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Embezzlement of donor funding in health projects

Donor funding has fuelled a vast increase in service delivery, medical research and clinical trials throughout the developing world. Yet, there is a dark side to this badly needed influx of funding: with pressures to spend funds quickly and achieve results, projects may not pay sufficient attention to internal monitoring and security systems to protect against embezzlement. This U4 Brief analyzes how this type of corruption occurred in a donor-funded project, and what can be done to minimize the risk.

Background

Embezzlement is defined as the misappropriation of property or funds legally entrusted to someone in their formal position as an agent or guardian. Everyone wants to believe that the people they hire are good employees who can be trusted to perform their responsibilities with integrity. Yet, research shows that embezzlement may arise even among the most well-trained, hard working and trusted employees in an organization.¹ The scope of corruption and fraud in



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1 De St. Georges, J.M., and D. Lewis. 2000. How can you protect yourself from employee dishonesty? *Journal of the American Dental Association*. 131: 1763-1764.

international aid projects, especially, is frequently underestimated, and may include fraud in the form of inflated or fictitious invoices, padded travel expenses and diversion of project assets to private use.²

Donor-funded projects in developing countries are particularly vulnerable to employee fraud for several reasons. First, the nature of project support and short implementation timetables often require large amounts of funds to be spent in a small amount of time. Under pressure to spend quickly, project managers often do not monitor project expenditures closely or set up appropriate financial checks and balances. Secondly, donors often need to establish bank accounts in both foreign (hard) and local currencies. While this arrangement may protect against currency risk from inflation, extra accounts add to the complexity of the financial system and make tracking expenditures and transparency more difficult. Finally, many everyday transactions needed to implement a field project in poorly developed economies are cash-based and vulnerable to theft. Other temptations to employee dishonesty are less visible: employees may have credit problems, a criminal history, or may come under pressure from their families to extract resources from employers, factors which create pressures or motivations to embezzle. Preventing embezzlement, therefore, is linked to strengthening financial systems, selecting financial staff who are less susceptible to pressures and temptations, and implementing supervisory and control systems for early detection of problems.

The case below illustrates one example of how embezzlement can occur. The brief analyzes the case of “ABC Project”, a multi-year research project with a multi-million dollar budget conducted by a US-based NGO in “Belletown”, an urban city in eastern Africa.³ Though the setting is a research project, the story is typical of the causes and consequences of embezzlement in many types of international aid project.

Project ABC

Project ABC was designed to conduct a clinical trial on a treatment for a common disease prevalent in the region. The Project was structured such that project administration and the laboratory were based at the same facility, the central office. Two satellite sites were located at Ministry of Health clinics in Belletown and were staffed by Project-funded nurses, counselors and doctors. These clinic staff were responsible for participant recruitment, all clinical and medical procedures, primary data and specimen collection and participant follow-up. A Subject Manager at each clinic was responsible for staff supervision, basic clinic operations, and regular reporting to the Project Manager based at the central office. The Project Manager had overall responsibility for Project ABC, including human resources, financial management and the integrity of the clinical trial.

2 Kramer, W. Michael. 2007. Corruption and Fraud in International Aid Projects. U4 Brief No.4, <http://www.cmi.no/publications/file/?2752=corruption-and-fraud-in-international-aid-projects>

3 The ABC Project has been disguised to protect the privacy of informants. Details crucial for interpreting the nature and consequences of embezzlement have not been changed. While written from the perspective of a donor-funded NGO, the vulnerabilities to embezzlement are universal concerns for local NGOs and local governments as well.

The Project Manager, a US expatriate fielded to Belletown, hired a Project Administrator to assist with the financial and human resource management. The Project Administrator’s CV indicated that he had previous experience in finance and specific training in financial management.

Typically, the ABC Project spent \$15,000-20,000 per month in field office costs, including transportation costs incurred by the study participants, medicines, general office costs such as rent and office supplies, and salaries for local staff. Expenditures were made primarily in cash from the central or main office and from satellite offices located at two clinical sites where patients were seen.

The ABC Project followed the common procedure of transferring funds from the funding agency to the NGO’s US-based head office, and then wiring them to a local checking account at an international bank in Belletown, where it was kept in foreign (USD) and local (LC) currency. This procedure had the advantage of insulating the funds from the effect of local currency fluctuation until the Project staff were ready to make purchases. Project staff would then withdraw money from the local USD account in two ways. First, some money was regularly transferred to the LC checking account to pay for salaries, insurance, medicines, rent and other monthly bills. Secondly, funds were withdrawn as cash and put into the office safe to be used at the two patient clinics and the head office to pay for day-to-day costs such as transportation reimbursement and for items purchased from vendors who did not accept checks.

A financial software package was used to record expenditures, which were documented largely with paper receipts. Clinic staff tracked subject reimbursements and bonuses using hand-written ledgers, which were later reconciled at the central office. The Subject Manager at each satellite site was accountable for reviewing and verifying receipts prior to sending them to the central office. Once receipts were received at the central office, expenditures were reviewed and reconciled by the Project Administrator. After paper receipt review, another cash allotment was provided to the clinic.

ABC Project staff knew the importance of regular financial reporting, both within and outside the Project. The Project Administrator balanced the bank statements monthly at the central office. The Project Manager then reviewed them and sent the expenditure reports and electronic files to the US-based office of the NGO. A project manager, based in the US, was responsible for the final review of the financial reports and for reporting the expenditures to the NGO’s US office administration and the financial donor institute.

Annual financial audits from the NGO’s US office, and the internal monthly and annual reviews, were completed for 3 years without any serious incident. Over time, the expatriate Project Manager granted complete financial responsibility to the Project Administrator, Bob. Bob had been working with the Project since its inception. He was extremely personable, respected and trusted by the management staff both in-country and at the US-based NGO head office. As the Project expanded, granting Bob more responsibilities was a natural progression as he was seen as a valuable employee who contributed significantly in all areas of the Project. He accepted the increased responsibility readily and

appeared to be adequately managing both the human and financial resources.

Raising concerns

In the Spring of 2003, the expatriate Project Manager was replaced due to expected turnover. During the transition period, the old and new Project Managers worked together to review data. Unfortunately, while reconciling the cash receipts and cash in the safe, a significant amount of money was noted as missing (LC 5,000,000 or about USD 2,000). When the Project Managers asked the Project Administrator, Bob replied that some receipts might have been accidentally misplaced, but he could not produce them.

The two project managers suspected that they had a problem and decided to conduct a more in-depth review. They started by examining the expenditures and withdrawals of cash from the bank account over the last six months. Graphing cash withdrawals over time, they observed an increasing trend of cash withdrawals from the bank. The amount and frequency of withdrawals had nearly doubled during this time. Furthermore, the overall expenditures in the field office significantly increased during the same period, specifically, the expenditures for fuel, cell phone minutes and car servicing. After two weeks of review, they determined that USD 13,000 in Project funds were missing. The Project Managers quickly realized that the most likely cause of the problem was embezzlement.

Diagnosis: corruption

A review of financial systems showed clearly that the procedures currently in place did not provide adequate protection against this type of employee fraud. The ABC Project managers realized that they were lucky to have detected the corruption early, thus avoiding greater losses. Three important weaknesses were noted: 1) the system did not include independent verification of the bank statement to computer totals; 2) the system did not provide for adequate separation of financial duties for checks and balances – thus it was possible for someone to abuse his or her position for private gain without it being detected by someone else; and 3) the system did not adequately monitor and control transactions or require some transactions to have special approval.

Independent verification of bank statements

Although the Project's bank statements were compared to the computerized financial records each month, the dishonest employee was the one mainly responsible for the comparison. Because the Project Manager trusted Bob, review of his work was not as thorough as could be. Additionally, at the NGO's US head office, accounts were only being reconciled from the receipts to the computerized financial records, but not to the actual withdrawals according to the bank statements. Bob was able to manipulate the receipts and computer records so that they matched. The reconciliation to the bank statements was the only way to catch the fraud, and no one did this.

Separation of financial functions

The Project Administrator performed almost all of the financial functions. This is common in a small project. For example, when creating the bank accounts years earlier, the NGO had only requested one signatory due to the small staff

size and the difficulty in obtaining double signatures on all checks. However, because of this Bob was able to withdraw, distribute and account for all project cash. This allowed him to steal funds without being caught, at least until the change in project management staff created the occasion for a special review.

Monitoring and control of transactions

The Project did not in fact have any controls and maintained few tracking methods. Staff were not required to sign receipts for receiving Project-funded resources such as phone cards, and receipts for transactions were simply left on the Administrator's desk with no record of who did the purchasing. In addition, the clinic's cash was not counted and reconciled with the recorded transactions each day.

Interestingly, later interviews with staff suggested that they were aware of the embezzlement, but did not feel it was their role to say something. It appeared that many people were benefiting personally from the lack of controls in the financial system. In addition, a sense of power imbalance between staff and project management, and a lack of mechanisms for safely and anonymously voicing concerns, might have prevented people from blowing the whistle.

Immediate action steps

Once the embezzlement was discovered, immediate action steps were taken to deal with those responsible for the embezzlement, try to recover the money, and to determine how to report the misappropriation. At the ABC Project, the Project Manager took immediate control of all financial responsibilities. The NGO also decided to confront Bob formally, offering him one final opportunity to explain. Bob could not produce any clear explanation for the missing money, and admitted only that he had failed in his responsibility to adequately manage the funds.

It was clear that Bob could not continue working for the organization, both to prevent further embezzlement and to demonstrate to staff that people would be held accountable for their actions and mismanagement would not be tolerated. However, dismissing a staff member is a difficult human resource challenge, and processes are dependent on organizational policy as well as national labor laws. Due to complicated labor laws, it was decided not to renew Bob's contract, which fortunately was expiring soon. Bob was paid through to the end of his contract and was asked not to come back to work. For a number of reasons, including the lengthy and uncertain process of filing a criminal complaint, Project ABC opted not to pursue a formal investigation, and therefore could not recover the money.

To be fully transparent, ABC Project reported the incident and remedial plan to the CEO of the NGO, and to the funding agency. The funding agency did not punish the ABC Project or the NGO; however, the reported embezzlement meant that the NGO Project no longer qualified for special "expedited financial reviews" by the funding agency. This meant that the annual performance review and budgeting process was now much longer and required more approvals. In addition, the financial offices at the NGO's US head office required additional monitoring and review procedures for the accounting process.

Strategies to prevent embezzlement

In moving forward, the ABC Project first took steps to discuss what had happened with Project staff. Staff had heard rumors of problems, and some had been interviewed in the course of the investigation. The ABC Project felt that being transparent about the problem would help employees see that the leadership was fully committed to ensuring accountability and would be proactive about preventing and deterring fraud in the future. The Project wanted to begin creating a system of compliance and accountability that would become an integral part of the organization's culture. Changing culture takes time, but the commitment to fraud detection and prevention was seen as an essential step toward promoting ethical behavior.

In addition, the Project shared the lessons it had learned with other NGOs. Although it was hard at first to overcome embarrassment at having been the victim of embezzlement, ABC Project quickly found that others had experienced similar problems. This confirmed the widespread nature of embezzlement concerns, whether petty or grand, proving that it was not unique to Project ABC.

Finally, Project ABC implemented a set of activities to prevent embezzlement in the future, including systems redesign to strengthen internal control. Project ABC contracted an NGO financial specialist to develop a better financial system. Within one month of Bob's dismissal, the new system was in place, with stricter internal controls on cash transactions, separation of financial functions, and proper steps to reconcile accounting records with bank statements. For example, cash was now kept in the main safe, with only the Project Manager having the keys. A voucher system was implemented with cash reimbursement or advances made only with written authorization from the Project Manager. The new vouchers recorded the names and signatures of those who (1) prepared the voucher, (2) authorized the voucher, (3) paid it, and (4) received the cash, again increasing the tracking and accountability of all cash flows.

A new "imprest" (petty cash) system was also implemented. Each petty cash transaction required a voucher and appropriate receipts and was tracked by category in a simple, user-friendly spreadsheet. When the account was depleted, the Financial Manager prepared a printed report from this spreadsheet, submitted it to the Project Manager for authorization, a cash count was conducted, and the account was refilled up to the limit. In another effort to separate financial functions, all major transactions were now paid only by the Project Manager, with lower level transactions approved by the new Financial Manager.

The old computer financial software system was reconciled as well as possible given existing records, closed out, and started anew. All vouchers were entered into the software accurately, and electronic files, bank statements and the pa-

per vouchers were sent to the NGO's US head office to be reviewed again, this time from all angles. Cash counts were conducted weekly by at least two people, to ensure that cash on hand was equivalent to that recorded electronically in the software.

The ABC Project immediately removed Bob as a bank account signatory, and began requiring two account signatories for every transaction, despite the inconvenience. A short-term administrative consultant was hired to write an organizational financial manual based on recent management policies and decisions. This administrative consultant facilitated the system implementation and ensured that the local staff were adequately trained in all areas of financial management. Spot-check audits were implemented to check cash balances and vouchers. Additionally, the NGO's US office began to conduct comparisons of the bank statements, paper receipts and financial reports on a monthly basis.

Three years later, the Project has not had problems. The NGO now uses the strengthened financial systems as a model for all new projects.

Conclusion

The global agenda for development means that aid money is being expanded to unprecedented levels. While not widely publicized, many organizations have dealt with the frustrations of financial mismanagement, embezzlement and theft. The experience of the ABC Project suggests several avenues for preventing embezzlement through tighter financial controls, better management policies and channels for disclosure, all of which increase the likelihood of detection. For projects that are just beginning, establishing a sound financial system should be a priority. Even in small projects with limited budgets, simple steps can be taken to reduce the risk of employee fraud. While no system is foolproof, changes in policies, procedures and reporting can help promote a culture of compliance and avoid corruption.

Further Reading

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