INTERNAL CONTROL FAILURES AT THE PINE GROVE YMCA

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CASE DESCRIPTION

The primary subject matter of this case concerns internal control failures in a nonprofit organization which resulted in two overlapping but unrelated fraud. The case has a difficulty level of four, appropriate for senior level. The case is designed to be taught in one class period and is expected to require five hours of outside preparation by students. This case can be used in an internal or external auditing class, a fraud course, or a nonprofit accounting class.

CASE SYNOPSIS

The case relates to accounting control failures in a nonprofit organization which resulted in two unrelated fraud. It is loosely based on a real world situation and so, the organization's name and the fraudsters' identities are disguised.

The first fraud involved the accounting manager, who stopped paying both state and federal payroll taxes on behalf of approximately 150 YMCA employees. She continued to file false quarterly payroll tax returns for a number of years, retaining the money in the organization's operating account. These actions resulted in the organization incurring a tax liability of approximately $1.4 million. In addition, the accounting manager wrote more than 168 checks for approximately $40,000 to herself from the organization's bank account over a five year period, disguising most as payroll checks. She also used her purchasing card to acquire approximately $23,000 worth of personal merchandise.

The second fraud involved the executive director, who hired a local contractor to perform landscaping and renovations at the YMCA locations. The contractor was also hired to perform renovations on the executive director's personal residence. As part of the 'contractual relationship', approximately 26 of the contractor's employees were placed on the YMCA's payroll with the executive director's approval. In addition, materials and equipment brought with the organization's funds were used for landscaping projects at the executive director's residence with the contractor's employees performing the work. Approximately $377,000 of the *organization's funds was diverted to the landscaper's employees with an additional $487,000 paid to the contractor for construction and repairs services.*

The executive director converted approximately $850,000 in federal YMCA funds for his use, disguising them as payments from the YMCA to the contactor. He then concealed his actions by destroying the records. The executive director also converted approximately $58,000 of the organization's funds for personal purposes.

INSTRUCTORS' NOTES

Recommendations for Teaching Approaches

This case is flexible and could be used in a number of ways:

1) In an internal auditing or financial auditing course (emphasizing corporate governance including COSO and internal controls)
2) In a nonprofit accounting (emphasizing internal controls and the responsibilities of the board of directors).

Ideally the case should be used as a semester long group project at the undergraduate level, and as one of the cases in a graduate level course.

Depending on the course in which the case is used a discussion of the Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit, the fraud triangle, the COSO control framework, and corporate governance, should precede the assignment of the case to students. Students could be assigned one, a combination, or all of the questions at the end of the case (A Call for Action) and asked to develop solutions.

Learning Outcomes:

Students should be able to:

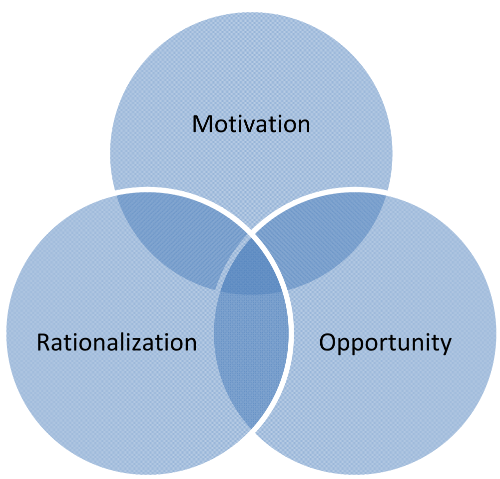
1. Identify the elements of a fraud by using the fraud triangle
2a. Identify strengths and weaknesses in internal controls and propose recommendations to address control deficiencies
2b. Report internal control weaknesses and propose recommendations to management in written form
3. Explain the differences between an ethical failure and a criminal or (illegal) act

Case Implementation and Effectiveness

The case was class tested in a graduate government and nonprofit accounting course in summer 2010. The students found the case easy to read and interesting as reflected in the assigned ratings. When asked to identify the one thing they found most interesting about the case, a student noted that "The one thing in the case I found the most interesting is that the woman was able to write payroll checks to herself over and over again. I was surprised their checks did not require more than one signature." Another student noted that "I found it very interesting that Ms. Jackson wasn't forced to take at least one vacation week in five years as the accounting manager. Most companies require their employees to take a week of vacation so they can find out if the employee is involved in some type of fraud." Finally, a student answered the question by stating that "the most interesting thing in the case to me was that the accounting manager and executive director were not charged for collusion in committing fraud. It's hard to believe that neither of them had an idea that the other person was committing fraud."

DISCUSSION QUESTIONS AND ANSWERS

Q1. Using the fraud triangle below, explain to the board of directors how the fraud was perpetrated without timely detection by organization personnel or the board of directors.



The first element of the fraud triangle is perceived pressure or motive. Clearly the need for funds (economics) was the motivation for the fraud at the YMCA. The executive director's monetary pressure was from living extravagantly, and the accounting manager's self-imposed pressure was to provide for family.

The second element of the fraud triangle is opportunity. In the case of the Pine Grove YMCA, weak internal controls and lack of clear policies and procedures allowed the fraud to continue without prevention. Also, both the executive director and accounting manager were at a high level within the organization and thus received a high degree of trust from superiors with a low level of supervision or oversight. In addition, the person responsible for overseeing the accounting manager (i.e., the executive director) was also committing his own fraud. So perhaps he was too busy hiding his own embezzlement to focus on the actions of his subordinate. Some of the control weaknesses that provided the opportunity for the fraud to occur are identified in Q2.

The final element of the fraud triangle is the rationalization or lack of integrity to overcome a person's sense of ethical responsibility. This will vary from person to person but it's possible that both the executive director and accounting manager rationalized their behavior in a number of ways such as "No one would ever find out", or "I'm borrowing the money and will pay it back", or "I am underpaid, so this is due compensation".

Q2. Using the COSO framework as a guide, identify the control concerns (or weaknesses) you might find in the organization that provided the opportunity for the fraud to take place. Write a formal report to the board of directors to discuss these weaknesses and your recommendations to address the control deficiencies.

The following are some of the control deficiencies that existed at the Pine Grove YMCA. It is not an exhaustive list and students could identify additional control weaknesses.

1. The board of directors delegated responsibilities to the executive director without adequate follow up. For instance, the executive director's expenses were not reviewed and/or approved by the board.

2. Maintenance of records was inadequate at the YMCA. For instance, the materials used at the CEO's residence renovation were bought from Y's funds and were listed as fixed asset additions on the organization's books.

3. The executive director entered into a contractual agreement with the local landscaper without the board of director's approval

4. The accounting manager had incompatible duties in that she was able to approve checks and record them in the general ledger. As a result, she wrote more than 168 checks totaling approximately $40,000 on the YMCA accounts between 1999 and

2002, disguising most of them as payroll checks. She also made personal purchases worth approximately $23,000 using corporate credit cards.

5. The accounting department did not have adequate personnel on staff to manage the organization's increasing activities.

6. The accounting manager stopped remitting both federal and state payroll taxes on behalf of about 150 YMCA employees in 1999, and continued to file false quarterly tax returns through 2002.

7. The general ledger was not reconciled to the subsidiary ledgers (or supporting records) on a monthly basis

8. The executive director was able to make large purchases without additional approval. For instance, he used corporate funds of approximately $864,000 to purchase materials for the renovation of his personal residence renovation and pay the landscaper's employees.

9. The business manager was able to create fraudulent bank statements through her computer (in order to cover up the fraud).

10. The organization did not have policies in place to address the use of purchasing cards.

11. The organization did not have a code of ethics in place

The formal audit report will vary based on instructor preference especially since there is no standard report format for reporting internal control weaknesses. However, a suggested report with the key findings and recommendations to the board of directors is provided in Appendix A.

Q3. Explain the difference between an ethical failure and a criminal or illegal act to the board of directors

A brief discussion of ethics, fraud and illegal act follows. This is not intended to serve as a formal response since students answers will vary based on their matriculation status and business knowledge. However, the information could assist instructors in leading a discussion on the question.

Ethical behavior is considered the decision which produces the greatest good or one which conforms to moral rules and principles. The accounting profession provides Codes of professional ethics to help address situations not specifically available in general ethics theories. Therefore an ethical failure is a violation of the greatest good or moral rules and principles theories, or the code of professional ethics. Fraud is knowingly making material misrepresentations of fact, with the intent of inducing someone to believe the falsehood and act on it, thus suffering a loss or damage. Illegal acts are violations of laws or government regulations by the company or its management or employees that produce direct and material effects on dollar amounts in the financial statements,

EPILOGUE

The organization significantly curtailed its activities once the fraud was discovered resulting in the termination of 1/3 of its employees. Maintenance was also deferred resulting in an unclean exercise facility for members. As a result, members opted to join other, newer exercise facilities in Pine Grove that were aggressively soliciting dissatisfied YMCA members. As noted in the case, the YMCA owed back taxes to the federal government of approximately $1.4 million, with an additional $800,000 in taxes, penalties and interests owed to the State of Michigan. Therefore, facing declining memberships and eroding finances and with no reserves to pay these back taxes, the organization developed a payment plan to pay all back taxes.

The three fraudsters in the case all had jury trials and were found guilty of the various charges. The former accountant (Ms. Jackson) was convicted on all charges and sentenced to 42 months in jail, followed by three years of supervised release. She was also ordered to repay $1.5million to the YMCA. The contractor was convicted on the embezzlement charges and sentenced to 65 months in jail. He was also ordered to repay $1.5 million in restitution to the YMCA jointly with the accounting manager. Finally, the executive manager was convicted on embezzlement and misleading conduct charges and sentenced to 97 months in jail. He was ordered to repay $1.4 million to the organization.

DISCLAIMER

This case and teaching note was prepared by Raymond Elson, Susanne O'Callaghan, Phyllis Holland, and John Walker and is intended to be used for class discussion rather than either effective or ineffective handling of the situation. The names of the organization, the individuals, and location have been disguised.

REFERENCE

Louwers, T., Ramsay, R., Sinason, D., Strawser, J., and J. Thibodeau (2011). Auditing and assurance services, 4th edition. New York: McGraw Hill.

APPENDIX A– FORMAL REPORT (RECOMMENDED)

Date: November 1, 20XX
To: The Board of Directors
The Pine Grove YMCA

From: Independent Accountant

Audit Results

The recent fraud at The Pine Grove YMCA resulted primarily from inadequate oversight by the board of directors and inadequate segregation of duties. These allowed the executive director and accounting manager frauds to go undetected for approximately five years. In addition to the embezzled funds, the organization also has a tax liability of approximately $1.4 million to the federal government and an additional $800,000 to the State of Michigan.

The details of our key business issues and our proposed corrective actions are noted below.

Issues and Recommendations

1. Board Oversight

The board of directors delegated responsibilities to the executive director without adequate follow up. As a result, transactions were initiated without its implicit approval. We noted that:

- The executive director was able to make large purchases without additional approval
- The executive director entered a contractual relationship with a vendor for over $500,000 without the board's approval
- The organization does not have a code of ethics in place for employees, vendors and board members

We recommend that the YMCA establish tier authority for purchases. This will ensure that significant transactions above a pre-established threshold are approved by the board prior to purchasing. Also, the organization should develop and establish a code of ethics which should be communicated to all employees and vendors. The board of directors should monitor compliance on an annual basis.

2. Segregation of Duties

The accounting manager had incompatible duties (and little oversight) and was able to embezzlement funds without detection. The accounting manager:

- Wrote more than 168 checks totaling approximately $40000 on the YMCA accounts between 1999 and 2002, disguising most of them as payroll checks.
- Made personal purchases worth approximately $23,000 using her company issued purchasing card.
- Stopped remitting both federal and state payroll taxes on behalf of about 150 YMCA employees in 1999, and continued to file false quarterly tax returns through 2002.
- Did not reconcile the general ledger to the subsidiary ledger or supporting statements
- Created fraudulent bank statements through her computer

We recommend that the YMCA:

- Hire additional staff to ensure that functions are adequately segregated
- Reconcile the general ledger to the subsidiary ledger on a monthly and hire a controller to ensure that all material accounting transactions are reviewed and approved
- Consider the cost/benefit of engaging an accounting firm to perform annual audits of its operations.

3. Policy and Procedures

The YMCA did not have policies and procedures in place to address critical business issues. We noted lack of policies and procedures in the following areas:

- The proper use of purchasing cards and the documents required to support usage
- The lack of competitive bidding over significant renovation projects

We recommend that the YMCA develop policies and procedures to address these critical business issues.