

Fiducia**Solutions**

White Paper

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Overview

The nonprofit and charitable sectors of the US economy are significant, diverse and very important to the day to day lives of millions of individuals and families. According to the 2012 Nonprofit Almanac (which was prepared by the National Center for Charitable Statistics at the Urban Institute) there were 2.3 million nonprofit organizations in the United States (about 1.6 million were registered with the IRS) in 2012. Nonprofit revenue was measured at over \$1.5 trillion which was offset by expense spending of about \$1.45 trillion. Nonprofit organizations reported assets of over \$2.5 trillion, with an estimated 63 million people volunteering a total of 15 billion hours of work.

As opposed to other sectors of the economy (public and private) the nonprofit and charitable sectors have not been subjected to the same level of regulatory scrutiny nor have they had a history of implementing robust enterprise risk management, internal control or fraud deterrence frameworks. The Committee of Sponsoring Organizations' (COSO) seminal work in the field of internal control has strongly influenced legislation such as the Sarbanes-Oxley Act of 2002 and the insurance industry Model Audit Rule, as well as the Information Technology COBIT frameworks. This thought leadership has been applied throughout the public and private sectors of the U.S. economy. However the financial control protocols that have emanated from this work have not typically been applied throughout the nonprofit or small business sectors. We believe this is one of the reasons that both these sectors continue to experience a much higher incidence of breach of trust crimes like fraud and embezzlement.

The result is that many of the organizations which have a direct positive impact on the lives of the most vulnerable people in our communities are insufficiently protected against fraud and embezzlement crimes. Losses from these type of crimes are consistently estimated to be in the 5% range of an organization's annual revenue¹ (on average) although typically higher losses are expected in the cases of small businesses and nonprofits. As might be expected, smaller organizations typically lose more than the average organization because of their lack of financial sophistication, limited staffing and resource levels.

Our goal at Fiducia Solutions is (using the most accepted control frameworks currently in practice) to help bridge the gap between what is considered standard internal control protocol in most public organizations and what is currently being done into combat fraud and embezzlement in the nonprofit and small business sectors.

¹ see Association of Certified Fraud Examiners (Biannual) **"Report to the Nations"** at <http://www.acfe.com/rtnn.aspx>

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Extent of Fraud/Embezzlement in Nonprofit and Charitable Sectors

Establishing how much capital and other assets are lost to fraud and embezzlement each year in the nonprofit and charitable sectors of the US economy is very difficult if not impossible to determine. The very nature of the act requires some level of concealment and many organizations do not have the controllership infrastructure necessary to identify who may be perpetrating the crime or even that a crime is being committed! Additionally, there is a significant lack of incentive for nonprofit and charity organizational leadership to publicize that they have been victimized by a fraud or embezzlement scheme. Surveys indicate that less than 50% of embezzlements discovered by management are ever reported to law enforcement authorities. ²

However, even without hard data we believe that it is possible to gain a general understanding of the potential magnitude of losses suffered in the nonprofit and charitable sectors of the US economy by extrapolating the results of several fraud surveys (which include nonprofit and public/private sectors of the economy). These surveys measure average losses as a percentage of revenue and this ratio can be applied to individual nonprofit organizations using tax filings as well as the overall sector. It is important to note that the surveys used include but do not isolate the nonprofit sector for estimated losses. Although, it is believed that on average the smaller and less regulated nonprofit sector is more likely to suffer more frequent and larger losses as a percentage of revenue than the more regulated private and public sectors.

Using data from the *Economist Intelligence Unit Survey Results “Global Fraud Report”* for 2011/2012³ and the *Association of Certified Fraud Examiners 2012 Global Fraud Survey*, and the *2014 BDO Australian Not-For-Profit Fraud Survey* we gain a sense of the magnitude of the fraud issue across organizations worldwide. The three global surveys have estimates of fraud losses as a percentage of revenue per organization of 2.1%, 5%, and 7%. We have taken the average of these three as part of our calculations. Obviously this is an inexact methodology but should be able to generate some estimate of the losses suffered based on current data available.

Estimated U.S Nonprofit/Charity Embezzlement & Fraud Losses

Estimated Sector Annual Revenue	1,500,000,000,000
Estimated Average Losses Rate (4.7%)	0.047
Estimated Annual Fraud/Embezzlement Losses	70,500,000,000

² see BDO Not For Profit Survey 2014 <http://www.bdo.com.au/resources/surveys/not-for-profit/bdo-not-for-profit-fraud-survey-2014>

³ see http://fraud.kroll.com/wp-content/uploads/2013/10/FraudReport_2011-2012.pdf

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Conservatively (due to the typically higher losses suffered by smaller firms and nonprofits) we believe that it is reasonable to assume that at least \$70.5 billion is lost to embezzlement and fraud annually by nonprofits and charities in the United States. This can be translated into about \$235 per every man, woman and child in the United States (est. 300 million) being donated and then stolen away from the stated mission of the nonprofit and their potential beneficiaries.

Stated another way, over \$70 billion that was presumably dedicated to improving the lives of individuals in our community was diverted away from that mission. Not only is the direct loss of those funds damaging to the community, but the crime also puts at risk the reputation of the overall organization, its philanthropists, board members, executive director, staff and volunteers. Which we believe compounds the injustice and seems tremendously unfair; that the very individuals most active in attempting to better our communities through the dedication of time, treasure and talent would have their professional reputations put to such high risk.

We do not believe that it is possible to completely stop these crimes. But we do believe there is significant value in applying proven internal control, anti-fraud and embezzlement frameworks specifically designed and customized for smaller more resource constrained organizations, in an effort to dramatically reduce the risk of these crimes occurring.

What If We Are Successful

When one considers that if the positive effect of adding these affordable, effective controls can impact enough nonprofits and charitable organizations in the United States to reduce the amount of embezzlement and fraud by just 1% the result would be an immediate increase of approximately \$700 million to nonprofit missions. After a detailed look at hundreds of frauds and embezzlements in the United States we have come to the conclusion that most of the perpetrators methodology for the thefts is so pedestrian and the controls to prevent the embezzlements so basic that reducing the losses suffered by at least 1% would not be difficult. Frankly we believe that the savings is really only limited by the number of organizations that adopt this or a similar anti-fraud or embezzlement protocols.

What We Know About Fraud & Embezzlement

The Association of Certified Fraud Examiners (ACFE) 2012 Report to the Nations

Since 1996 this group has been surveying its members and issuing a biannual (every 2 years) publication on occupational fraud. The 2012 report surveyed over 32,000 of its members who reported on the details of over 1,300 frauds and embezzlements that they investigated in almost 100 countries around the world. This report focuses on occupational fraud which includes nonprofit fraud but is not an exclusive nonprofit or charity group's fraud survey.

The median response of the 32,000 members surveyed indicated **that based on their experience their belief was that on average approximately 5% of an organization's revenue was lost** to fraud or embezzlement annually. This percentage estimate has been remarkably consistent throughout the years that this survey has been published and is very similar to other group's survey results.

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Additional insights from the ACFE 2012 survey:

- The most common type of fraudulent activity (almost 90%) involves asset misappropriation, with an average loss of \$135,000 per instance although it should be noted that over 20% of the frauds identified cost the victim organization at least \$1 million in losses.
- Asset misappropriation includes the following actions:
 - cash skimming
 - larceny (stealing cash/assets after its been recorded on the books)
 - billing irregularities
 - fraudulent expense reporting
 - check tampering
 - payroll fraud
 - check register voids
- The **average duration** of a fraud/embezzlement scheme lasted **18 months**.
- The presence of **anti-fraud controls correlated with a significant reduction in losses** and duration of the scheme to defraud. **Victim organizations that had instituted any of the 16 common anti-fraud controls suffered considerably lower losses and duration of the crime than organizations that did not institute any anti-fraud controls.**
- Occupational **fraud is much more likely to be discovered by a tip (43.3%) than by any other method**, including discovery by an **external audit (3.3%) or internal audit (14.4%)**.
- The smallest **organizations in the study suffered the largest average losses**. These organizations typically had fewer, if any, anti-fraud controls in place which dramatically increases their vulnerability to fraud and embezzlement.
- **Most individuals caught embezzling were first time offenders (87%)** having had no previous contact with the criminal justice system, and 84% had never been disciplined or terminated by an employer for fraud related conduct.

Some conclusions highlighted from the review of the three fraud reports:

1. **Small businesses and nonprofits are especially vulnerable to fraud and embezzlement risk.** These organizations typically have fewer resources to dedicate to anti-fraud measures. Unfortunately since there are fewer resources to cushion a loss the impact to these organizations is typically much greater than with better capitalized organizations. These organizations are at more risk of dissolving after a significant misappropriation of assets.
2. **Providing a method to allow employees, volunteers and vendors the ability to report suspicious activity is a critical anti-fraud program.** Not only are the vast majority of ongoing frauds detected this way, but we believe that publicizing and having

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management encourage employees to use this tip service is a major deterrent to potential embezzlers, instilling the “perception of detection.”

3. **External audits should not be relied upon as an organization’s primary fraud detection method.** Such audits were the most commonly implemented control in our study; however, **they detected only 4% of the frauds reported**, and they ranked poorly in limiting fraud losses. While external audits serve an important purpose and can have a strong preventive effect on potential fraud, their usefulness as a means of uncovering fraud is limited.
4. **The cost of occupational fraud — both financially and to an organization’s reputation — can be acutely damaging.** With **nearly half of victim organizations unable to recover their losses, proactive measures to prevent fraud are critical.** Management should continually assess the organization’s specific fraud risks and evaluate its fraud prevention programs in light of those risks.
5. **Targeted fraud awareness training for employees and managers is a critical component** of a well-rounded program for preventing and detecting fraud. Not only are employee tips the most common way occupational fraud is detected, but research shows organizations that have anti-fraud training programs for employees, managers and executives experience lower losses and shorter durations of frauds than organizations without such programs in place. **At a minimum, staff members should be educated regarding what actions constitute fraud, how fraud harms everyone in the organization and how to report questionable activity.**

Our Approach at Fiducia Solutions

What is Fiducia Solutions?

Fiducia Solutions is a management tool specifically designed to reduce the risk of fraud and embezzlement at small businesses and nonprofits. We have developed this tool to be effective, affordable and to bring a high level of transparency to virtually any organization. The tool can be quickly included in your financial process, is easy to implement and sustain and is designed to be affordable for any organization interested in protecting themselves from the estimated 5% of annual revenue lost to fraud and embezzlement.

Why We Do What We Do

Our goal is to dramatically reduce the instance of fraud and embezzlement in nonprofits and small business. If the experts are correct, significant portions of donated funds which are directed toward worthy causes end up being stolen before being put to good use. Also, many small businesses fail due to suffering sustained embezzlement schemes from employees or others. The loss of small businesses cost our communities precious jobs and services. Small businesses are the economic engine of our economy and literally can lift members of our community out of poverty.

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How Does the Tool Work?

Using on-line surveys and interviews with key financial personnel we develop a financial control “snap shot” of the organization at that moment in time. That snap shot is then digitized and compared to a “Best Practice” Internal Control Model and (and soon to be added) a “Peer Group” Internal Control Model. Variances between the “snap shot” and the Models are identified and analyzed. Weaknesses are isolated and assessed and risk mitigation processes designed and recommended. The Models are updated frequently as new fraud and embezzlement schemes are identified across the country.

We then perform what we call Sarbanes-Oxley light, which involves having all the major financial processes mapped. These maps detail the risk situations and offsetting control points in place. The adequacy of the control points are assessed in relation to the risks posed and adjustments are suggested. Surprisingly to many, this process often leads to less work as risks may be covered multiple times in other processes. The most important control points are scheduled for quarterly “independent” self-testing; results are presented to the Board.

Does the Fiducia Tool Work?

Yes. The tool has been in development since 2000. It was first installed at a nonprofit in 2003 and is currently being utilized in Virginia, New York, Washington DC and Massachusetts at Nonprofits and a Physician practices. During the summer of 2012 it was also successfully implemented at the United Way Worldwide organization (the largest private nonprofit organization in the world) and is now being deployed across the United Way system of 1,800 offices in 41 countries and territories.

How Long Do The Surveys Take to Complete?

Currently there are 7 surveys that on average include about thirty questions each. The surveys are yes/no type answers and take no longer than 15 minutes to complete.

Why was Fiducia Solutions Formed?

Around the year 2000 a small group of friends and colleagues realized that some of the most important and valuable organizations they were supporting had at one time or another been victimized by a fraud or embezzlement crime. It may have been a church, a school, a day care center, or a small business that employed our friends and neighbors. We all began to recognize that the most important organizations, the organizations that impact the day to day lives of many in our communities are also the least protected organizations. This small group which includes a teacher, physician, a medical sales representative, a publisher, a nonprofit communications director, a CPA and a sourcing executive decided to try and develop a tool that could be used by virtually all small businesses or nonprofits to better protect themselves against fraud and embezzlement.

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Using basic controllership principles and Sarbanes-Oxley models we believe we have built this tool.

Is This Process Expensive

Our goal is to help small businesses and nonprofits dramatically reduce the risk of fraud and embezzlement. We realize that many small businesses and nonprofits are stretched pretty thin from a financial perspective. We have done everything in our power to make this tool cost effective, AND we have special pricing plans for organizations that have recently gone through a fraud/embezzlement or are in severe financial straits. If you consider that the estimate of average loss per organization is 5% of revenue and our cost structure puts us at significantly less than 1% of revenue for most organizations we feel this may be a good investment for any organization.

None of our principles takes a salary (we all have “day jobs”) and we have worked with our IT infrastructure partners to keep costs to a minimum recognizing that if this service is too expensive then the organizations that most need our services may not be able to afford them. We also can bill monthly, so 1/12 of the fee can be paid a month. Please do not rule out working with Fiducia Solutions before speaking with one of our representatives. We are all very active in the nonprofit community and I am certain we can work out an arrangement that will help protect your organization and its mission.

How Should We Start if We Are Not Ready To Commit?

The single most effective step you can take to catch an embezzlement in progress is to install an anonymous tip line in your organization. According to the ACFE 43% of embezzlements are caught from a tip. Compare this to 4% that are caught from an annual CPA audit. We have decided that to attain our goal of dramatically reducing the instance of fraud and embezzlement in small businesses and nonprofits, we should start by offering an anonymous tip line to all small businesses and nonprofits for no cost. We believe that even just having the posters in your offices will act as a deterrent to someone who is considering committing an embezzlement. Organizations can sign up for this free service at our website FiduciaSolutions.org. We also provide a poster which can be downloaded for no cost.

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