

Embezzlement In The Library

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ABSTRACT

This paper examines the unique aspects of fraudulent acts committed among non-profit organizations. By analyzing a specific non-profit fraud committed in a small East Texas town.

Keywords: Embezzlement; Non-Profit Fraud; Fraudulent Acts; NPO Accounting Systems

INTRODUCTION

It is estimated that non-profit organizations (NPOs) lose about \$40 billion annually to acts of fraud (Greenlee *et al.* 2006). This is a phenomenal dollar amount, but it represents only about 6% of NPO revenues (Association of Certified Fraud Examiners 2006). The purpose of this paper is to examine the unique aspects of fraudulent acts which are committed within NPO accounting systems, and to then analyze an incident which occurred at an NPO in a small town of Texas in the mid-90s. The goal is to use the analysis to gain a better understanding of the risks, exposure, and corresponding safeguards within which an NPO operates.

FRAUD DEFINED

The common perception of fraud includes any act of theft or deceit for personal gain. Using this definition, the act of making false statements on a resume would be a fraudulent act. Employee theft of parts, supplies or inventory would also be a fraud. Conducting personal business on employer time would be included in this generalized definition of fraud. While these acts may be unethical or even criminal, our interest here is accounting fraud; specifically, embezzlement.

Since embezzlement is a criminal act, it is appropriate to identify the specific legal requirements for obtaining a fraud conviction. It must be proved that the fraud included the following elements (Farlex 2012):

- a false statement of material fact made by the perpetrator
- the perpetrator knew the statement was false
- intent of the perpetrator to deceive the victim
- justifiable reliance on the false statement by the victim
- injury/loss to the victim as a result of the false statement

The range of embezzlement schemes is stunning. The Association of Certified Fraud Examiners, as part of a continuing effort to standardize fraud investigations, has codified/organized acts of fraud into the “Uniform Occupational Fraud Classification System”. The system identifies 49 separate schemes under which an institutional fraud can be perpetrated (Association of Certified Fraud Examiners 2004). Within that system, at least 19 of those could be characterized as accounting embezzlement schemes. Because of the breadth of imagination exhibited by perpetrators of embezzlement frauds, it is worthwhile to list these schemes:

- Larceny of Cash on Hand
- Larceny from Deposit Transactions
- Other Acts of Larceny
- Skimming of Unrecorded Sales
- Skimming of Under-recorded Sales
- Receivables Write-off Schemes
- Receivables Lapping Schemes

- Unconcealed Skimming of Receivables
- Skimming of Cash Refunds
- Shell Company Billing Schemes
- Non-Accomplice Vendor Billing Schemes
- Personal Purchases
- Ghost Employees
- Forged Check Endorsements
- Altered Payee Checks
- Concealed Checks
- Schemes by Authorized Check Maker
- False Voids
- False Refunds

THE PERPETRATOR

Although it may be misleading to stereotype the perpetrator of an act of embezzlement, accounting and audit authorities have evolved a profile – a list of typical behavior and personality characteristics – which seeks to help identify embezzlement risks. This “red flag” profile is best used when hiring accounting personnel. Unfortunately, and all too often, this profile is compared to an embezzler only after the embezzlement is discovered.

The significant personality traits embodied in an embezzler are (Detecting and Preventing Fraud 2011):

- Competence – accounting personnel are often among the most intelligent people in an organization. An intelligent, experienced accountant or accounting manager is absolutely equipped to conduct an embezzlement scheme. An embezzler believes that he knows the accounting system better than anybody else, and he believes he is skilled enough to conceal the fraud. Often, he presents the appearance of working harder than anybody else.
- Arrogance – In almost every fraud case, the perpetrator is not just intelligent, but he believes he is smarter than everybody else. Often, but not always, this character trait is exhibited as controlling, micro-management behavior. Sometimes, his arrogance reaches the level of being a “bully” where the embezzler seeks to intimidate others, both supervisors and subordinates.

In addition to these two basic personality traits, the following three elements must be processed through an embezzler’s mind before he commits the fraud:

- Pressure – The embezzler must feel/experience a powerful sense of personal financial pressure. This can be a need to pay for habitual behavior such as drugs or gambling. It can be an act of desperation such as the need to pay for large medical bills for a family member. Quite often, it is simply self-gratification in the form of anything from paying for cosmetic surgery to providing a better standard of living for himself or his family. In a word, indulgence.
- Rationalization – Before an act of fraud occurs, the perpetrator will almost always justify the act to himself. He may feel wrongfully disadvantaged in some way, or he may feel unappreciated for his work. He may justify the fraud as only a temporary “loan” with the intent to eventually repay it. He may justify his theft as being his share of the wealth of the organization.
- Opportunity – The recognition that he has access to organizational funds, and the theft can be successfully concealed. It is the belief that “I know how to do this and nobody is watching.”

Statistically, larger embezzlements are perpetuated by males – possibly because men tend to hold higher supervisory/authority positions than women – and research shows that as much as 75% of embezzled funds are stolen by men (Herman 2001). But most acts of embezzlement are committed by women, typically occurring in smaller amounts and in smaller organizations where (1) there are few, or only one, accounting personnel, and (2) compensation tends to be lower, thereby attracting fewer men (and more women) into the organization. Embezzlement schemes perpetuated by men tend to run longer before they are detected than are those perpetuated by women.

THE NPO

There are three characteristics which make an NPO particularly vulnerable to embezzlement:

- NPOs are typically funded by contributions, and a lot of it is in cash. Cash contributions to a NPO are typically poorly documented, if at all. There is no easy way for management to know how much money came in from the church collection plate, the Salvation Army bucket, or in the mail.
- NPOs are typically managed by volunteer boards. A volunteer board is often amateurish in composition, and can easily become more of a social organization than a conscientious oversight body. Further, there is a tendency within NPOs to assume that everybody is dedicated to the cause of the organization. Nobody wants to think that somebody would steal from an NPO.
- NPOs usually have small accounting operations. Adequate segregation of duties is nearly impossible in a small accounting shop.

Thus, an NPO offers all the necessary elements of opportunity to commit an act of embezzlement. There is plenty of undocumented cash, oversight is minimal, and the accounting shop often consists of one “business manager” who opens the mail, counts the cash, makes the deposits, maintains the books, writes the checks, reconciles the bank accounts, and prepares the financial statements.

There is another characteristic of NPOs which inadvertently contributes to an environment conducive to embezzlement. An NPO relies heavily on the generosity and trust of the public for funding. NPO boards almost always seek to avoid publicity of any impropriety, adopting the philosophy that improprieties – particularly acts of embezzlement – must be covered up, and often not even prosecuted, in order to preserve the public trust. Otherwise, the public trust will be lost, and the public will stop giving to the NPO. From the perspective of the board, it is a matter of survival.

The problem with this “cover up” philosophy is two-fold. First, the absence of public knowledge of frauds vigorously prosecuted may lead a prospective fraudster to believe that punishment will be slight. Second, cover-ups are sometimes revealed, and with consequences even more damaging than had the act been handled openly from the beginning.

THE CASE: EMBEZZLEMENT AT THE LIBRARY

Note: This is an actual case of embezzlement which occurred in the mid 1990’s in a small town in Texas. The names have been changed in an effort to protect the privacy and confidences of some very good people.

The author has lived in this small town for 29 years, serving on other NPO boards with some of the people involved in this case. This embezzlement was consciously and successfully hidden from the public; not one word was printed in the local newspaper, and the author learned of it when, in the course of researching this paper, a former board member told her about it. This is the first and only comprehensive record of the case except for the actual court documents.

To the extent possible, the author interviewed the people involved in this case. The perpetrator, who now lives in a town near Houston, was located, but it was decided not to confront her with her past deeds. Her sister, who still lives here and surprisingly (to the author, at least) attends church with the author, was interviewed about her recollections.

Diane had been employed for six years as the bookkeeping clerk and promoted to business manager in some point at Bidwell Memorial Library. The library, founded in 1923 by a pioneering industrialist family, was an independent non-profit organization which relied on contributions from the community for funding. The Bidwell Foundation often provided funding for capital projects at the library. Over the years, the community and the Foundation had been generous to the library; by the mid 1990’s, the library had accumulated a large endowment fund which helped smooth out any funding bumps in its operating budget. The library, along with its operating

budget and endowment fund, was governed by a board of directors. Some board members were prominent and respected members of the business community; others could be classified as social appointments.

In 1996, the library was at a crossroads. The building needed renovation, but the cost of the renovation caused the board to consider the possibility of building a new larger modern library to incorporate all the exciting new electronic technologies which were then coming to market. The Bidwell Foundation never-the-less made a \$1.6 million grant to the library for renovations, with the stipulation that the use of the money would be reconsidered if the board decided to instead build a new facility.

The director of the library, Aaron, recently hired by the board, was an enthusiastic man; dedicated to his profession and excited about the future of his library. Aaron was not, however, a numbers person. The accounting was left, mostly unsupervised, to Diane. After all, Diane was experienced, competent, and had the confidence of the board. Then, Aaron got sick with an ultimately terminal illness that sapped his energy and limited his time at the library. Diane was left alone with millions of dollars within her reach.

Oscar was a member of the board and one of the most respected CPAs in town. One afternoon in October 1998, a few select members of the board were called to an unscheduled meeting at Oscar's office. Included in the meeting were the local bank officer, Kay, and a prominent estate lawyer, Rowland. Kay served as treasurer of the library; Rowland chaired the library board. Oscar presented his concerns about the recently completed fiscal year-end financial statements. He felt there was something wrong with them. He couldn't figure out exactly *what* was wrong, but the numbers just didn't work right, and he had a bad feeling about them.

It was decided that Kay would go to the library and pick up the bank statements for the last six months. As she drove to the library, Kay became uneasy about confronting Diane. She decided to tell Diane that there was no problem, but there must be some timing differences between the fiscal years which were making the budget-to-actual numbers look funny. Diane was cheerful and quickly pulled the bank statements and handed them to Kay. "What a relief; that was easy," Kay thought to herself as she walked to her car. Later that day, Diane gathered her personal belongings and left the library early, telling the librarian that her child was sick. Diane never again returned to the library.

Kay returned to her office at the bank, where she began looking at the bank statements. Kay was a banker, not an auditor, and at first she was not even sure what she was looking for. She decided to match the cancelled checks to the statements (back in 1998, the actual cancelled checks were still included with the monthly statement in the mailing to the customer). A sinking feeling washed over Kay. There were missing cancelled checks; lots of them.

By the time Kay ticked off six months of bank statements, it was late. She was alone in the bank, and it was dark outside. There were missing checks totaling over \$100,000, and suddenly Kay was scared. "People have been killed for less money than this," she thought to herself. She called Rowland's home and told him what she had found. Rowland offered to come to the bank and escort Kay to her car, but Kay decided she was over-reacting and declined his offer. But the next day, Kay contracted for the installation of a security system in her home.

The library banked at Kay's bank. Copies of all cancelled checks were maintained on microfilm files, and the first thing the next morning, the bank started hunting down the missing checks. Oscar and Rowland waited with Kay in her office. It did not take long. Many of the missing checks had been written to the computer services business operated by Diane's husband, and although two board member signatures were required on a check, the signatures were clearly forgeries. Kay later told the author "you have no idea how sick a feeling it is to see your own name forged on a check." Rowland picked up the phone and called the police.

A small town police force is not usually qualified to conduct a white-collar criminal investigation, and the city police recommended that the FBI be called in. The case was turned over to the Feds without protest from anybody. Working through the holidays, the pieces were meticulously assembled, and on January 21, 1999 the U.S. Attorney, Eastern District of Texas, filed the indictment charging Diane with embezzlement of \$407,230.24 from library funds during the period 1996 to 1998.

It was apparent that Diane's husband was involved in the scheme because, if nothing else, he personally deposited the forged checks into his business bank account. But he insisted that he was unaware of the scheme; that Diane kept the books for his business, and he just thought everything was fine. He claimed that he innocently/ignorantly deposited whatever she gave him to take to the bank. The investigation, however, included interviews with the bank tellers, and they told a different story. The tellers stated that he would routinely make a noticeable effort to use different tellers when he made his frequent deposits, and that, from time to time, he had told tellers that he was doing a large computer installation for the library.

Kay also recalled a conversation she had with Diane in the early days of Diane's forgery scheme. A check had been issued with only one signature, and Diane came to the bank to tell Kay because she was worried about it. Kay told her that it was okay because the bank policy is to compare signature cards and authorizations only when a check exceeds a specified amount. Since the single-signature check was below the threshold amount, there would be no problem; the bank would process the check without pulling the signature card or asking any questions. After Diane's scheme was discovered, Kay realized that she had innocently helped Diane by giving her the knowledge that nobody was watching at the bank if the dollar amount of a forged check was below the bank's threshold amount. Using this knowledge, Diane never forged a check which exceeded that threshold amount.

Although \$400,000 had been stolen, and although Diane's husband claimed that he never noticed the massive pile of money in his business and in his household, it had mostly disappeared by the time Diane was arrested. Her claim was that it went to pay medical bills for her sick child, but library employees including Diane and her family were covered by medical insurance under the city employees' group policy through an agreement with the city.

Diane was jailed and did not / could not post bond. In June, Diane accepted a plea agreement whereby she would plead guilty to the charges, pay restitution, and no charges would be brought against her husband. She was incarcerated at the Federal Prison Camp for Women in Bryan, Texas, a federal "country club style" minimum security facility. Diane was released from prison on June 18, 2002, having served three years in federal prison plus about five months in the county jail while awaiting trial.

The restitution agreement was allocated between the library and the bank. The bank, by federal law, was responsible for up to 60 days of improperly authorized disbursements upon receiving notice of a fraud. Thus, the bank was on the hook for about \$35,000, the amount of Diane's forgeries for August and September, 1998. Restitution payments of \$20 per week were still being paid to the bank as recently as 2006, but no current bank official would confirm if payments continue to be made. The bank has since been acquired by a large national bank which is no longer headquartered locally.

In 2000, ownership of the library was officially transferred to the City, but former library board members even today insist that this had nothing to do with the embezzlement incident. All employees and all accounting and administrative functions are now the responsibility of the City. In 2001, the library moved into a beautiful new building which was paid for by a \$5 million contribution from yet a different (ostensibly anonymous) charitable trust. The City owns and operates the new building. Since the time of the embezzlement incident, there has been a complete turnover in City management. The current City Attorney could not find any record of the case in the City's files.

Today, the library board oversees a relatively small budget which is used to purchase content for the library. Of the board members interviewed, none would disclose or discuss how the library's old endowment fund or how the \$1.6 million renovation grant funds were disbursed. The current board would not confirm if restitution payments are being made currently or if any restitution was recovered at all.

CONCLUSION-LESSONS LEARNED

The basic element of this case was the absence of adequate internal controls. There was progressively less oversight of the business manager, until a point was reached that oversight became almost nonexistent. The most significant lesson learned from this case is how important it is to have a strong supervisory environment. Like most

NPOs, this was the responsibility of the board of directors, but a series of successes (the renovation grant and the endowment fund) created a false sense of security among the board members, and personnel problems (the tragic illness of the library director) distracted attention from their oversight duties and caused the board to default broad new authority to the business manager. Diane would not have had the opportunity to commit her embezzlement had the board been more attuned to the degradation of supervision which progressively occurred over time.

Second, a frequent and dismaying lesson learned is that NPO boards all too often place an excessive amount of trust in one person. A recurring theme in fraud cases is that the theft was perpetuated by an individual who was believed to be loyal and trustworthy. A culture of “trust without oversight” is dangerous to the individual and to the organization. Internal controls protect the individual from accusations and suspicions. Conversely, a relatively simple set of internal controls provides an element of protection to the organization. Implementing safeguards against fraud and embezzlement is not an act of distrust, but rather a best practice that should be exercised by all NPOs.

Third, don’t let the criminal get away just because it is embarrassing to prosecute them. The lesson learned from this case is that, unfortunately, crime does pay when it is embezzlement from an NPO. The argument, that prosecution does no good because the money is already lost, is a disservice to our society because it removes the consequences of a criminal act. In this case, three decisions were made which allowed none or only minimal consequences:

- The case was turned over to federal instead of state prosecutors. The feds did a great job of documenting the case, but a federal prosecution almost guaranteed minimal incarceration in a country-club facility. Had the case been referred to the Texas Ranger Investigation unit, it would have almost certainly been prosecuted more aggressively.
- An easy plea bargain was offered in exchange for an easy conviction. Diane’s husband was clearly a party to the crime, but he was allowed to remain free, probably for the benefit of their young children.
- Restitution was agreed to, but it was minimal and ultimately not enforced.
- The case was kept out of the local news media. The message that “she got caught, and she went to prison” was not publicized as a deterrent to other prospective fraudsters.

Fourth, the board was at a disadvantage because they had no uncompromised transaction documentation. The bank statement should be retained in organized file for all board members to easily access along with the check register and the receipts of all donations. Someone independent of the check processing should receive the unopened bank statement and review the activity and the signatures on the cancelled checks for any possible forgery before passing it on to the person for reconciliation. All checks should be mailed by the treasurer and not by the person who issued the checks. A list of issued checks should be maintained by the treasurer and matched to the periodic bank statements. By doing so, any unauthorized disbursements would be quickly identified.

Fifth, an independent audit should be performed annually. Prior to this case, there had never had an independent audit. While an audit report emphasizes that it is not a search for fraud and it does not certify that no fraud has occurred, an audit does remind a potential fraudster that somebody is watching. It is notable that the United Way now requires an annual audit report from each of its local member organizations (Gallagher 2005).

Sixth, funds should be made available to operations only to the extent immediately necessary. One of the most important lessons learned in this case is that the organization itself can create circumstances of great temptation. The library mixed its operating funds, its endowment fund, and (the icing on the cake for the embezzler in this case) a \$1.6 million grant of cash that sat untouched for two years. It made it possible for Diane to move and shift money in and out of accounts in an effort to hide her embezzlement activity. Those funds should never have been accessible to her.

Finally, a lesson learned is that fraud exists even if you don’t see it. During interviews with board members, questions about controls over cash were asked. In every case, the response was “oh no, there was no problem with cash. This was about forgery.” It makes you wonder how much was stolen that nobody ever knew about.

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