

## *Non-Profit Fraud: The Ethical Failures of our Boards*

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**As Seen Online – Alliance for Non-Profit Management Insights**

### **The Research Is Conclusive**

The ethical standards of non-profit organizations are eroding<sup>1</sup>. Financial fraud among non-profits is more prevalent than in business or government. Non-profit boards are failing to set clear ethical standards for their organizations. The research goes on to report that fraud levels are back to pre-Enron levels and on the rise and nowhere is that more evident than among the Boards of Directors and senior leadership of non-profit organizations.

It is time to explore why this is the case and what can be done about it.

Consider this “hypothetical” scenario: *The Vice President for Administration of the small NGO approached the Chair of the audit committee of the board with a problem. The CEO had redirected a significant sum of “restricted” funds - monies dedicated to projects specified by the donor - to cover operating expenses during a temporary cash flow crunch. The VP’s concern was that this was a violation of the promise to the donor, company policy, approved accounting practices and the law. The committee chair simply said, “Don’t worry. It’s a common practice. Non-profits do this all the time. As long as the money is put back before we close our books, no harm, no foul.”*

Compare that with a recent conversation with the CFO of a mid-size insurance company. They were doing better than most through the early stages of the current economic crisis and, ever curious, I pressed for an explanation. “Simple” she said. “When I took over this position about three years ago I met with my staff and asked each direct report to brief me on their areas of responsibility. Our investment portfolio manager presented a breakdown of our holdings. They included a large percentage of “securitized debt”. I asked for an explanation of how that investment worked and his reply was, ‘They are Triple A rated and we make buckets of money.’ When pressed for an explanation of exactly how they worked, he reiterated, ‘I’m not sure, but they’re Triple A and we make buckets of money’ adding, ‘Two outta three ain’t bad.’ ”

“I suggested he come back and brief me on exactly how they worked. The next day, he attempted to defend these instruments but he couldn’t explain it. My position was simple. Get rid of them. If I can’t explain them to the board, I won’t have them in our portfolio.” Her company is still hurting from the current crisis, but in her industry they are a shining star and she is an exemplar of how a CFO should act. Internally she is a “hero”. Were it

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<sup>1</sup> *National Nonprofit Ethics Survey*, Ethics Resource Center, 2007 ([www.ethics.org](http://www.ethics.org))

not for her scruples, they would be in the same boat as so many others, where boards failed to meet their governance and oversight obligations.

True, this is a corporate example, but how many of your boards are on top of your finances – aware of the risks and strategies – doing more than ensuring that income exceeds expenses and the books balance? How many of your CFOs would have figured “Two outta three ain’t bad”?

There is an implicit question in these examples. Not, “Are non-profit boards failing?” but rather, “Why are non-profit boards failing?” How much of this is board fraud and how much is **misfeasance**?

**Comment [SMC1]:** I prefer the more commonly used “Malfeasance”...but it’s your paper.

Again, the research identifies the most common frauds in non-profits: alteration of documents, alteration of financial records, lying to external stakeholders and employees and misreporting of hours. These are not accidents or oversights.

How is this a board problem? If nothing else, when compared to private sector employees more than twice as many non-profit employees report that it is their board that sets the ethical tone of the organization. That is likely a function of the fact that in most non-profits the board is better known to employees than in the private sector, thus more directly influential.

### **Nonprofits Have a Governance Problem**

Governance<sup>2</sup> is the system by which corporations are directed and controlled. Governance is strategic. It spells out the rules and procedures for making decisions on corporate affairs, setting organizational objectives, attaining those objectives and monitoring performance. Governance has a long-term focus on unbounded goals as defined by the mission of the organization: whom they serve, how they serve them and how success will be measured. And governance is the province of the board. The board approves management goals, measures management’s performance and holds management accountable.

It is also understood that it is the obligation of the board to establish ethical standards and help to create and sustain an ethical culture – the context in which goal attainment occurs. This requires more than blind faith or cursory oversight. The board is obligated to ensure that the information received from top management is **complete and true**, that top management is keeping its explicit and implicit promises, setting the right example and being held accountable.

**Comment [SMC2]:** “accurate and true” seems like a redundancy.

This means that the board must be free to talk with executive leadership about the importance of ethics, how management goes about modeling ethical behavior thus setting the right example. The board must both support the leadership and hold them accountable. In non-profits good governance is more than a fiduciary responsibility to

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<sup>2</sup> per OECD (1999)

shareholders – it is a moral responsibility to society. Moreover, the survey data, as well as the headlines, note that too often non-profits boards fall short.

### **Ethics Programs Can Work Well in Nonprofits**

There is now some thirty-plus years of history with formal organization ethics programs. Their intended purpose, from the beginning, was to encourage a strong ethical culture characterized by ethical leadership founded on a set of embedded ethical values. Unfortunately, few board members see their company culture as it really is.<sup>3</sup> The good news is that we now know what makes ethics program effective. The components of an effective program are well known and well publicized. So too are the specifics that differentiate the best in class from the run of the mill.

### **The Devil is in the Details**

Creating and sustaining an effective ethics program is within the reach of even the most modest non-profit – and it starts with the board. The traditional role of the non-profit board is to hire, evaluate and compensate the CEO/ED, approve the strategic plan, approve the budget, monitor strategic progress, provide budget oversight and assume responsibility for organizational integrity. We need to remember that non-profits are different. They operate under an explicit agreement with civil society. Non-profits are afforded a special place in society. In exchange for that privileged position there is an expectation that the non-profit will provide an affirmative good to society – it will give back more than it takes and society will benefit in the end. That makes the obligation of the board to foster an ethical culture even more apparent.

The non-profit board has an obligation to represent the community's interests and ensure that the non-profit keeps its promise of an "affirmative good". The board is expected to establish and sustain an ethical organizational culture that is a reflection of their own values and those of society.

Part of the challenge lies in the differences between for-profit and non-profit boards. Typically, non-profit board members are volunteers - unpaid helpers who are there to support the mission. They may be special interest representatives - advocates for a specific constituency, and/or ambassadors - advocates for the non-profit to funders and supporters: and, their fiduciary oversight obligation is more than an accounting function. It is an obligation to preserve and protect non-financial assets such as reputation and public trust.

In addition, there is one other critical difference. Unlike their corporate kin, non-profit board members are often expected to be direct contributors to the financial and mission-specific success of the organization. Consider these examples paraphrased from templates for non-profit boards provided by Board Connect ([www.boardconnect.org](http://www.boardconnect.org)). Non-profit

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<sup>3</sup> *Board Failure Exposed*, Corporate Secretary, November, 2006

board members are expected to make meaningful personal financial contributions, participate in fundraising activities, provide referrals, and participate in networking, advocacy and promotion.

### **The Challenges to Non-profit Boards**

By their very nature, non-profit boards may be more vulnerable to two challenges: fraud and conflicts of interest

Fraud, in the broadest sense, is a deception made for personal gain. The specific legal definition varies by legal jurisdiction. Fraud is a crime and is also a civil law violation. In criminal law, fraud is the crime or offense of deliberately deceiving another in order to damage them - usually, to obtain property or services unjustly - and can be accomplished through the aid of forged objects. In the criminal law of common law jurisdictions it may be called "theft by deception," "larceny by trick," "larceny by fraud and deception" or something similar.

Conflicts of interest are situations where the interests of the decision maker and the organization being served conflict or could appear to conflict to a reasonable observer. They suggest that the decision-maker's objectivity could be compromised by the impact of various alternatives on the decision maker him/herself.

### **What Can Boards Do?**

The key to meeting the ethical obligations of any board begins with the recruiting, vetting and training of board members. It continues with oversight, checks and balances and includes systems to facilitate the reporting of suspected fraud from within the board and to the board from within the organization. This typically requires a conscientious effort to legitimize the dialog on fraud and conflicts of interest. These have to be issues so routine and commonplace that every instance where fraud or conflicted interest could possibly exist is freely and openly raised and decided – where the discussion of potential ethics conflicts is routine - the rule rather than the exception.

However, these are not the only challenges. Consider what I call “the legacy dilemma”. A former board member (a corporate CEO who just completed a 4-year term as board chairman) retires and nominates his chief legal counsel as his company's representative to the board. Can either the nominee or the non-profit refuse that nomination? Ought that nomination be refused? What is that person's commitment to the organization, its mission and long-term success? Is it equal to that of the outgoing chair? Is this one of those “other duties as assigned” that no reasonable, career-minded executive would turn down?

Effective boards and board members often point to board training as critical to their success. What training content would suit the typical non-profit board? How do you get past the egos that see the suggestion of board training as a personal affront, rather than a significant precondition for long-term success? Susan F. Schultz, in *The Board Book*, notes that as minimum incoming board members need to be briefed in some detail, and

provided a detailed review of board and company organization charts, mission, vision and values statements, strategic plans, core strategies and milestones, company history, the board charter, structure, bylaws, director biographies, meeting schedules, prior agendas, board and committee minutes, policies and procedures, financials (including analyst reports), executive compensation, evaluations and succession planning and more.

### **Oversight, Checks and Balances**

Another concern addresses the age-old question, “Who’s checking the checkers?” How does the board increase their collective confidence that they are meeting their financial and ethical obligations? Who provides oversight to the oversight body?

Consider this “hypothetical” oversight failure. The organization exceeds its performance expectations. The board, noting the potential to do even better, encourages management to raise the bar. The higher expectations result in management exerting increased pressure on performance that results in further increases in achievement, but only as a result of marginal and/or unethical practices used by employees to meet what they consider “unreasonably high” expectations. The board, focused on the recent success, failed to explore how/why employees overachieved. The board failed to consider the potential ramifications of increased performance expectations. Predictably, the “house of cards” collapses and the organization fails. The board fires senior management. But who is empowered to fire the board?

One obvious failing in the above example is the lack of mechanisms to encourage and facilitate the reporting of suspected fraud both from within the board and from within the organization. What effort had been made to encourage the reporting of suspected misconduct? What protections were offered to whistleblowers? Were those mechanisms well publicized? Were they trusted? Were there well-known and widely understood policies outlining employee responsibilities to report things like undue pressure to reach unrealistic goals to a “safe haven” within the management team?

**Comment [SMC3]:** This may be a bit awkward, but after two or three readings I understood your reference to a “safe haven.” The next sentence, I believe, says it better.

Did the organizational culture allow employees to raise these issues to management and/or for management to raise them to the board? Were those mechanisms supportive of a culture of personal responsibility, commitment to the highest ethical standards and “ownership” of the ethical culture at every level of the organization? Was the raising of compliance and ethics questions deemed a legitimate responsibility for every employee, irrespective of level or tenure?

### **Creating and Sustaining the Right Culture**

What is a “right” organizational culture? At a minimum, it is mission driven and values-based. Employees at every level are well informed regarding their roles and responsibilities, standards and expectations, including the explicit commitment to maintain an organization that is fraud and deception free.

One of my favorite words is “congruence” - the degree to which related items are aligned - fit together. Examples: Are the stated and operational values, existing leadership style and decision making processes aligned? Are standards and expectations reasonable given the current resources and circumstances? Are there an inappropriate number of “routine exceptions” to the formal rules? Are there cliques and alliances, hidden agendas and informal rewards and punishments that undermine the formal systems?

What is the “common sense” understanding of “how things really work around here”?  
What unwritten rules, though undocumented, are critical for success? What does the “new” employee or the board member spend the first few weeks trying to figure out?  
What is “right”, “fair” and “good” in the organization? On the board?

**Comment [SMC4]:** I don't get this fragment. What does it mean?

### Next Steps

What actions are you willing to take, today, to ensure your board's long-term success in avoiding fraud and conflicts of interest? What commitments are you willing to make to your board, today, to ensure the long-term success of your organization? How do you plan to prevent and detect financial fraud and the other predictable ethical lapses to which your board and non-profit organization might be susceptible? What are you going to do to stem the rising tide of unethical board conduct that might be setting the stage for your non-profit organization's failure?

I suggest that your answer should include “an effective program to prevent and detect violations...” and a commitment to creating and sustaining a board culture where the ethics of every debate and every board and management decision is routinely examined.

Closing Option A:

Alternatively, I suggest you be certain that the press knows how to spell your name. It would be a shame to make the front page of the Business Section and have it spelled wrong.

**Comment [SMC5]:** Barbara is right. This is a bit cheeky.

Closing Option B:

Business and government are finding value in effective programs to prevent and detect violations. In organizations where this represents a real commitment to creating and sustaining an ethical culture (rather than a minimalist act of compliance to satisfy auditors and Inspectors General) we see measurable declines in fraud. In addition, fraud, both within the organization and within the board itself, ought to be the concern of every non-profit board member.