



## **The American anti-Corruption institute**

### **INTERNAL CONTROL WEAKNESSES IN NONPROFIT ORGANIZATIONS**

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Technical Staff

This document is a part of The AACI series of anti-corruption resources made available to our CACM members <sup>1</sup>. The contents of this document constitute an integral part of the CACM Review textbook that would be available in countries where the CACM will only be offered by exam.

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Reading the earlier published nonprofit two parts of this series<sup>2</sup> will help you understand and appreciate the internal control weaknesses in nonprofit organizations. Our objective is not to discuss internal control weaknesses at transactional level; it is an overview of glaring avoidable weaknesses in most nonprofits.

As our constituents exist all over the world, we will limit our discussion to those major deficiencies that apply worldwide.

Whenever there is a fraud or corruption in a nonprofit organization, you will most likely find, at least, one or more of the following significant internal control weaknesses present.

#### 1. LACK OF PROPER AND EFFECTIVE OVERSIGHT BY THOSE CHARGED WITH GOVERNANCE

When corruption hits a for-profit, shareholders will ask the normal and classical question: where were the auditors? When a nonprofit makes news headlines, one should ask: where were the board?

*"The Virginia Scholastic Rowing Association in Alexandria said it lost as much as \$223,000 — an estimate the association president now has raised to \$500,000 — to a longtime bookkeeper, later convicted of embezzlement. "People are going to say, 'You stupid people,' " said the group's president, John D. White. "They're exactly right. You have to pay attention.""*<sup>3</sup>

The board members and executive management should have the required level of skills and competence to exercise proper oversight. They should have financial and anti-corruption intelligence.

#### 2. LACK OF PROPER SEGREGATION OF DUTIES (*discussed in details in the earlier published two parts*)

#### 3. EXCESSIVE TRUST IN ONE OR MORE EMPLOYEES, DIRECTORS AND/OR EXECUTIVES

Trust is fundamental in any business dealing. But it must be accompanied by accountability. Every member of the nonprofit must perform his duties following its policies and procedures and in compliance with the applicable laws, rules, and regulations.

#### 4. INSUFFICIENT TRANSPARENCY WITH PUBLIC, CONSTITUENTS, AND REGULATORS

Those charged with governance of a nonprofit should follow the applicable laws when they suspect fraud or corruption or find any irregularities. They should not fear public retaliation or donors anger. They should not act like many of those nonprofits reported by the Washington Post.<sup>4</sup>



*“In Legacy’s case, its report not only failed to disclose the total of its estimated loss but also did not reveal that multiple diversions had occurred over seven years and that they were not discovered until more than a decade after they began.”<sup>5</sup>*

## 5. DONORS DO NOT REQUIRE INFORMATIVE AND COMPLETE REPORTS FROM NONPROFITS

Donors should seek to have complete and reliable information about what the nonprofit did with their money. We believe donors should google the nonprofit to find out if there are any concerns about its activities. For example, donors can search the Washington Post searchable database of nonprofits that have disclosed diversions, available at [wapo.st/diversionsdatabase](http://wapo.st/diversionsdatabase).

## 6. IMPROPER AND INADEQUATE REGULATORY OVERSIGHT OVER NONPROFIT OPERATIONS

In both developed and developing countries, regulatory agencies should do more to scrutinize nonprofit operations. The well-known Washington Post investigative report shows the need for regulators to do more to monitor nonprofits<sup>6</sup>. In discussing a nonprofit scandal, Keith Jennings states

*“With the IRS and other governmental agencies stretched thin and unable to timely address such fraud cases, it reinforces the need for nonprofits to ensure that they are being run ethically and with good internal controls. This burden falls on nonprofit managers, board members and even donors.”<sup>7</sup>*

## 7. INADEQUATE ACCOUNTING AND MANAGEMENT INFORMATION SYSTEM

Nonprofits are run in the same manner as for profit organizations. All economic events and transactions should be recognized in a well-designed and proper accounting system. The output of the accounting system is an integral part of the management information system. Symptoms of the inadequacy of these systems could be visible enough in too many nonprofits. For example, the board members do not obtain financial reports on time. They may also do not receive complete and reliable financial and management reports.

## 8. DOMINANCE OF THE BOARD BY ONE OR TWO MEMBERS

A dominance of the board by one member or more is a serious red flag. Dominance, in this context, means controlling the vote of the board. In other words, the other members of the board just sign the board meetings and agree on what the “boss” wants them to approve or disapprove. For example, one *may* conclude that the Bill Davis, former CEO, dominated the board of Community Action of Minneapolis. He pleaded guilty over spending on trips, cars.<sup>8</sup>

## 9. LACK OF EFFECTIVE FRAUD AND CORRUPTION PREVENTION POLICY

It is not uncommon to find out that there are too many nonprofits that do not have fraud and corruption prevention policy. It is not also surprising that nonprofits do not invest in training their



employees to equip them with proper skills and competencies to prevent, deter, and detect fraud and corruption.

It is not enough to have audited financial statements<sup>9</sup>. It is not also sufficient to have internal audit function. What always matters is the internal culture and ethical conduct prevailing in the nonprofit. It is the tone at the top that will always determine the nonprofit susceptibility to fraud and corruption.

## Nonprofits of Developing Countries

Nonprofits in developing countries are generally not in a good shape. Though we mentioned the following in part 1 of nonprofits, we would like to reiterate it.

Nonprofits in developing countries share the same organizational and business weaknesses observed in those of developed countries. However, fraud and corruption magnitude, breadth, and extent are worse. As there is not reliable and verifiable fraud and corruption independent information in most, if not all, developing countries, this also applies to nonprofits. Though it is beyond the scope of this paper to discuss in details several relevant issues, we believe that the following, at the minimum, provides opportunities for fraudulent and corrupt practices:

1. Lack of deterrent laws, rules, or regulations
2. Inefficient and/or ineffective judicial systems
3. Lack or absence of inadequate laws
4. Establishing nonprofits as vehicles for corruption
5. Donors' inadequate oversight over nonprofits they support
6. Significant lack of transparent operations
7. Weak external audit profession

*Caveat:* We did not and will not mean that ALL nonprofits in developed or developing countries of any size or any form or governance structures are corrupt.

###END###

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<sup>2</sup> Part 1 and 2: Corruption Prevention, Deterrence, and Detection - Nonprofit Organizations published on April 28, 2017 and May 31, 2017 respectively.

<sup>3</sup> Joe Stephens and Mary Pat Flaherty, "Inside the hidden world of thefts, scams and phantom purchases at the nation's nonprofits," Washington Post, October 26, 2013, [https://www.washingtonpost.com/investigations/inside-the-hidden-world-of-thefts-scams-and-phantom-purchases-at-the-nations-nonprofits/2013/10/26/825a82ca-0c26-11e3-9941-6711ed662e71\\_story.html?tid=a\\_inl&utm\\_term=.c9090fb413be](https://www.washingtonpost.com/investigations/inside-the-hidden-world-of-thefts-scams-and-phantom-purchases-at-the-nations-nonprofits/2013/10/26/825a82ca-0c26-11e3-9941-6711ed662e71_story.html?tid=a_inl&utm_term=.c9090fb413be)

<sup>4</sup> Ibid

<sup>5</sup> Ibid

<sup>6</sup> Ibid



<sup>7</sup> Keith Jennings, "Recent Nonprofit Fraud – What Can We Learn?" <http://www.snydercohn.com/2015/07/recent-nonprofit-fraud-what-can-we-learn/>

<sup>8</sup> Alejandra Matos, "Nonprofit CEO Bill Davis pleads guilty to fraud, theft charges" Star Tribune, June 16, 2016, <http://www.startribune.com/nonprofit-ceo-bill-davis-pleads-guilty-to-fraud-theft/383272061/>

<sup>9</sup> Baptist Foundation of Arizona was the largest non-profit in U.S. history. The auditors were Arthur Andersen, the same firm that audited Enron. <https://youtu.be/BxPYcKXOBdI>

