting

- Explain issues in terms of what could go wrong, not just what policy was missed
- Distinguish between isolated exceptions and repeatable process weaknesses
- Clarify whether the issue affected audit approach or reportable deficiency or both
- Recommendations should reflect the entity's staffing model and control environment

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Next Steps

- Tighten segregation or add real compensating review in high-risk cycles
- Strengthen documentation standards for for approvals, reconciliations, and exceptions exceptions
- Assign owners, deadlines, and evidence expectations for each remediation step
- Review user access, vendor setup, and manual manual journal-entry activity regularly
- Build board or committee follow-up into the remediation remediation timeline
- Focus recommendations on a few high-impact impact fixes rather than broad policy rewrites rewrites
- Reassess whether the new control is operating as intended after implementation
- Prioritize the top three control gaps with the highest fraud or misstatement exposure

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Last Thoughts

Do

- Need clear accountability, documented review, and visible follow through

Do Not

- Need perfect systems in place

Fraud considerations are strongest when grounded in actual process vulnerabilities

External auditors add value by translating control weakness into meaningful audit insight

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Poll: Which cycle most often changes your audit approach in engagements?

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Poll: Where do walkthroughs or control tests most often reveal that reality differs from policy?

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Poll: What red flags tend to elevate a routine control issue into a fraud concern?

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Poll: Which recommendations are most practical for small and mid-sized organizations?

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Sources: AICPA NFP Conference: Fraud-Resilient Nonprofits: Building, Strengthening & Auditing Internal Controls