

# **FRAUD CONTROLS FOR SMALL, REGIONAL NOT-FOR-PROFITS AND LOCAL GOVERNMENTS**

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## **ABSTRACT**

This paper considers whether fraud controls of small not-for-profits and local governments are adequate. Historically society has accepted fewer fraud controls for these entities than those required of larger entities, particularly corporations regulated by the Sarbanes-Oxley Act of 2002. This has occurred through a combination of: consideration of resource constraints, belief that all participants are community members and thus “known,” and trust in individuals’ dedication to the philanthropic mission. Violation of trust in these community based entities has significant consequences. The confluence of this with fewer fraud controls may be more significant than currently recognized in the regulatory process.

## **INTRODUCTION**

Significant changes to US accounting standards and related processes have occurred in recent years as a result of our society’s concern with financial fraud. The collapse of Enron was the impetus for the formation of accounting laws and rules that may eventually be judged revolutionary. The Sarbanes Oxley (SOX) laws are a notable example. Society’s concern with the harm caused to individuals as a result of financial fraud is a major impetus to these changes. This concern will continue to underlie refinements and new regulations implemented over the next years.

Many of the new accounting regulations are designed to address - in a new and more stringent manner - fraudulent financial acts and reporting either by or within a corporations, particularly those who must register with the SEC. In recent years, society’s recognition of serious harm resulting from financial fraud in not-for-profit as well as state and local governments has produced similar results. Accounting principles with similar goals as SOX have been, and continue to be, designed and implemented for these organizations. For example, a national survey of 700 not-for-profits by Grant Thornton LLP found a significant increase from 2003 to 2004 in awareness of SOX and implementation of SOX like controls (Grant Thornton, 2004).

The new accounting requirements are intended to increase transparency in reporting and to decrease fraudulent accounting. It is important to recognize that SOX – for both corporations and the governments and not-for-profits for which it has been imitated– is intended to address more than fraudulent reporting. These new principles certainly share the focus of past legislation such as the Foreign Corrupt Practices Act of 1977 and of the Treadway Commission Report of 1992. It is relevant to note that internal controls for financial institutions have undergone a similar progression. The 2001 US Patriot Act, which

supersedes the 1970 Banking Secrecy Act, has been called “SOX for banks” because of the Act’s strengthened emphasis on internal controls. These diverse regulations share an emphasis on the significance of internal controls to efficient operations and as tools for hindering and uncovering fraud.

From the 1977 through 2007, society through the regulatory process has placed an escalating importance on internal controls as critical fraud controls. And, specific regulations regarding controls have become more comprehensive and more stringent than those of the recent past. When fully implemented and when viewed as a whole, these new accounting principles and processes will result in change in the practice of accounting and reporting that is as significant, in the author’s opinion, as that which occurred as a result of the 1927 stock market crash. Much as practitioners mention accounting “after the crash” they will mention accounting “after Enron.” The accounting changes in the 1930’s and our current accounting changes share a foundation of concern for innocent individuals and the economic harm caused by financial fraud. Thus a similarity exists in the societal goals underlying both the design of accounting rules after the 1927 crash and those of today.

Our society seems to view the acts of corporations as well as not-for-profits and state and local governments (in more recent years) as “good.” These entities are to be allowed or even encouraged to operate as freely as possible – unless and until – individuals both within and outside those organizations suffer economic harm. A heightened concern with harm caused by accounting fraud has existed since the collapse of Enron. Changes that occur in society drive changes in accounting; accounting is indeed a social science. Thus when our society deems that harm to innocent individuals is occurring, our accounting regulations are one of the tools used in an effort to correct the specific issues believed to be contributing to that harm.

Historically this process has generally defined harm to individuals caused by financial fraud in solely economic terms. A purpose of this paper is to begin considering whether constraining the measurement of that harm to direct economic losses/effect has encouraged society to give an inappropriately small weight to accounting as a tool to prevent fraud in certain organizations. This paper is intended to be heuristic. The following constitutes a beginning discussion and exploration, a prelude.

## **PARAMETERS**

For the purposes of this discussion “fraud” will be used to mean financial fraud in both reporting and in conducting the operations of the organization (embezzlement within the organization or defrauding a donor as an example). “Harm” will be used to mean harm to the individual caused by that fraud. “Accounting” will be used to mean accounting reporting and recording and as used in organizations’ operations. “Fraud controls” will refer to accounting rules and regulations that are designed, at least in part, to prevent or minimize fraud.

The “specific organizations” mentioned above, those which are the focus of the questions considered here are: small, regional not-for-profits and governments. These are defined as operating within regions, and with numbers of employees and operations small enough that any interested individual is able to know most of the directors, managers, and employees. In addition, this personal knowledge extends outside of the organization and occurs in many activities in the locality. A sense of community exists. These organizations will be represented by the symbol “SNGs.” When necessary, the terms “not-for-profit SNGs” and “government SNGs” will be employed to distinguish the specific type of entity under discussion. The term “non-SNGs” will be used to designate organizations subject to SOX and SOX like regulations: corporations and large governments and not-for-profits. Other entities, as discussed below, are totally excluded from this discussion, except where mentioned.

SNGs have a criterion that is important to the focus of the questions considered here. This characteristic is central to the discussion of whether the definition of harm should be expanded beyond measuring only direct economic losses. SNGs are not only community based, they exist to fulfill a mission valued by that community. They receive recognition in their communities as providing a good necessary to the quality of life of all society. This recognition includes an understanding that no direct connection need exist between those providing resources and those receiving services. The individuals within the community trust that all involved with the SNG work honestly to benefit others in a manner that profits society, rather than oneself. This criterion does not exist in small, regional for-profit businesses. While a regional business certainly may have the same community interrelationships as SNGs, its mission is not the same. Those who provide the business, the for-profit, with resources are intended to directly receive benefits. For this reason, small for-profits are excluded from the discussion of this paper.

Additional support for excluding for-profits, of all types, exists in recent comments by the Chairman of the Financial Accounting Standards Board, the private sector organization in the US charged with establishing financial accounting and reporting standards. Recently, the Chairman expressed the following rationale for creating differing accounting regulations for not-for-profits and governments and for-profits:

An example of specialized accounting guidance that does seem necessary to properly reflect underlying differences is that for not-for-profit entities. These types of organizations clearly do have different objectives than typical for-profit businesses and the users of the financial statements, such as donors, are looking for different types of information. .... And though I am not an expert in governmental accounting and reporting, differences between such entities and for-profit enterprises and differences in user needs would also seem to warrant differences in the accounting in this area. (Hertz, 2007)

In recognition that for-profits have different accounting needs and because an altruistic focus is unique to both not-for-profits and governments, this discussion excludes the former but includes both of the latter. The altruistic focus is particularly noted by individuals where the organization is regional and most, if not all, the individuals involved are known within the community. Thus, again, “SNGs” are defined for this discussion as small and regional.

## **DISCUSSION**

Central to this discussion is whether accounting rule makers assess the harm caused by fraud within SNGs solely on a measure of the dollars involved, the direct economic cost. Do significant unrecognized costs that should be measured and included in a concept of total harm, or total cost, exist? This concept would recognize that where fraud causes individuals to question or doubt the altruism of their regional entities, their SNGs, a significant harm can result. Fraudulent acts may cause violation of individuals’ and society’s’ trust. This violation may lead to a harm that outweighs or is as great as the direct economic harm traditionally considered. Inclusion of this type of harm might change fraud related regulatory policies.

If the ability to trust local governments and regional not-for-profits is a central determinant of the quality of life in our society, then the harm caused when trust is violated is potentially great enough to be formally recognized in accounting rule making. This harm is caused to innocent individuals but also threatens the viability of the organization themselves. Viability is particularly threatened where the not-for-profits’ mission is accomplished largely by volunteers. Workforce demographics won’t matter, however, if knowledge of fraud causes donors to cease providing needed resources. An SNG type

government certainly won't cease to exist as a result of fraud. However, there may be great damage to the future operations of that government. The ability to fulfill the mission upon which society relies may be injured. Measurement and inclusion of this type of harm in a concept of total harm might indicate that the decision process relating to required fraud tools for SNGs needs change. If a measure of total harm were used rather than direct economic harm, would SOX like regulations be required?

If the answer is yes, the custom of exempting SNGs from certain fraud controls might be viewed as inappropriate. Traditionally SNGs have either not had to comply with certain accounting rules or have been permitted to implement specific rules later than others. Some measure of size and resources has been the determinant. For example, the author's local government of approximately 20,000 citizens has no audit committee, internal auditor or internal audit function. This is consistent with the historical trend of either not requiring a control or permitting it to be phased in by largest first, smallest several years later. This trend has also existed for IRS requirements of SNG not-for-profits.

Certain accounting regulations are not applied to SNGs in a de facto manner. For example, certain organizations may be excluded by implication of the wording of a regulation. A custom appears to exist of not enforcing certain rules due to resource considerations; the resources considered are those of the enforcement agency or the SNG. Another cause is management's lack of awareness that accounting rules designed to prevent or minimize fraud are lacking or being violated. In recent months, the author's statewide media reported a surprisingly large number of SNGs lacking appropriate fraud controls and experiencing fraud. These are predominately volunteer directed organizations such as local recreational leagues or churches. Those involved with the organization seemed to have no knowledge that important fraud controls were absent. Unfortunately, it is not unusual in such a setting for a single person to count money, make deposits, and sign checks.

These types of violations make fraud much easier, more tempting, and perhaps more prevalent. Accounting principles that have as their subject fraud and/or internal controls increasingly include a reminder that evidence of weak controls and fraud are found in the same environment. For example, SAS No. 99 highlights certain discrepancies that if found may indicate fraud. These discrepancies are examples of actions that accompany weak internal controls. Although financial institutions are excluded from both the definition of SNGs and non-SNGs in this paper, it is noteworthy that internal controls are a major focus of 2001 US Patriot ACT. Section 352 of the Act stipulates that financial institutions will have internal controls and independent audits (see the discussion below regarding audits) as components of anti-money laundering programs.

A discussion of fraud and internal controls should note that the manner of the fraudulent act itself is not generally unique in SNGs. Fraudulent acts in SNGs and non-SNGs can be quite similar; the possible violations of internal controls or other fraud controls are similar. Perhaps the perpetrations of fraudulent acts themselves occur in a different pattern in SNGs. This may relate to the fact that for SNGs society has a unique reliance that all involved are known to the community and are selflessly dedicated to the mission of good for others.

An unintended consequence of this reliance may be that of enabling fraud. An acceptance of a lack of both fraud controls and other appropriate accounting controls may result in the act of fraud being more prevalent in SNGs than in non-SNGs. Additionally, our society may assess the occurrence of fraud differently for SNGs than non-SNGs. An acceptance of the type of violations mentioned in the previous paragraph may exist in the SNG setting. SNGs may be permitted fewer controls because of a perceived altruistic focus and in concert with a sense of community. These may influence society to deem that fraud is unlikely or its cost would be negligible.

Last year's report on fraud by the Association of Certified Fraud Examiners (ACFE) finds that smaller organizations continue to suffer disproportionate losses from occupational fraud. The ACFE finds the median loss from fraud to be higher in organizations with fewer than 100 employees. The report notes a major reason for this result: smaller organizations do a poorer job of proactively addressing fraud than larger organizations (ACFE, 2006).

Although this ACFE report regards corporations, this finding is relevant to a discussion of the effects of fraud in SNGs. By definition most SNGs have fewer than 100 employees. As noted earlier, the manner of fraudulent acts is usually not unique. Fraud in SNGs has similarities to that in corporations studied by ACFE. Despite this fact, SNGs have escaped many of the new SOX and SOX type regulations. The factors that cause SNGs to be treated differently include those mentioned: size, resources available, demographics, perceptions of altruistic focus, and a weighing of the potential economic cost of fraud. The existence of other factors needs to be investigated. These factors appear to have influenced society to determine that the cost of accounting principles designed to hinder fraud outweigh the potential benefits. This would be particularly so where society considers the potential dollar amount lost by fraud and deems it negligible or acceptably small. However, society's judgment may be incorrect. As mentioned earlier, the judgment is influenced by a focus on absolute dollars lost and some measure of size and related resources.

Consideration should be given as to whether "cost" should be expanded to include other harms such as that caused by violation of trust. When the extent of fraud at Enron was realized, anxiety was expressed that our stock markets might be negatively affected due to investor psychology. That is related to the belief of some that a culture in which fraud is easy and accepted threatens the economic health of the US society. The importance of trust among all parties in business relationships has long been heralded as a cornerstone and essential element of our American society. When trust is dishonored society attends to potential harm. An example is significant attention given by our national media to an FBI investigation of illegal betting by referees. A dialogue resulted regarding damage to the NBA and its players and fans – the trust placed in referees is deemed critical to the viability of the sport. Trust in one another is interwoven into fabric that serves as a foundation to our culture. This extends to all aspects of relationships of our community and government. However, the regulatory process may not have recognized it as important in computing the cost of fraud in an SNG.

Violation of trust may have significant costs due to the characteristics of SNGs. This is impacted by a confluence with the lack of the same, stringent fraud controls of SOX. Should the regulatory process for SNGs utilize a total harm, or total cost, approach? Using "total cost" might lead to recognition that the factors above are not valid reasons for permitting SNGs to not have the same stringent anti-fraud rules and regulations of non-SNGs. When costs are more comprehensively determined, society may judge the cost of fraud to be as significant as that of non-SNGs. The regulatory process might be changed to acknowledge that as the methods of perpetrating fraud are the same and the costs are as significant, the fraud controls should be the same.

Using a concept of total cost, or total harm, may indicate that the total cost to society of exempting SNGs from all or some fraud controls might be much larger than that previously recognized. The historic practice of using a cost versus benefit model that defines costs as solely economic costs may result, unintentionally, in active discouragement of needed, proactive measures for small organizations with limited resources. If instead total costs are employed in the model, accounting rule makers may decide that cost is significant enough to require SNGs to implement all fraud controls required of non-SNGs.

This tradition of exempting SNGs from implementing appropriate fraud controls has been impacted by a combination of the factors mentioned and has been particularly influenced by the community's trust that all involved in the SNG are altruistic and dedicated to serving others. The nature of accounting as a social

science may interact with these factors in a manner that may be inappropriate. Society's perceptions and judgments may be incorrect due to a reliance on solely economic cost. The interplay between society's judgment and the regulatory process may need careful investigation as regards SNGs. Research may show that society has not recognized the total cost of fraud in an SNG. If fraud controls are instituted to achieve society's aims and society has incorrectly measured harm as it relates to SNGs, then SNGs have inappropriately exempted from fraud regulations.

A significant cause of reliance on direct economic cost may be the difficulty in identifying and measuring other costs. For example, the amount of dollars embezzled can be quickly measured. No so, the cost of harm caused by violation of one or more individual's trust in an SNG. Determining the cost of the latter will be quite problematical and involve subjective as well as quantitative measures. One difficulty relates to assessing the harms that will occur in the future. An example is the distrust of a government SNG that can result when fraud is discovered. This distrust can result in individuals rationalizing the act of cheating on their taxes. These complications in recognition and measurement might suggest that society is not able as a whole to readily assess total cost of harm from fraud. Thus it might be appropriate that society's concerns be delegated a smaller voice in the regulatory process.

These complications also suggest it may be difficult to conduct research to determine if a measure of total harm would lead to different accounting decisions regarding fraud tools. However, the potential cost of unrecognized harm seems to be of a size that such research is necessary. Questions that might form the initial phases of this research are in Table I.

<b>Table I</b>
Are there types of harm from fraud that are unique to SNGs?
Are there types of harm other than economic, can these be measured?
What factors does society weigh in determining harm from fraud?
Does US society consider only direct economic consequences of fraud?
Have accounting rules and processes been inappropriately impacted by a focus on harm that is solely economic?
Is the cost benefit model ineffective where it includes only economic harm?
Have other costs been excluded from the cost benefit model because of difficulty in measuring?
Do the characteristics of SNGs require a measure of total cost for the model to be effective?
Has our society weighted the potential of fraud damage in SNGs and judged it to be of not of much consequence?
Has society determined that fraud tools to prevent/minimize harm in SNGs are not as necessary as in non-SNGs?
Is there an historic pattern of SNGs not being required to have accounting rules that are as stringent as non SNGs?
Is there an historic pattern of designing fraud tools to respond to only direct economic harm in SNGs that is larger than a determined amount?
Have weak controls resulted and perhaps flourished in SNGs as a result of not considering total harm caused by fraud?
Will the current practice of permitting small organizations to implement new accounting rules years later than large organizations be judged inappropriate if harm is defined from a total cost perspective?
Do external auditors adjust for - and does the public recognize - that weak controls make fraud easier to perpetrate and more likely?
Is the cost of total harm of such significance as to indicate that SNGS should

be required to follow all regulations required for non-SNGs?
Is there a need for the process of decision making for accounting requirements to be changed, particularly regarding the interplay between concerns of society and decision making?

## BACKGROUND

As stated earlier this paper is intended as a prelude to determining whether the cost of fraud in SNGs includes a significant unrecognized cost. If this cost is recognized through a total harm/cost concept, might SNGs be required to implement all fraud controls required of non-SNGs? The purpose of the following is to provide support for the existence of significant, unrecognized cost. The following is not intended to represent research. Rather this section discusses recent occurrences. The discussion is intended to serve as background for a total cost concept that recognizes the harm of violation of trust in SNGs.

By their definition SNGs are interwoven in their community. The trust placed in these organizations as discussed above combined with the personal investment of directors, management, other employees, individuals served, supporters, and others within the locality greatly magnifies the potential harm of fraud. The personal relationships and community based familiarity of all involved interacts and magnifies the consequence of violation of trust. The potential exists for many individuals in the community to suffer a significant personal, emotional harm. As discussed, the difficulty in measuring this is a significant cause of the lack of inclusion in cost benefit models of accounting decision making. Yet, violation of trust can threaten the entity's viability. Violation of the community's trust can lead to instances, and acceptance, of unethical or illegal acts. These may be within the entity or by those who interact with it. Discouraged employees may lose their dedication and either leave or quietly obstruct the mission of the entity.

An example relates to the fiscal health of a government. Cheating in payment or collection of taxes and other revenue items may be tempting and tolerated by some as a reaction to personal harm caused by violation of trust. The impact of decline in revenues can be magnified in a small, local government, an SNG. Small size and fewer revenue sources can lead to serious consequences for all constituents. This is because a certain amount of revenue must be raised from local sources. Cheating may cause the burden of supporting the government to fall disproportionately on those who do not cheat.

Another characteristic of a significant, unrecognized cost to fraud relates to the laxness that, unfortunately, can be a component of the accounting in SNGs. This laxness seems to have been accepted, as discussed earlier, due to a weighing of available resources, the potential maximum size of a fraud (in dollar terms), or lack of knowledge. Often this takes the form of weak or non existent, internal controls. Since internal controls are important fraud controls, the result is greater ease and temptation for an employee to engage in fraud.

Not discussed earlier in this paper is an unrecognized, and difficult to measure, cost involving the individual who perpetrates the fraud – who but for the ease of doing so might never have become involved in dishonesty. For example, a local mother might never have become a thief had she not agreed to be the treasurer of the local soccer league; a job that no one else wanted or would help with. Others working with the soccer league were volunteers who defined their participation as – solely - involvement with the children and the games. As a result the treasurer was given sole custody of all monies collected and sole authority to write checks. This violation of internal control principles made embezzlement tempting and easy. The personal and community relationships existing in this soccer league caused the

harm to encompass not only a family forever damaged by criminality of a mother but also many people within the community suffered a very personal pain related to loss of trust.

Unfortunately, this pain does not seem to lead society to conclude that SNGs require a full complement of fraud controls. Instead, the community's reaction to the personal harm threatens viability of the SNG. This reaction includes reluctance to support the organization and its mission. In the example above, the ability of children to have the positive experiences that accompany a sports league is damaged. This cost is not included in cost/benefit decisions of society and accounting rule makers. Adding this harm to economic harm currently included in the cost benefit model might indicate that fraud controls for SNGs are necessary regardless of whether resources, financial and human, are limited.

Another result of the weight given to the limited resources is audits that are nonexistent or cursory. Unfortunately, this has been prevalent in not-for-profit SNGs managed and operated by volunteers. The lack of appropriate audits is an example of the potential negative impact of the historic cost benefit model applied to decisions regarding fraud controls. Communities and participants judge the cost of a formal, appropriate audit to be too expensive; the cost is deemed to be more than the potential benefit obtained. As a result, SNGs - such as the soccer league discussed above or a local food bank as another example - escape having to undergo an external audit. This is a serious concern especially in light of the lack of fraud controls in these organizations as mentioned above. A dangerous condition exists when internal controls and audits, which particularly under the newer accounting regulations are critical fraud tools, are absent.

The authors' State Board of Accountancy provides an example of requiring not-for-profit SNGs to have the same critical fraud controls required of non-SNGs. This is very recent and is restricted, at present, to audit requirements. The Board's new regulations are designed to correct the problem discussed above. SNG not-for-profits must now undergo a full audit which can no longer be conducted in a cursory manner. The Board's intention is to bring SNG audits into compliance with stringent audit requirements of non-SNGs. For example, new regulations include the prerequisite for the auditor to be in compliance with peer review regulations. As a result of the Board's actions, the factors discussed earlier in this paper may no longer be used to justify nonexistent or superficial audits. Although these new regulations currently only address audits, their existence lends support for the need for fraud controls of SNGs to be similar to those of non-SNGs, irrespective of resources or other considerations. However, these new audit requirements are in the process of being implemented. Cursory audits of small not-for-profits are still prevalent – but they are no longer permitted.

As discussed earlier in this paper management that consists of volunteers may have no idea that fraud controls are lacking or being violated. The Board's new rules may have the unintended effect of encouraging this to occur. Although the new rules have the consequence of requiring all not-for-profit SNGs to have formal audits, the rules are written from the perspective of the individual conducting the audit. By requiring the auditor to comply with the new regulations, the SNGs are in effect regulated. A disadvantage of this approach is that the same individuals who perform cursory audits are those unlikely to stay current on regulations. This is impacted by the fact that volunteer management may also be unlikely to have knowledge of the new regulations. Therefore, it will likely be some time before SNGs in violation realize that audit regulations are being breached. While these new regulations lend support for requiring similar fraud controls of SNGs and non-SNGs, any change in implementing new controls for SNGs must be from the perspective of the entity, not the accountant.

The lack of knowledge just discussed lends support for being cautious when society's perceptions and judgments are included in accounting decision making regarding fraud controls. The regulatory process needs to reflect that management's lack of knowledge is not acceptable. The characteristics of SNGs, including lack of resources in dollars and personnel, cannot be utilized to justify lax controls. Support for



this view can be found in the Attorney General of New York's document for the Charities Bureau. Attorney General Cuomo gives a clear and definitive summary of the responsibilities of directors of not-for-profits. Relevant to SNGs, he states that size does not matter regarding internal (fraud) controls:

Charitable organizations contribute substantially to our society. They educate our children, care for the sick, preserve our literature, art and music for us and future generations, house the homeless, protect the environment and much more. The boards and officers of those charitable organizations are responsible for managing and preserving the charitable assets that benefit all of us .....Whatever their mission or size, all organizations should have policies and procedures established so that (1) boards and officers understand their fiduciary responsibilities, (2) assets are managed properly and (3) the charitable purposes of the organization are carried out. A failure to meet these obligations is a breach of fiduciary duty and can result in financial and other liability for the board of directors and the officers. Effective internal controls will help to protect an organization's assets and assist in their proper management (Cuomo, 2005).

Another example of society's misjudgment of the harm, or cost, of fraud with resultant lack of appropriate controls exists concerning cursory (superficial) audits. Empirical evidence suggests that for the not-for-profit SNG anxiety regarding cost of implementing a control influences the decision whether to implement it. And the decision not to implement is also impacted by participant's perception of the philanthropic mission and personal relationship of all involved. For example, small churches in the author's state generally have a long-standing custom for audits to be performed by a related party, often with no audit fee. This has been viewed as satisfactory as a result of weighing the resources available, the impression that everyone can trust each other, and the potential for harm of fraud. Here again exists the potential unrecognized cost. These audits are relied upon by the entity's community as providing assurances, including assurance that fraud is not present. Unfortunately entities reassure donors with the information that a yearly audit is performed. Donors assume an adequate audit has been performed. Harm occurs when donors rely on a superficial audit conducted by a related party, obtaining a level of comfort that may not be appropriate.

These quick evening audits by a related individual are equivalent, in the author's opinion, to no audit at all. The State Board's new regulations constitute an essential improvement to the operations of not-for-profit SNGs. Regardless of size or resources, the Board requires the auditor to be independent with up-to-date knowledge and expertise. Thus this Board's new rules constitute a positive answer to the question of this paper, at least regarding audit regulations. It is important to determine whether other accounting regulatory bodies are currently designing similar stringent fraud controls for SNGs either in the form of audit or other fraud tools. Empirical evidence indicates this is not the case. As mentioned earlier, SOX was passed in 2002 and in the past few years SOX like regulations have begun to be designed for governments and not-for-profits. Perhaps there has not been time, or the recognition of a necessity, to get to address similar regulations for SNGs.

If regulatory bodies are found to be considering regulations for SNGs, then these bodies are in the vanguard. Society as represented by communities of SNGs seems not to be expressing that the harm of fraud dictates the need for new regulations regardless of available resources. For example, many stakeholders of SNG not-for-profits have expressed serious concerns regarding the costs of the audits discussed in the previous paragraphs. The new requirements heighten the apprehension that the cost of these audits will be too high, and therefore, unacceptable especially when compared to the anticipated maximum dollar loss of a fraud. For example, directors recognize that peer reviews are expensive and increase audit fees. Implementation of other fraud controls is weighed in the same manner.

The potential exists - due to the nature of a SNG not-for-profit - for directors to be so committed to the mission of the organization that they reject any costs deemed too expensive or “not really” necessary. This is heightened where directors misjudge the true, or total, cost” of fraud. A concern with cost of the required audits compared to the current balance in the checkbook encouraged managers of a local food bank to be tempted to “fly beneath” the radar. This perpetuates the problem of ease of embezzlement due to laxness in the accounting process.

The discipline of auditing provides another example relevant to the discussion of this paper. This exists in the dysfunction between society and accounting regulatory bodies regarding the purpose of an audit. Historically auditors did not believe their job included considering the existence of fraud. It is interesting that the public (society) historically relied on the impression that an audit gave assurance that a search for fraud was conducted and none found. Auditors themselves never had that impression; neither, again, did they consider or search for fraud. After Enron, the field of auditing has evolved to include the requirement to consider fraud. While newer auditing standards address the disconnect between society and auditors, the technical requirements for searching for fraud have yet to be defined by regulatory bodies. Although these regulations are for non-SNGs, this divide between the public’s impression and that of auditors is informative. As mentioned above, accounting rules for SNGs may be negatively impacted by society’s using economic cost, rather than total cost, when considering the harm of fraud in SNGs. Consideration as to whether the regulatory process regarding fraud in SNGs should be changed must include careful consideration of components and effects of societal judgments.

Misunderstandings about audits and inadequate audits can have consequences that are particular to, or heightened, in SNGs. A lack of appropriate audits for SNG not-for-profits was discussed above. Governmental SNGs are prevented from having cursory or non-existent audits by state and federal laws. However, the problem of dysfunction between the auditor and those relying on the audit exists in much the same manner discussed in the previous paragraph. This, however, this is magnified by the characteristics of SNGs, and may be appropriate to not-for-profit SNGs as well. It is unfortunately not unusual for members of the Board of Directors to have very little accounting or finance knowledge. In a government, the director’s election by fellow citizens is influenced by many factors; unfortunately, financial expertise is not often one. Yet, society believes that directors investigate and understand all the functions of the entity. The Attorney General of New York writing for the Charities Bureau gives a clear and definitive summary of the responsibilities of directors of not-for-profits. And, he opines, these duties are mandatory regardless of size. The financial functions are significant to all citizens and to viability. A community trusts that its elected representatives provide assurance that all is well within their government. In addition, the public expects that, like a not-for-profit, the focus and dedication of all involved is to a defined mission. Another assumption is the belief that everyone “knows,” and can therefore trust, everyone else. These assumptions can underlie the same lack of desire to institute proactive fraud measures that exist as discussed earlier in SNG not-for-profits.

Elected officials as directors may - with good faith - believe that the entity is protected from fraud due to a yearly audit; even where an inadequate audit function exists. Where a lack of knowledge is accompanied by lack of appropriate advice from those relied upon, the potential for fraud and harm increases proportionately. Another circumstance making fraud and potential harm more likely is that the nature of an SNG may encourage elected officials who are interested in aspects of the government other than operations. They may rationalize neglecting their duties by trusting that all involved are honest people who only act to further the communities’ interest. If directors’ responsibility to act as a control or assurance is abdicated by delegation of operational responsibilities to an administrator, a fraud control is violated. Too much power resides in one person, making deception more probable.

In an SNG it may be both tempting and easy for an elected official’s efforts to be directed not to the community’s benefit, but to personal interest and gain. As discussed above, our society seems to accept

fewer fraud controls for SNGs. This may have the consequence of creating ease for someone to be trusted who does not deserve that trust. This ease is available to all involved in the entity, not just the directors. There have been several reports in the author's state - within a relatively short time period - of fraudulent acts in local governments. Informed individuals expressed great disbelief and shock that this could happen in "their" government. As discussed earlier, these acts may occur more frequently due to lack of controls within a climate of trust. As in the soccer league fraud discussed above, fraud in a government has the potential for very personal, emotional harm to members of a community. The cost of this harm is currently unrecognized in the decision of when, or if, to implement fraud controls required of non-SNGs.

## **SUGGESTIONS FOR FUTURE RESEARCH**

The questions posed in Table I are important to a determination of whether a significant, unrecognized cost of fraud exists in SNGs and whether this indicates the need for change in the creation of accounting regulations - fraud tools - for SNGs. Additional considerations include:

- What questions need to be asked to assess total harm and its impact on society?
- What measures should be used to determine a concept of total harm/cost?
- What scale should be used to determine when total harm is large enough to dictate that SNGs should implement the same fraud tools as non-SNGs?
- Should the cost benefit model be employed with total cost serving as the "cost" measure?
- What research methods need to be designed to serve as a foundation for accounting regulations for SNGs?
- What methods are necessary to design fraud controls that not only aid in detection but are also proactive?
- What should comprise those methods?
- Should this research be based on case analysis in recognition that fraudulent acts and society's response influence the weight given to regulatory decisions regarding accounting processes and principles?
- Would case analysis effectively address fraud that has occurred, fraud that may occur, related harm to innocent individuals, and societal expectations regarding accounting and its role?
- What other methods might be used?

## **CONCLUSION**

The dedication of individuals to the betterment of others as expressed in small, community not-for-profits and in local governments is an important foundation of our way of life. This foundation is threatened by fraudulent acts. Unfortunately our society and our regulatory organizations may not recognize that the harm caused by fraud in these entities is significant to individuals and society. This may be evident when that harm is measured in a total cost concept. Total cost would include more than direct economic cost. For example, the cost of violation of trust would be measured and included. While this measurement would be difficult, it may be necessary as discussed in this paper. The result is that a concerted effort may be needed to investigate and address accounting and fraud prevention for these small organizations.

Hopefully, this paper assists in fostering recognition this investigation needs to consider whether: 1) fraud in these entities is as serious as in corporations for whom Sarbanes Oxley was created and those to which

it has been extended, 2) the characteristics of these entities result in types of harm that should be measured and included in a total cost perspective, 3) those harmed include individuals, the entity and our society; and 4) the regulatory process regarding accounting rule making may need to be changed with lesser emphasis given to society's judgment of the cost/benefit regarding fraud in SNGs.

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