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## Defalcations

F. W. Lafrentz

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## Defalcations

By F. W. LAFRENTZ

The modern banking, manufacturing and distributing systems have been matters of slow growth. As late as the beginning of the nineteenth century the unit of organization in each line was very small. The agent abroad, when one was needed, was apt to be a man conducting his own business independently and compensated by a commission which was—in the case of a sales agent—frequently on a *del credere* basis. Those houses which made a business of acting as agents had many of them been long established. Their continuity was maintained for generations, and the relationship of agent for any house once established was rarely disturbed. Banks operated through correspondent banks rather than through branches, and banks were much more interested in exchange and collections than in deposits and discounts. Under this system of organization the personnel of any particular house was not large and each individual was known personally to the master. The master generally had a strong personal interest in each member of the staff, studied him, used him, and advanced him as much as possible, for advancement for any member of the staff meant increased business and increased profit for the master. Cash and securities were to a large extent under the sole control of the master or, at most, of a single confidential clerk. The business was supervised by the master in person and good or bad conduct met with prompt reward or punishment. Each man engaged in the business was an apprentice, a fellow-craft, or a master—and master meant master. When a workman had progressed to the point where he was entitled to be known as a master workman he started his own business. This was true whether the business was that of manufacturing, distributing or banking. The apprentice was one who was studying the business and in the meantime furnishing as much and as valuable service to the master as was consistent with that purpose. He usually lived in the master's household and was considered one of his family, was compensated by board and lodging, and at the end of his apprenticeship was furnished with certain clothing, his kit of

tools or other equipment, a small sum of money and a certificate that he had completed his apprenticeship. Ordinarily he was then registered with the guild as a fellowcraft or journeyman, and traveled seeking employment where he could find it. He was rarely content to settle down for any length of time, for by travel and service under several masters he hoped to secure a thorough knowledge of the trade or business and to fit himself to become a master workman. When that time came, he either started a new business in a small way on his own account or was accepted as a partner in an established business. In time, if successful, he retired to make way for the next generation.

All were in close touch with each other. The chances of defalcation were reduced to the minimum. Each was more or less interested in the other, and industrial difficulties were rare. Dishonesty in a trusted employee, while not unknown, was rare and apt to be soon discovered. When discovered, punishment was sure and swift, and in most cases during the middle ages it was death. With the development of modern machinery and of the modern business organization, all this changed. Economic conditions in most lines would not permit a small organization to compete successfully. Large capital became necessary—larger than could be found in the hands of single individuals. As a multitude of owners did not make an effective executive, the corporation developed. This produced a new class of people who were interjected between the owners and the workers, and they then took the place to a certain extent of the masters. They have been developed to a very high degree of efficiency and are known as executives. The motives governing them, however, were not at all times the same as those governing the masters. When master and owner were synonymous and the personnel was small, any neglect of the personnel was reflected in the results of the business, with the result that either the individual who was a misfit was dropped or the master took upon himself the task of changing him so as to make him fit. So long as the organization of business was made up of small units, the dropping of an individual by one master did him but little harm for there were many other masters, and he would, quite likely, fit in somewhere else. The executives operating large units found themselves under the primary necessity of producing dividends or of showing good cause for not doing so, as owners had no object in investing capital in a business except to realize

dividends either at once or prospectively. Unless executives could produce these they were useless and were dismissed from the service. As always happens, a primary necessity is met, and executives did produce dividends, but in many cases without reference to the effect of overwork or of unsatisfactory or unsafe working conditions upon the employees. So long as this continued unrestrained, it provoked rebellion, dishonesty, disloyalty and what not on the part of the employees, for abuse is always compensated in that manner. They knew they were being imposed upon, and knew further that when—through disease or industrial or other accident—they became unfit, they would most likely be thrown aside to sink or swim. In case of premature death their families were frequently left in want. The condition this produced in England has been well set forth by Charles Kingsley in some of his stories. Fortunately all this has changed in the course of time; owners and executives have learned that they are their brother's keeper. They have also learned that it is not only inhumane but economic waste to neglect employees. They have learned that one who works with his hands or with his brain will produce more in eight hours a day than he will in ten or twelve, and will retain his health and efficiency longer.

Everywhere we find trained personnel managers, welfare workers, employees' committees and many other means for giving voice to the needs and wishes of the employees and bringing them to the notice of the executive and when necessary to the notice of the owner, thus bringing employer and employee into closer connection. Every competent executive feels that his object in life is, not merely to use the people employed under his direction to the best advantage of the owner, but so to use them as to protect them against their frailties, to develop them to the best of his ability and, should the relationship of employment at any time cease, to send them away better equipped to live their lives than they were when they came under his direction. This is the inspiration of the capable executive, for he knows that his work is of a class inferior to none in its importance and in the value of its results to the human material which comes under his direction.

Owners and executives should do everything in their power to create conditions which will discourage any kind of dishonesty and will lead to prompt discovery of any such act which may occur. This lesson has been very well learned, and business

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organizations of the better class have been arranging so as to reduce to as near a vanishing point as possible the opportunity for undetected dishonesty.

Obviously there will remain some opportunity for dishonesty, and sometimes the necessarily small compensation paid those of limited capacity adds to the temptation. The comradeship resulting from common employment makes immediate supervising employees and associates trustful; the ordinary precautions are often neglected. When dishonesty occurs, not only does the owner suffer, but the dishonest employee has lost his character and has thus lost his opportunity for a successful life and drops to the class of drifters, of no value to himself nor to the community. The wrong thus done the employee we should feel is even more serious than the harm done the owner whose property has been diverted.

However, after all is said and done, the one thing that impresses me in my experience as a surety man is the high average of honesty on the part of men of all stations, and the thing that impresses me next is that a large number of defalcations which occur would never occur if proper accounting systems were used and regular audits maintained. A few instances which have come to my attention recently will, I am sure, interest the readers of this article, and bear out what has just been said.

A young woman in the employ of a telegraph company caused a loss of about \$450 in the following circumstances: In one office she concealed cash receipts and finally overpaid herself on account of salary thirty dollars. Being transferred to another office, she concealed cash receipts in several instances and kept money received for transfer by telegraph. On being discovered and dismissed, she calmly proceeded to another city, took another name, and was employed by the same employer at two different places, and stole in a very short time over \$3,000 more, apparently using similar methods. The auditing department of the company ultimately traced the transactions resulting in the loss, of course.

A woman serving as assistant bookkeeper for a coal company was found short in her accounts about \$80,000. She expended the money in the purchase of securities, of jewelry and of an automobile. The salvage recovery was very considerable in the circumstances. The methods employed by this person to secure the funds of her employer were bold but simple. She drew

cheques to the order of fictitious persons for fictitious bills for supplies, presenting the cheques so drawn to the bookkeeper who presented them to the treasurer, with his approval. The treasurer affixed his signature and returned them to the defaulter to be forwarded to the payees. She then forged the endorsements thereon and collected them either through her own bank account, or placed them in the cash drawer of the employer, withdrawing an equal amount in cash in lieu thereof. There were approximately 250 separate items of theft in this case, and although cheques bore the endorsement of the defaulter, as she deposited them to her own credit, the defalcation was not discovered for over a year. How a defalcation of this amount, made up of so many items, could have accumulated before discovery thereof is a mystery. The bank that accepted them for deposit was certainly negligent, and whoever was charged with the reconciliation of the bank account of the company certainly failed to scrutinize them, for it seems to me that the most elementary examination should have revealed the defalcation.

A certain man was agent for four coal companies and vice-president of a bank. These companies were large. For some months at least, this person was kiting cheques between the several companies. He deposited their cheques to his own credit. Then, as vice-president of the bank he made false returns of the bank balances, until he succeeded in converting to his own use upwards of \$107,000. Then discovery came. In the meantime the bulk of the proceeds had been dissipated, and the loss to his employers was far in excess of the suretyship carried. Even a casual inspection of the canceled cheques returned to any one of the coal companies should have led to discovery of the defalcation. But the auditing departments failed to function properly.

The president of a bank in one of the Rocky Mountain states also headed a real-estate company which he controlled. This real-estate company needed funds for development, so for a period of more than a year, using his own bank and another, he filched \$55,000, covering his tracks by committing forgery and by false entries in the books of the bank.

In the state of Indiana a successful business man commanding the respect of all who knew him, as the crowning event of his life organized a national bank, a savings bank and a trust company. Upon his retirement his sons and son-in-law succeeded to

the management of these three institutions. Becoming interested in oil promotions they found themselves in need of funds and proceeded to make improper loans to themselves, concealing these loans from the directors and the bank examiners by transferring them from one institution to another as necessity demanded. As the loans could not be realized ultimately the banks were forced to close their doors. Not until then was the true condition disclosed.

In a western state a father, mother and son operated a bank. The son proved unfaithful to his trust. The bank failed because of certain manipulations of his which resulted in a loss of about \$70,000 to the institution. The case is still under investigation, and the real facts in the case have not as yet been ascertained.

The cashier of a bank in northeastern Pennsylvania became party to the kiting of a cheque by a depositor in the year 1919. Additional cheques were kited by the same person thereafter, and in October, 1923, a loss amounting to upwards of \$97,000 was created. The suretyship bond was only \$10,000, and the heavy unsecured loss to the bank caused its failure. How these frauds went undetected for so long a time when so much manipulation had to be resorted to is beyond me.

In the latter part of last year a young woman in the employ of a small bank drew a cheque for \$2,800, signing the name of a depositor in the bank there, and making it payable to a fictitious person. She then introduced herself at another bank, opened an account there and deposited this cheque to her credit. By drawing three cheques against it she exhausted the amount. The fraudulent cheque passed through the exchanges and was paid. Having successfully gone through with this transaction, she indulged in similar ones during the succeeding months, until the depositor sought information regarding entries against his balance, no vouchers covering them having come to him. Inasmuch as the evidence had been destroyed, it was most difficult to get at the bottom of the matter. Ultimately, clever detective work disclosed the identity of the culprit, the young woman confessed and her friends made good the loss. In observing this case one wonders: first, how a forgery could so easily pass the teller of the bank on which the cheque was drawn; and, second, how the young woman could succeed so readily in opening a bank account at another bank without proper introduction and identification.

Because we served notice on an employee of one of the largest banking institutions of the northwest of our intention to retire from our suretyship in his behalf, he resigned his position, went on a hunting trip, and returned to his domicile. In the interim a defalcation in excess of \$150,000, for which he appeared to be responsible, was discovered. We were notified in due course and as the loss was so very large, the president of the bank came to see me personally about it. I asked him if he felt certain that all of the loss was created during the currency of our bond, which was about two years. He was positive that such was the case, for he felt that it would be impossible for anyone in his institution to cover a shortage for any considerable period of time. I advised him to state the amount of loss as of the date of discovery and with this prima facie proof in hand caused an examination to be made of the books and accounts. We succeeded in finding about \$75,000 of the total to have been occasioned prior to the date of our obligation of suretyship. That much could be traced to the satisfaction of the claimant bank. No doubt the sum was larger than that, but vouchers had been returned, statements and other evidence destroyed for one reason or another, and we were obliged to let it go at that in face of the assertion of the culprit that he had taken a thousand dollars a month for more than twelve years. He was in charge of foreign accounts and manipulated them with ease.

These instances might be added to indefinitely, for never in our history have so many defalcations come to our notice as during the last few years. And some of them are really staggering. I call to mind, as I am bringing this article to a close, the failure of four national banks within the last two years, due to the dishonesty of one or more of their officers. In one case the sum total embezzled was \$500,000; in another it was \$600,000; in another it was \$800,000; and in another it was \$1,600,000. In the last instance the president of the bank took in addition all readily convertible securities contained in the safety deposit boxes rented by the bank to customers. He obtained access to these by means of duplicate keys.

Almost every loss resulting from dishonesty on the part of the principal on fidelity bonds brought to my attention is the result of some omission in accounting supervision which is perfectly apparent after the loss occurs. Of course no system, how-



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ever perfect, is an absolute shield against a designing defaulter. There is always a weak spot somewhere, but a proper system of accounts usually makes attempts of the kind easy of detection. Public accountants ought to be employed not only to install accounting systems adaptable to the particular businesses, which insure the introduction at the same time of proper safeguards, but also to audit the accounts regularly, for they, from the nature of their calling, are taught to take nothing for granted and to insist on receiving information regarding that which is obscure or out of the ordinary.