

# FRAUD IN HOUSES OF WORSHIP

## What Believers DO NOT Want to BELIEVE



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**Houses of worship** are particularly vulnerable to fraud, but most feel they are impervious. The authors provide reasons why churches feel so bulletproof and seven practical steps fraud examiners can use to help churches stop fraud in its tracks.

**A**n accounting professor who teaches a fraud investigation class recently told a story about a student in her class who approached her for help on a personal project. The student's church had asked the student to attempt to determine the dollar amount of damages in a recent embezzlement. The perpetrator, a former church secretary, had been defrauding the 200-member church for 18 months by writing herself duplicate paychecks, stealing cash from donation deposits and taking out credit card accounts in the church name, among other schemes.

The church discovered the fraud when the secretary was called away for a family emergency, and the previously inattentive manager received a phone call about an unpaid credit card bill. The manager did not know the credit card existed. Because the church had not segregated employee duties, the secretary had free rein over all aspects of church finances: she kept the books, paid all the bills, handled cash receipts, managed the payroll, issued paychecks and reconciled the bank account. The sky was the limit for her fraud. A simple search of public records would have revealed that the secretary was in financial trouble — a serious red flag for fraud. But the church did not conduct that search until it was too late.

The professor was not surprised by such a common scheme. However, she was taken aback when she opened the student's work file to review the case. She recognized the name of the perpetrator as a secretary in her church and confirmed this identity by questioning the student investigator. Internal controls in the professor's church were a bit better — it had segregated some accounting duties — but were still insufficient. In fact, internal controls were bad enough that no one could ever know if the secretary stole from the professor's church.

It was quite common for people to drop cash and checks by the church office during the week and leave them with the secretary for use in special funds, such as one to aid local homeless people. It would have been easy for the secretary to simply pocket some of the funds, and no one would have been the wiser. The secretary eventually resigned; it is unknown if she stole from the professor's church during her tenure there. She was replaced with another secretary who had her own financial problems — her home was in foreclosure within six months of taking the job.

The professor advised church officials that they needed to improve internal controls, but the staff members believed that “no one would ever do such a thing here.” Indeed, fraud examiners who deal with finances, fraud and internal controls in houses of worship may be labeled overreacting conspiracy theorists when they tell church staffs they may have fraudsters in their midst. However, fraud examiners know that houses of

worship — churches, synagogues, temples, mosques etc. — are among the most vulnerable entities.

**WHY ARE CHURCHES SO VULNERABLE?**

Churches typically emphasize the importance of good acts and deeds, so we might expect their tone at the top would protect them from fraud. Not so. A variety of factors lead to the opposite situation. Donald Cressey’s research on the fraud triangle showed that pressure, opportunity and rationalization are present in almost all frauds. (See pages 10 through 14 of “Occupational Fraud and Abuse,” by Dr. Joseph T. Wells, CFE, CPA.) However, some forms of these three elements are more prevalent in houses of worship.

**PRESSURES AND RATIONALIZATION**

In many cases, ministers, secretaries and other staff members in houses of worship are expected to work long hours on paupers’ wages for the love of a deity, while mingling with the wealthiest of society. These working conditions can create resentment, desperation and rationalization, such as “they owed it to me.”

Church staff and volunteers can also face financial problems from feeding vices and addictions. A pastor or church member with a serious vice likely will feel that any resulting financial pressure is highly “non-shareable.” Cressey emphasized that the non-shareable aspect of a pressure made it a particular impetus for fraud.

**OPPORTUNITY**

Churches might be the poster child for fraud opportunity for a variety of reasons. First, they tend to be small organizations. The ACFE’s 2010 “Report to the Nations” found that fraud happens most frequently in entities with less than 100 employees — a category that would include most houses of worship. Because of their small size, churches tend not to be willing or able to hire professionals who have significant financial expertise or are knowledgeable about internal controls. Also, by default, small organizations find it difficult to adequately segregate duties or install independent checks.

Secondly, trust among employees and volunteers fuels church engines. Unfortunately, church cultures foster the belief that trust is an adequate control — a fallacy that can create affinity frauds, such as the \$78 million fraud that Daren Palmer, a pillar of his church, perpetrated against members. (<http://tinyurl.com/4xae883>) Because of the tight-knit culture, it is common for churches to hire family members and close friends, which increases opportunities for collusion.

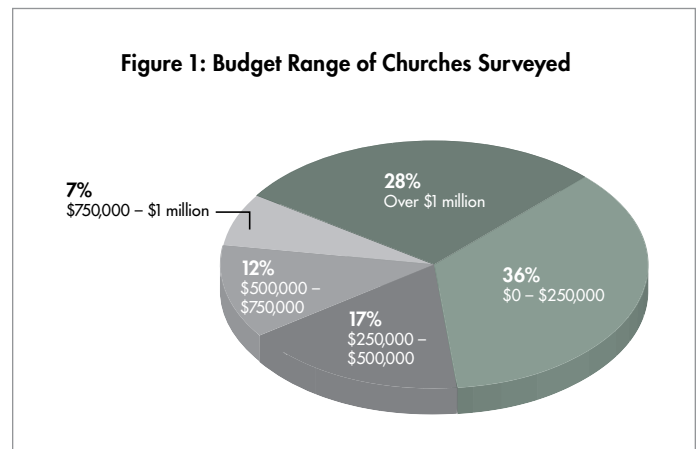
Also, churches often do not create the perception of consequences that is necessary to deter fraud. History and human nature show that when a fraud does occur in a church, staff members often hide the crime so they will not upset members and other potential donors. In the opening case of the embezzling church secretary, the fraud at the first church was never publicized or prosecuted because a close relative of the secretary

was a significant donor to the church and a powerful member of the church board. In addition, U.S. nonprofits generally are not tightly regulated. State attorneys general and the Internal Revenue Service (IRS) are the only entities in a position to provide regulatory oversight to churches. Attorneys general are typically preoccupied with other issues. And churches are exempt from the rule that nonprofits must file informational tax returns with the IRS. So only parent denominations, church governing boards and possibly church members are likely to be privy to financial information.

**DO THEY REALLY BELIEVE IT CANNOT HAPPEN IN THEIR CHURCH?**

To get a feel for churches’ perceived fraud invincibility, we interviewed individuals who provided financial oversight in 132 U.S. houses of worship. Our survey included a broad variety of denominations (primarily Christian) of differing memberships, annual budgets and numbers of employees. Memberships ranged from 25 to 37,500, with an average of 1,168 and a median of 425. Annual budgets ranged from \$10,000 to \$30 million, with an average budget of \$1,089,045 and a median budget of \$430,000. Figure 1 illustrates the distribution of church budgets. Most of these churches had at least a few paid employees, and some were affiliated with national or international denominations providing some oversight role.

Fraud had indeed reared its ugly head with 13.4 percent of the church leaders acknowledging they had experienced a fraud



in their organizations within the previous five years. The estimated sizes of the frauds ranged from a few dollars to \$35,000. We suspect that the actual frequency and dollar amount of fraud were seriously underreported for two reasons.

First, our interviews indicated that churches generally lacked proper internal accounting controls, including segregation of duties, and that even if those controls were in place, the churches did not consistently follow them. The reported levels of controls in most of these institutions were so poor that they probably harbored many undetected frauds. For example, most of the churches we surveyed did not separate record keeping from as-

set custody, particularly with respect to the payment of expenses. Also, in most cases, the same person who wrote the checks also reconciled the bank statements. Figure 2 illustrates the frequency of various control violations that we found in churches.

The second reason we suspect underreporting is that it is likely that some interviewees were unwilling to admit frauds, or their churches did not tell them about discovered crimes. Ministers and church elders are accustomed to holding the “sins” of their flocks close to the chest, and this emphasis on confidentiality may prevail even in the case of white-collar

sins. The cloak of secrecy may mean that the right hand does not know what the left hand is doing within the church. Also, in the same way that those who have been scammed are often too embarrassed to admit their victimhood, church ministers and other financial leaders may be hesitant to reveal their vulnerability.

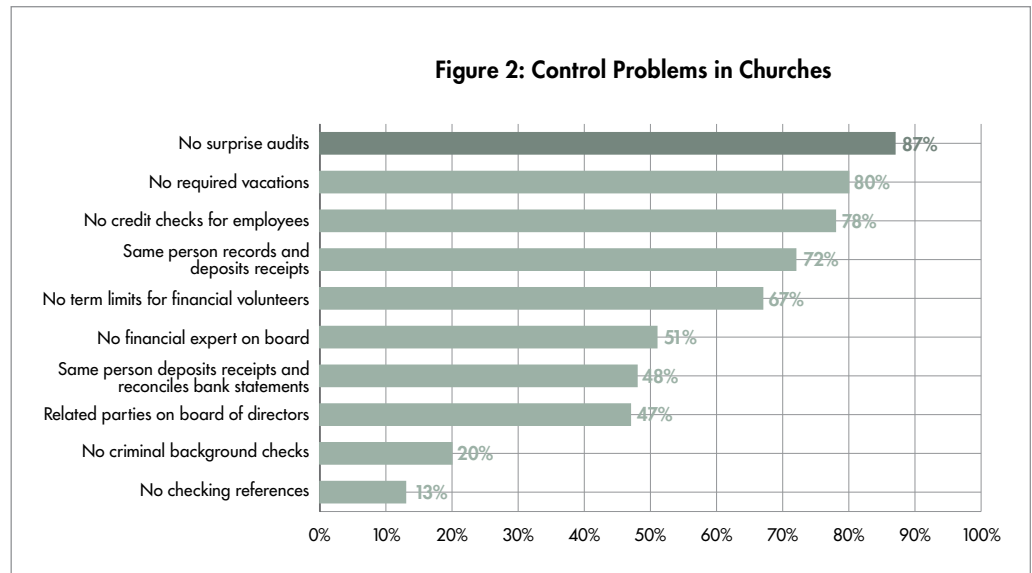
We asked interview participants how vulnerable they thought their organizations were to employees’ or members’ illegal or unethical financial actions. Despite generally poor levels of controls, none of the respondents — even those in organizations that had experienced fraud — felt their organizations were extremely vulnerable. Almost a fourth said they were not vulnerable at all to fraud, and nearly two-thirds said they were only slightly vulnerable. Table 1 on page 22 presents the perceptions of vulnerability to fraud within churches that experienced a fraud within the last five years and those that had no reported fraud over the same period. Overall, most believed that “it wasn’t going to happen here.”

### WHY DO THEY FEEL SO BULLETPROOF?

The lack of a realistic perception of vulnerability is driven by several psychological mechanisms including overconfidence, ignoring base rates and confirmation biases.

#### Overconfidence

Overconfidence is a particularly difficult psychological barrier to overcome, even among those with high levels of education. Psychologists and economists, who have studied the overconfidence phenomenon since the 1960s, find that this mindset results from two factors. One might be called the Lake Wobegon effect (from Garrison Keillor’s “A Prairie Home Companion”): we all think we are above average.<sup>1</sup> Secondly, we tend to have an illusion of control over circumstances.<sup>2</sup> The combination of these two factors leads to unrealistic optimism. Researchers find that people are more overconfident when they are faced with



difficult or very difficult tasks. The “hard-easy effect” suggests that they are more vulnerable to fraud when 1) it is difficult to assess the likelihood of fraud, and 2) they lack the skills to appropriately safeguard their most valuable assets.

#### Ignoring Base Rates

Cognitive researchers find that even when people are provided information on the likelihood of fraud, they tend to ignore “base rates.” (A base rate can be defined as the average number of times an event occurs divided by the average number of times on which it *might* occur.) Consequently, if we were to tell a group of church leaders that 20 percent of all houses of worship (a hypothetical number) are likely to be victims of fraud within the next five years, their over-optimism will lead almost all of them to conclude that they will *not* be victims of fraud. In other words, people tend to place themselves into the group that is not affected by frauds instead of accurately assessing if their particular situation is more reflective of the group that will experience a fraud.

#### Confirmation Bias

Auditors and fraud examiners do not tend to conclude that assets are safe unless they have assessed the quality of the controls in place. The “average Joe,” however, suffers from a confirmation bias. In other words, Joe will rely too much on confirming evidence, such as “we have never had a fraud before.” At the same time, he will dismiss contradictory arguments, such as “we do not have adequate controls in place.” This bias increases with the amount and strength of confirming evidence. It will decrease with contradictory evidence but at a much slower rate.<sup>3</sup>

Walt Pavlo, the perpetrator of a multi-million dollar fraud at MCI and WorldCom, expressed confirmation bias well. At the Oklahoma State University 2008 Financial Reporting Conference, he was asked where the auditors were while he was committing his

Fraud Occurred in Last 5 Years	Perception of Vulnerability to Fraud					Grand Total
	Not Vulnerable	Slightly Vulnerable	Vulnerable	Very Vulnerable	Extremely Vulnerable	
Yes	24%	53%	17%	6%	0%	100%
No	25%	66%	6%	3%	0%	100%
Total	24%	64%	9%	3%	0%	100%

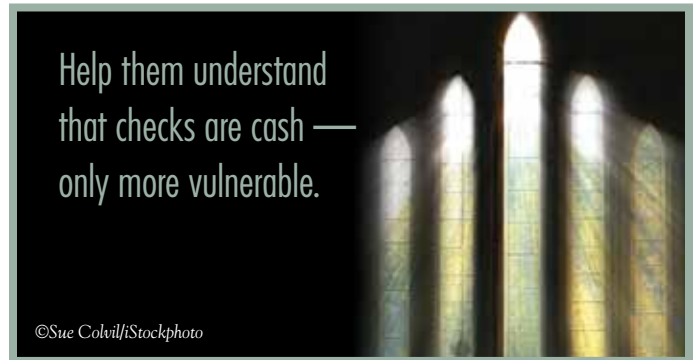
Table 1

crime, which involved overstatement of receivables. His response: “No one wants to question good news.” In the for-profit world, the evidence has shown that excessively high revenues are a much bigger red flag for fraud than excessively low revenues.

**HOW TO HELP**

Based on our survey findings and observations, we offer seven steps fraud examiners can take to help churches avoid fraud:

1. Freely lend your expertise to small nonprofits and church boards to help them understand and implement the concept of separation of duties and independent checks.
2. Help them understand that checks are cash — only more vulnerable. You could explain this by saying, “If someone steals a \$1 bill from you, the most they have stolen is \$1. If they steal a \$1 check from you and then add a few zeroes, they have stolen much more.”
3. Combat overconfidence through education and training. Church boards must understand that trust is never an effective internal control.
4. To achieve adequate perception of detection and consequences, encourage church boards to be open and forthcoming about problems and consequences and to prosecute when appropriate. Such prosecutions could have prevented the secretary in our opening story from moving to the next church to possibly do the same thing.
5. While churches may be in the business of “bringing the good news,” it is a good idea to remind them that at least when it comes to financial affairs, they should always question news that is “too good to be true.”
6. Church leaders are becoming aware of the need (and sometimes the legal requirement) to conduct background checks to specifically find sex-related crimes. Help them understand that they also can use criminal and credit checks to protect the church’s financial assets and help ensure that donors’ wishes are honored by applying donor funds to good deeds, rather than using them to feather the fraudsters’ pockets.
7. While we have a psychological tendency to ignore base rates, we tend to respond to stories. These stories help bring the reality home; so share stories about church frauds. And if you are feeling really brave, leave a few copies of *Fraud Magazine* in the church library.



Individuals who contribute to religious institutions or other nonprofits do so with the intent that their sacrifices will help the institution and/or the parties it serves. Fraud examiners can help these institutions ensure good stewardship over these resources and prevent the unintended distribution of resources to the pockets of fraudsters. An essential element of providing this help involves convincing them that yes, it can happen here. 🔍

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<sup>1</sup>Alicke, M. D., & Govorun, O. (2005). “The better-than-average effect.” In M. D. Alicke, D. Dunning & J. Krueger (Eds.), “The self in social judgment.” 85-106. New York: Psychology Press.

<sup>2</sup>Gino, F., Sharek, Z., & Moore, D. A. (2011). “Keeping the illusion of control under control: Ceilings, floors, and imperfect calibration.” *Organizational Behavior & Human Decision Processes*, 114, 104-114.

<sup>3</sup>Juslin, P., Winman, A., & Olsson, H. (2000). “Naive empiricism and dogmatism in confidence research: A critical examination of the hard-easy effect.” *Psychological Review*, 107, 384-396.

## It Can Happen in Your Neighborhood

### Example 1

A husband and wife served as treasurer and assistant treasurer in a small church in North Carolina. When their business began failing, they stole several thousand dollars from the church by simply writing checks to themselves over a three-year period. The fraud was discovered when a contractor complained that he had not been paid for work on the church property. (<http://tinyurl.com/2e2gm2w>)

### Example 2

Three unrelated individuals who served as office manager, facilities manager and a volunteer in a California church colluded to steal \$500,000 from the church coffers to fund extravagant lifestyles. The threesome carried out their thefts by issuing fraudulent checks and making inappropriate use of credit cards. The theft was discovered when the church pastor became suspicious and reported the theft to the finance committee. (<http://tinyurl.com/66cqchg>)

### Example 3

The pastor of a large Ohio church commingled funds, laundered money, tampered with records, forged documents and sold 19 acres of church land to steal more than \$1 million from his church and cover his tracks. The proceeds were used to buy cars, a boat, a pool and hair treatments in addition to funding private-school tuition for his children. When a church employee reported that funds were missing, it took two years to investigate the crime before charges were filed. (<http://tinyurl.com/6dpmvch>)

### Example 4

The business manager of an Oklahoma church was accused of embezzling \$140,000 to pay her personal expenses. The alleged theft was discovered when the bank notified the church of an overdrawn account. The suspect said she could not have stolen that much money because the church was audited every year. (<http://tinyurl.com/6bpqblr>)

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