



Chapter 1

Case 1: Misappropriation of Benefits

Learning objectives

- Determine how benefits might be misappropriated in a fictitious not-for-profit (NFP) entity.
 - Use the fraud triangle in light of operations at offsite locations in a fictitious NFP.
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Before we start

Fraud risks associated with benefit programs can sometimes be overlooked because there is typically no physical asset relating to the benefit. Program benefits provided by NFPs may be provided to beneficiaries that do not qualify for the benefit or do not qualify for the level of benefit provided include the following:

- Unemployment
- Food stamps
- Housing assistance
- Financial aid
- Healthcare
- Legal assistance
- Child care
- Membership
- Education

Indicators that program benefits might be misappropriated include the following:

- Copies of missing application forms and underlying supporting documentation
- Participant files lacking required information (for example, interview sheets, tax returns, and so on)
- Decentralized intake centers or centralized intake centers with little or no monitoring by management or supervisory personnel
- Inadequately trained or supervised program personnel
- Inadequate or ineffective controls over program assets
- Lack of periodic physical inventories of program assets

Background

Level Field Preschool is a large regional NFP organized under IRC Section 501 (c)(3), controlling and operating five preschool education and child care facilities in three counties. The population served by Level Field is primarily low-income families residing in the county where the education/child care facility is located. The primary sources of revenue for Level Field are various education and child care state grants (80%). These revenues are augmented with fees for program services (5%) and contributions from the United Way and the community (15%). Fees for program services are assessed on a sliding scale using family size and household income to determine the fee amount.

Each location is operated by a director and is staffed with teachers, student aides, and childcare assistants based on the number of students enrolled in the preschool education and child care programs. In addition, each location has a bookkeeper who is responsible for processing daily cash receipts and preparing the deposit. The location director takes the locked bank bag to the bank for deposit whenever there are receipts for deposit and the bookkeeper notifies the administrative office of the deposit amount and date. All receiving reports and invoices for goods/services received/provided at the locations are approved by the director and sent to the administrative office for payment.

Operational oversight responsibility is performed by administrative office staff who are based in the downtown education/child care facility. Each location director hires and fires all personnel needed to operate the location. However, all job postings, recruiting, and background checks are done by the human resources department at the administrative office. Employees track their time on a daily basis using a cloud-based time management system. Supervisors electronically approve the time submitted and release the information for processing by administrative office staff. Due to the nature of the child care industry, and high turnover rates of Level Field teachers, aides, and assistants, payroll is processed on a weekly basis.

Level Field refers to its five locations as the Downtown location, East Side location, West Side location, South Side location, and the North Side Location. State grants relating to the various preschool education programs are awarded for five years and are awarded at the location level rather than at the entity-wide level. The state requires Level Field to undergo a financial statement and compliance audit each year. State grants for child care programs are awarded for three years, subject to annual availability, at an entity-wide level. The chief executive officer (CEO), vice president of operations (VPO), and chief financial

officer (CFO) allocate the child care grant funds to the five locations based on a child-driven formula. Grant compliance for all grants is delegated to each location director.

Knowledge check

1. Which is accurate of Level Field?
 - a. Level Field receives 10% of revenues from fees for program services.
 - b. Level Field is a United Way agency.
 - c. Level Field operates in a five-county area.
 - d. Level Field is heavily dependent on community contributions to fund its programs.

 2. Which is accurate of Level Field?
 - a. Location directors post job vacancies, recruit, and perform background checks for location employees.
 - b. Level Field uses manual time sheets for employees to log hours worked.
 - c. Operational oversight responsibility is performed by administrative office staff who are housed in the downtown education/child care facility.
 - d. Payroll is processed on a biweekly basis.
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The case

The following discussion takes place after-hours at the unofficial teacher happy hour staff meeting between Downtown teachers Kelly Carter, Amanda Miller, and Brittany Nelson.

"Hey Amanda, you know what really bothers me about Level Field?"

"No Brittany, I don't know what really bothers you. Why don't you tell me?"

"Wait, Amanda. I know what Brittany is going to say because it is what bothers me the most as well."

"Well, go ahead, Kelly. I may only be two weeks on the job but I'm all ears."

"All right. You know how we can have a certain number of families in the program who don't meet the low-income threshold?"

"Uh, hello, Kelly. I've only been here two weeks and have no clue what you mean."

"Kels, give it up. Let me explain it as I am the one who asked the question in the first place."

"All right, Brittany you do it. Age before beauty after all."

"As I was trying to say a few minutes ago, the thing bothering me the most is we seem to be accepting all of these families into the program with higher incomes and putting the low-income families on the waiting list. I assume we aren't exceeding the maximum allowed in the program but it doesn't seem right to be letting the higher income families take away a spot from the low-income families."

"Amanda, are you sure this is going on because it doesn't sound right. I don't think we had anything else like this at my last job. You know the main reason I left my old job for this one was because Level Field focuses on providing preschool education and child care services to only low-income families. At least this is what I was told by HR when I interviewed."

"That's what Brittany and I were told when we interviewed as well. We had our brand new early childhood education degrees looking to make the world a better place working in an inner-city preschool. Boy, did we drink the Kool-Aid."

"We all may have drunk the Kool-Aid but maybe we can do something to change things."

"What do you mean, Amanda? We are only barely experienced preschool teachers. What could we really do?"

"I'm not sure yet, Kelly, but give me some time to check on a few things, then I'll get back with you and Brittany about what I learn."

"Sounds good. Let's do this again next Friday and see what you find out, Amanda."

The following discussion takes place between East Side Director Dana Curran, North Side Director Karen Durham, and Downtown Director Rich Hawkins, before the monthly directors' meeting held at the administrative offices. South Side Director Pat Simmons joins them later.

"Hi there, Karen. How are things going out in the northern tundra?"

"That's not really funny, Rich. This cold weather makes it hard for our students to stay warm at home. The cold is also keeping parents from bringing their kids in for school. We are always under pressure to meet state performance measures, and kids not coming to class doesn't help us meet those goals."

"I hear you, Karen. At least you don't have the CEO and VPO breathing down your neck and popping into classes all the time. At least once a week someone at the top reminds me how important it is to keep our quality high and the enrollment at capacity. It is getting harder and harder to keep our program quality high with the cuts the Legislature keeps making in grant funding. I get we need to keep the state happy to keep the grant money coming in but sometimes the pressure is too much."

"Hey guys. Have we started yet?"

"Hi Dana and, no, we haven't started. I was blowing off steam about how much pressure we are all under to keep enrollments at capacity and how hard it is to provide higher quality with less funding."

"Yes, Karen and I are really lucky being offsite. I know we only see the VPO at East Side when he thinks we have a problem. What about you, Karen?"

"About the same, Dana. Thankfully, North Side is quite a hike from Downtown, which means we don't see a lot of the VPO. I don't really mind it when he does come up but I wish he really understood how hard we work to keep things running smoothly."

"I couldn't help but overhear you and Karen talking and I agree with everything you said. On a happier note, I may have something to help our families struggling to keep warm this winter. Pat out at South Side told me about a new state program last week. She said it provides a flat subsidy amount to help low-income families with heating bills and it is fairly easy to complete the application paperwork. Where is she, by the way? Oh, here she comes. Hi, Pat."

"Hey guys. Did I miss anything important?"

"Only the usual complaining about having to achieve higher program quality with less money. We were also discussing how the cold weather is affecting our attendance numbers and our families. Dana was about to tell us about the assistance program you discussed with her last week."

"You're right, Rich, Dana and I did talk about this last week. The program may seem a little too good to be true because it is easy to apply for and be approved. The maximum subsidy is \$600 and it's based on income and family size like our program requirements. It is only a one-time amount though, which may not go very far if this cold weather continues much longer."

"It sounds like something our East Side families could qualify for and it is certainly something to help them with their utility bills. Maybe our new CFO, Amy Wallace, knows more about this. I have to get back to the center as soon as our meeting ends, but Rich you're right here. Do you have some time after the meeting to stop by her office?"

"Sure, Dana, I can drop by and ask her about this program."

The following discussion takes place the following week at another after-hours unofficial teacher happy hour between Downtown teachers Kelly Carter, Amanda Miller, and Brittany Nelson. They are joined by two South Side teachers, Ryan Cavanaugh and Jeremy Gregg.

"Hi guys. I hope you don't mind but I brought two friends of mine who teach at the South Side location. Meet Ryan and Jeremy. Ryan, Jeremy, meet Kelly and Amanda."

"No problem, Brittany. The more the merrier. Someone snag our server and let's order. In the meantime, what did you learn this week, Amanda? Did you have time to find out anything about the mix of low-income and non-low-income families?"

"Hold on, Kelly. Let me give the server my drink order first."

"Come on, Amanda. Where are your priorities? Just kidding."

"What are you guys talking about? Anyone feel like cluing me and Jeremy in to the conversation?"

Kelly and Brittany explain what they discussed the previous week and how Amanda was going to research the issue and report back tonight.

"All right. I think Jeremy and I have it now. You may not believe this but I have heard of this before. My cousin works at one of the Big 4 accounting firms . . ."

"The 'Big 4', Ryan? Is this like a college basketball playoff bracket?"

"No, Kelly, it's not. I'm not really sure what accounting firms do but apparently the 'Big 4' do a lot of different things and serve a lot of different types of clients. Yes, there are only four *really big* firms, hence 'Big 4'. My cousin works at one of them in DC and has worked on a lot of not-for-profit clients over the last two years. He was telling me at Thanksgiving how surprised I would be at the number of people who receive federal benefits without meeting the program qualifications."

"You mean like doctors doing all kinds of procedures and tests because Medicare pays for it? This is my grandad's No. 1 complaint about healthcare for seniors."

"Not quite Jeremy. My cousin told me about some programs for which people provide false documentation to prove how much they make in order to receive a bigger benefit. He also told me about some public housing program for which people were paying staff to put their name at the top of the waiting list. According to him, you can find all kinds of government reports on the internet reporting this stuff."

"I hate to interrupt you Ryan, but I'd really like to talk about what I learned this week about our program. Oh look, our drinks are here."

"No problem, Amanda. Here's your wine, Kelly, and here's your beer, Brittany. Amanda, are you good with your Cosmo?"

"Yes, and no more interruptions. I don't have a cousin at a Big 4 firm but I do have a roommate who works at one here in town. She helped me look up information on the state website about the requirements of our preschool education program. I understand totally what learning objectives our programs are supposed to achieve and the programs we use to do this. But, the stuff my roommate found sounded like a foreign language to me. She did give me some information in plain English though."

"Spit it out, Amanda."

"Patience, Brittany. According to what she found, we can have up to 10% of the families in our program with income above 120% of the state poverty level. I think she said these families are called 'over income' families or something like that. Families with incomes below the 120% are 'under income' families. Also, there are limits to the maximum number of kids any one location can have."

"Wow, I never was good at math but even I can see where this is going."

"You're right, Jeremy. With a limited enrollment, over income families take away spots under income families would otherwise fill which is what Kelly, Brittany, and I discussed here last week. Ryan, based on what your cousin said do you think 'over income' people might be paying staff at the Downtown location to be put on their waiting list? Our program has some of the best success stories and has been recognized as a Preschool of Excellence the last 10 years."

"I don't know, Amanda, but it is something to think about. Our program at South Side is not as prestigious as yours, and our demographics are very different, but we do pretty well at holding our own. We have a number of families a little better off than others who pay part of the tuition. Do you think anyone might have used fake income information to avoid having to pay tuition?"

"Anything is possible, Ryan. Oh look, here's our food. Let's eat."

"Good idea, Kelly. Why don't we all see if we can find out if anything like this is going on in our programs and then report back next Friday?"

Over the next week, Kelly, Brittany, and Amanda start paying more attention to conversations of staff and parents and becoming more aware of the atmosphere outside of the classroom. One day in the breakroom, Amanda hears the following conversation between teacher's aide, Susan Andrews, and the bookkeeper, Janice Weatherly.

"Don't you shush me, I'm telling you, Susan, something is going on here."

"Janice, I've told you to quit watching all those true crime shows. You are starting to see things where they don't exist."

"Really, dreaming things, Susan? What do you think about the two new families we let in after the holiday break?"

"We had two spots open up before Thanksgiving and we filled them is what I think."

"What if I told you the surnames of those two families happen to be the maiden name of our esteemed director's wife and his daughter-in-law? What does this tell you?"

"Well, I don't know. How do you know this anyway, Janice?"

"You know I've always wanted to be Columbo; it's in my DNA. It makes me suspicious of all kinds of things. When I saw the cars the two moms drove up in, my Spidey sense started tingling. I'm not one to judge but if you can afford a relatively new luxury SUV I don't think you qualify for our subsidized preschool program."

"Janice, you know how judging gets you in trouble. Driving a nice new car could mean someone took advantage of one of those car loan programs they are always advertising during the 11pm news."

"Well, in this case, Susan, you would be wrong. I looked up the surnames using the state databases. From there, it was easy to trace them back to Rich and his daughter-in-law. I looked them up on social media, too. You wouldn't believe the seven-day cruise one of them went on over the holidays."

"Janice, it still doesn't mean they didn't qualify for our program."

"You can be as naïve as you want to be, Susan. I know what I know and those two families do not qualify for our low-income program. They are taking a spot away from one of our truly deserving families."

"They may have been let in for a good reason, you know. Besides, maybe they are paying customers."

"Susan, in the 25 years I have been here we have never had anyone in our program with enough money to have a new luxury SUV. If our community found out we are accepting families who don't qualify when we have a waiting list of 200 families, they would be outraged. As for paying tuition, I am the bookkeeper. Don't you think I would know if they were paying tuition?"

"Well, I guess you would know who pays and who doesn't. What are we going to do?"

Amanda leaves the breakroom a few minutes after Janice and Susan leave and texts Brittany, Kelly, Ryan, and Jeremy "Can't wait to spill 411. C u @ stf mtg Fri. ☺"

Two weeks after the directors' meeting, Dana Curran calls Rich Hawkins to follow up with him about the low-income subsidy program they discussed before the meeting.

"Hi, Rich. This is Dana. Is this a good time? I purposely called during student nap time to try and catch you."

"Good call on your part, Dana, as I have a bit of time right now. What can I do for you?"

"I wondered if you had a chance to find out any more information about the subsidy to help low-income families with their power bills. This cold front seems to have taken up residence over the region and they aren't forecasting warmer temps any time soon. Our families could really use some help."

"I meant to follow up with you and Karen but things have been crazy with open enrollment going on the past two weeks. It seems our program here becomes more popular every year and a lot of people want their kids in it. Right now I'm looking at a waiting list of three years based on our current enrollment capacity."

"No problem, I certainly understand. We have a different income demographic out here at East Side but we still have more families needing our program than we have openings. Was Amy able to give you any information?"

"She gave me a lot of good information and links to the program's website. The subsidy is for a flat amount, which is \$300 for a single individual and \$600 for a family of any size. It is based on income and uses the same 120% of the state poverty level we use to qualify our preschool families. You can apply for the subsidy online via their website or go to one of the state Health and Human Services offices. If you want, I'll send you the link to their website."

"Thanks, Rich. I'll get it posted for our families and on our website as soon as I get it from you."

"No problem, Dana. See you in two weeks."

Later the same day, Dana calls Pat Simmons, South Side director, to thank her for mentioning the program.

"Hey Pat. This is Dana at East Side. Do you have a minute?"

"Sure. My teachers have everything under control right now, which means I have time to breathe. What can I do for you?"

"I wanted to thank you for mentioning the power subsidy program the state has. Rich talked to Amy about it and he gave me the information today. This will be extremely helpful for our families here at East Side."

"You're welcome but I didn't really do much. I let our families here at South Side know about it last month. Several families applied a few weeks ago and received their checks this past week. I guess this extended cold weather has motivated the state to get these benefits disbursed sooner rather than later."

"Well, I think it's a win-win. Thanks again for the info. See you at the next directors' meeting."

The next day at the South Side location, Ryan arrives earlier than usual and walks to Pat's office to let her know he is going to start the coffee. Before he reaches Pat's office, he hears her talking on the phone and turns to go to the breakroom but stops when he hears Pat mention a low-income program she is scamming.

"I'm telling you, Karen, this is the easiest scam I've ever run. I started by simply using names and addresses I found on social media sites and the Internet White Pages. Last week, I came up with the idea to apply 'on behalf' of our families..."

"Yes, that's what I'm trying to tell you. The state folks processing these applications are trying to get the checks out as quickly as possible in order to help people keep their power on during this cold weather. They don't seem to be comparing any information to any database and all you have to provide is proof of income."

"What do you mean it's hard to get people to hand over proof of income? I used my weekly pay stub and told them it was a monthly pay stub. I know what income level they use because it's the same one we use here."

"You don't have to use a pay stub. They take a letter from an employer or a tax return as proof of income. Rich told me how to dummy up a letter and how to use the 1040 tax form at www.irs.gov. All you have to do is bring up the form and input bogus information. It doesn't save to the IRS database so you only need to print it and use it as proof of income."

"Oh yeah, what I was saying about our families. I learned about this program several months ago from a friend of mine who works at HHS. We weren't having weather issues then and I didn't remember it until this cold front moved in last month. Don't judge me, but I really didn't mention it to our families. Listening to the parents talk when they picked up their kids, I figured none of them knew about the program. I used their names and income information and applied 'on their behalf' for the benefit. You have access to all the family information in your files there at North Side, don't you?"

"You are two steps ahead of me. I set up a post office box at a place in an almost abandoned strip mall a few weeks ago to use as the mailing address. By the time the state figures it out, I'll have closed it down and no one will be the wiser, well, except for you. In the meantime, if you want to use it let me know and I'll give you the details."

"Oops, I hear someone in the breakroom. Gotta go. Talk to you later."

Knowledge check

3. Which is accurate of Level Field?
 - a. Amanda Miller, Kelly Carter, and Brittany Nelson are teachers at the Downtown location.
 - b. Pat Simmons is the director for the Downtown location.
 - c. Rich Hawkins is the director for the South Side location.
 - d. Jeremy Gregg has a cousin who works for a Big 4 firm in DC.

Exercises

1. What elements of the fraud triangle¹ (that is, opportunity, incentive or pressure, and rationalization or attitude), if any, are present in this case?

2. What procedures could have been in place to ensure eligibility and waiting list requirements were met?

3. What, if any, internal controls are missing or inadequate, which might indicate there is a potential for fraud in this case?

4. What types of preliminary audit procedures might detect this situation? What types of other audit procedures might detect this situation?

¹ Paragraph .11 of AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA Professional Standards) (see course appendix A) states three conditions are generally present when fraud occurs: opportunity, incentive or pressure, and rationalization or attitude. These three conditions are commonly referred to as the fraud triangle. Paragraph 11(b) of ISA section 240, *The Auditor's Responsibility Relating to Fraud in an Audit of Financial Statements*, does not include rationalization or attitude as a fraud risk factor.