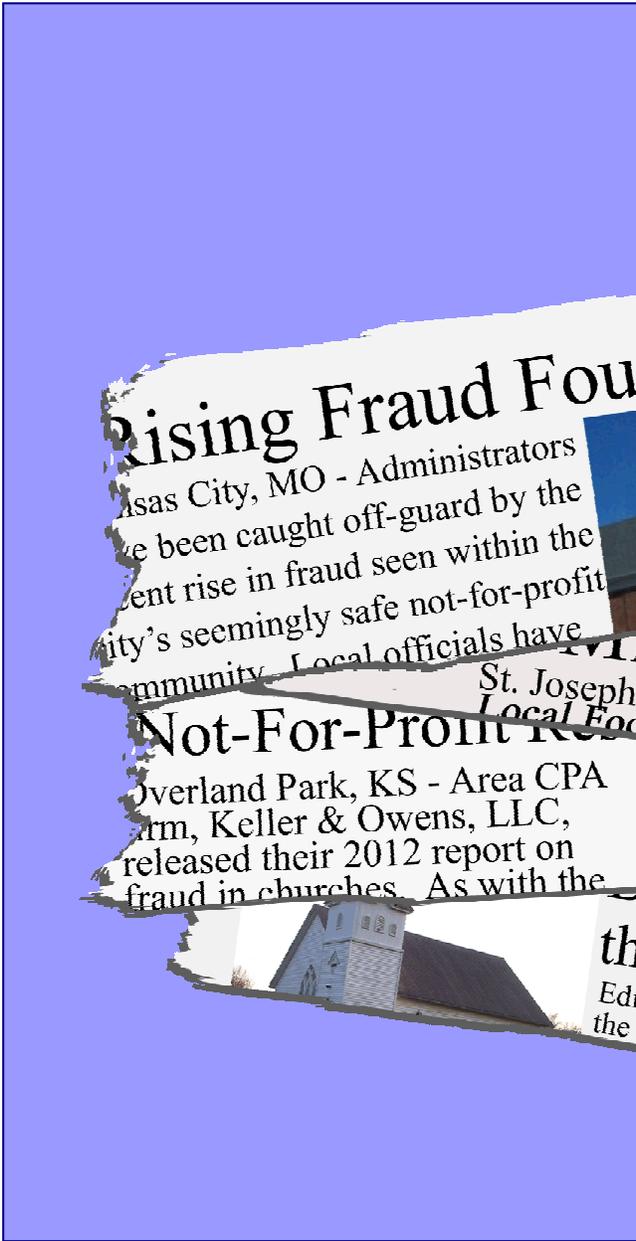


Financial Fraud in Heartland Churches: A 2012 Survey Report



Keller & Owens, LLC
Certified Public Accountants



NOTE FROM THE AUTHORS

For over twenty-five years, Keller & Owens, LLC (KO) has served the professional needs of faith-based, not-for-profit organizations, especially churches. Sadly, we have seen the incidents of financial (also known as occupational) fraud gradually increase to its present levels. Of course, any theft of precious church resources is unacceptable. Unfortunately, significant financial frauds often also result in the disruption of normal church operations, distrust of church leadership and even church splits. However, the most damaging effect occurs as the general public's view of the Christian church declines even further.

A few years ago, the owners of Keller & Owens, LLC decided to take steps to help not-for-profit organizations prevent and detect financial fraud. Since then we have been providing these entities with helpful resources. The resources include samples of anti-fraud, conflict of interest and whistle-blower policies, assessment checklists for governing boards and management and the booklet *Detecting and Preventing Fraud in Not-For-Profit Organizations*. In the spring of 2012, we took the next steps. In January, Rich Bili, CFE and John Parrish, CFE, both owners of Keller Owens, LLC and Glenn Miller, CFE, President of Miller Management Systems developed a 19 question on-line survey. In February, 2012, we invited over 12,500 churches in Kansas and Missouri to participate in the on-line survey over a six week period.

This report provides the results of that survey. We hope the findings in the report will help churches stem the tide of financial fraud.



Gregory D. Owens, CPA
Managing Owner, Keller & Owens, LLC.

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EXECUTIVE SUMMARY

Summary of Findings

- Even though churches responding to the survey were nearly evenly split between Kansas and Missouri, substantially more Missouri churches reported experiencing financial fraud.
- Substantially more churches from small, rural communities (under 25,000 in population) responded to the survey.
- Slightly more than two-thirds of the churches that were victims of fraud reported average Sunday worship attendance of less than 250 congregants.
- Fifty percent of fraud victims reported annual average budgeted revenue of \$250,000 or less.
- Nearly 60% of churches that experienced fraud reported having only 1 to 2 people assisting in the accounting/finance areas underscoring the importance of the internal control principle of adequate segregation of duties.
- The survey found that estimated losses ranged from less than \$1,000 to a high of approximately \$400,000 with a median loss of \$40,000.
- Respondents to the survey reported 32 incidents of asset misappropriation fraud, the most common type of fraud that occurred.
- Seventy percent of the respondents in the KO survey reporting incidents of fraud identified “red flags” that might have given observers reason for concern, such as defensiveness, living beyond means or refusal to take vacations.
- The survey found that poor or non-existent oversight or inadequate internal controls provided the fraudster with the most frequent opportunities to commit fraud.
- The survey found that employees, i.e., non-pastoral staff, when combined with volunteers committed only slightly more of the reported frauds than did management or pastoral staff.
- While precise data was not provided, the age of the frauds reported in the KO survey would suggest an average duration of about 2 ½ years.
- Actions taken by churches when fraud was discovered varied from doing nothing to referring the matter to law enforcement.
- Sixty-five percent of the churches that reported having no financial fraud gave strong oversight, good segregation of duties and sound internal controls as the reasons for no fraud.

INTRODUCTION

An Eternal Truth

There is One Who truly understands both the sources and consequences of fraudulent actions. Long ago, He said, “For the love of money is a root of all kinds of evil, for which some have strayed from the faith in their greediness, and have pierced themselves through with many sorrows.”¹

Survey Demographics

As indicated earlier, over 12,500 churches in Kansas and Missouri were invited to participate in an anonymous, on-line survey. The survey asked questions about instances of financial fraud that occurred in these churches. The survey also requested information regarding internal controls implemented by the churches. This document reports only incidents of financial fraud.

Survey respondents² were nearly evenly split by state with slightly more Missouri churches participating. Substantially more churches from small, rural communities (under 25,000 in population) responded to the survey.

The survey also reported respondents² by average Sunday worship attendance. Slightly more than 76% of the churches participating in the survey reported average Sunday worship attendance of less than 250 congregants.

Two-thirds of the reporting churches² had average annual budgeted income of \$250,000 or less. The largest segment of participating churches (59%), reported total budgeted annual income ranging from \$50,000 to \$250,000. Churches with budgets of \$251,000 to \$500,000 and \$1,000,001 to \$5,000,000 made up 13.5% and 12.7% of respondents, respectively.

The survey participants² also reported their denominational affiliation, if any. Baptist churches were the largest segment at 24.5% followed by United Methodist churches at 7.6%, Lutheran churches at 6.7%, Presbyterian churches at 3.3%, and Catholic parishes at 1.6%. The remaining 56.3% of the respondents either were non-denominational churches, members of smaller denominations or declined to report this factor.

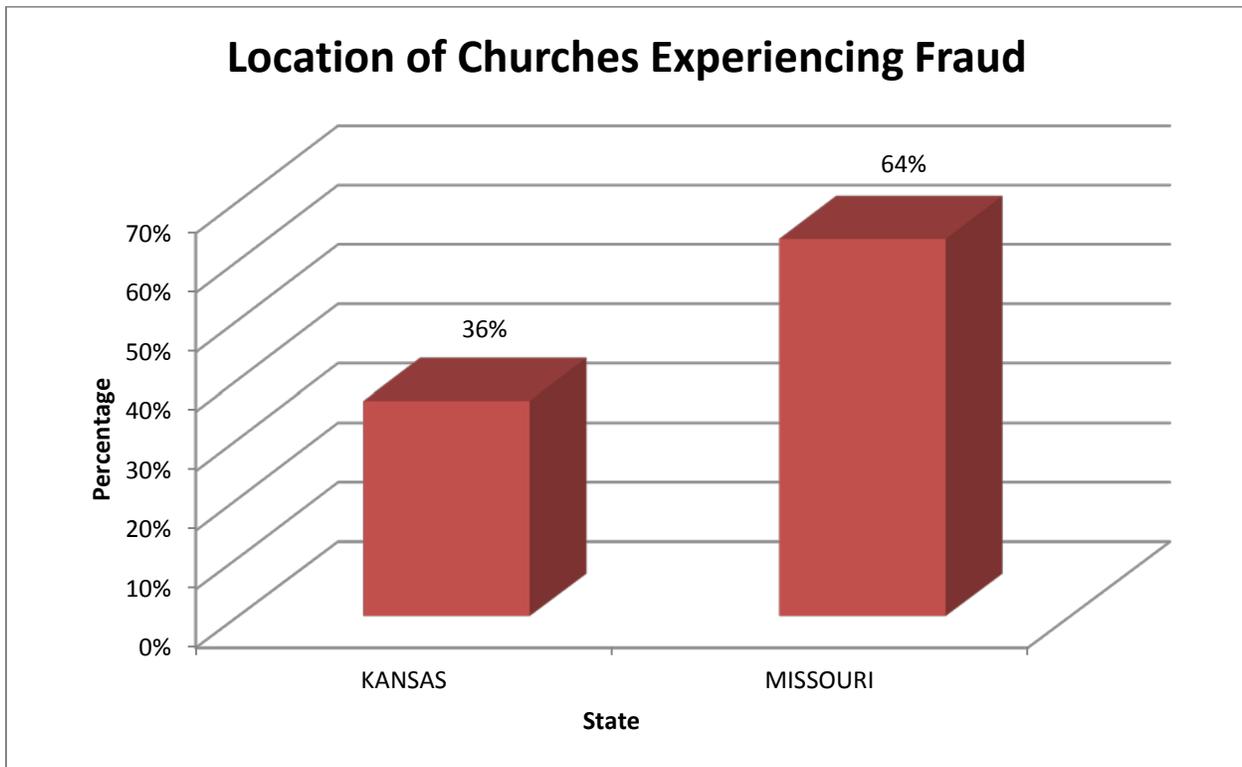
Finally, the survey asked participants to indicate the number of employees or volunteers who played an active role in the church’s accounting and finance activities. The results were somewhat surprising considering that the data above indicates a predominance of respondents² (50% or more) were from small churches. The survey found that almost 80% of participating churches reported that 3 or more persons played an active role in the accounting and finance activities of the church. Twenty-six percent used 6 or more while 8.4% used only one person in these critical roles.

¹ Timothy 6:10, *the Bible*, New King James Version

² Includes respondents reporting fraud and reporting no fraud

Characteristics of Churches Reporting Financial Fraud

While survey respondents were nearly evenly split by state with slightly more Missouri churches participating, substantially more Missouri churches reported experiencing financial fraud.



The survey used two criteria, average Sunday worship attendance and average annual budgeted revenue, to categorize churches reporting incidents of financial fraud by size.

As shown by the following graph, slightly more than two-thirds of the churches that were victims of fraud reported average Sunday worship attendance of less than 250 congregants. A little more than 76% of the total number of churches¹ participating in the survey were of similar size by this criteria.

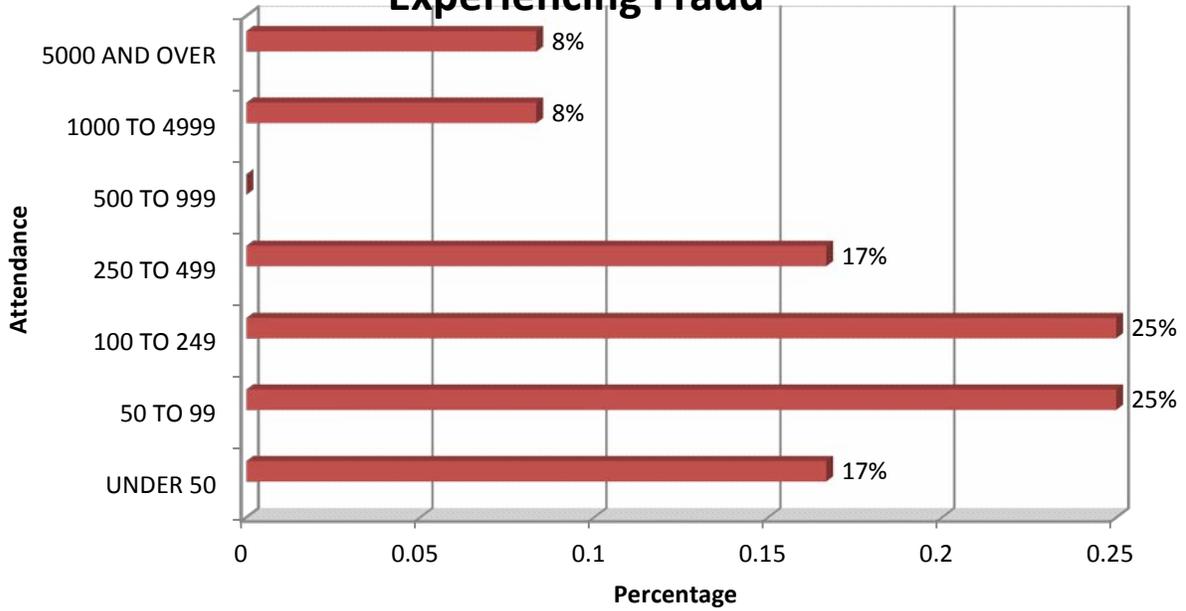
The second graph below shows that 50% of fraud victims reported annual average budgeted revenue of \$250,000 or less. Increasing the revenue amount to just \$500,000 per year increased the percentage to 83% of victim respondents.

The 2012 *Report to the Nations on Occupational Fraud and Abuse* published by the Association of Certified Fraud Examiner (ACFE) reported that “small organizations (those with fewer than 100 employees) continue to be the most common victims in fraud instances reported to us.”³ Though not based upon employee population size, we believe that our survey reaches a similar conclusion.

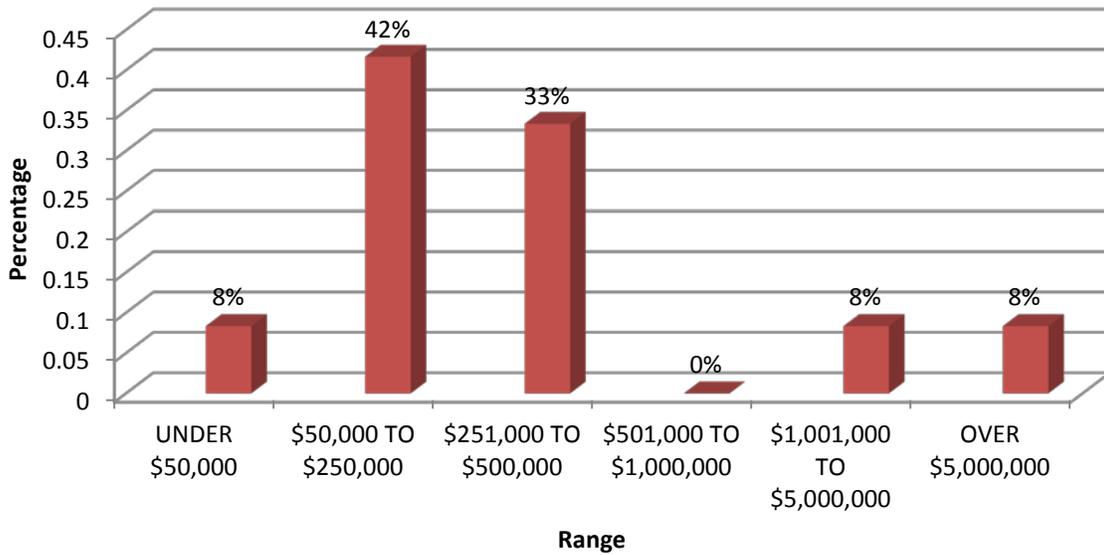
² Includes respondents reporting fraud and reporting no fraud

³ *Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey*, Association of Certified Fraud Examiners

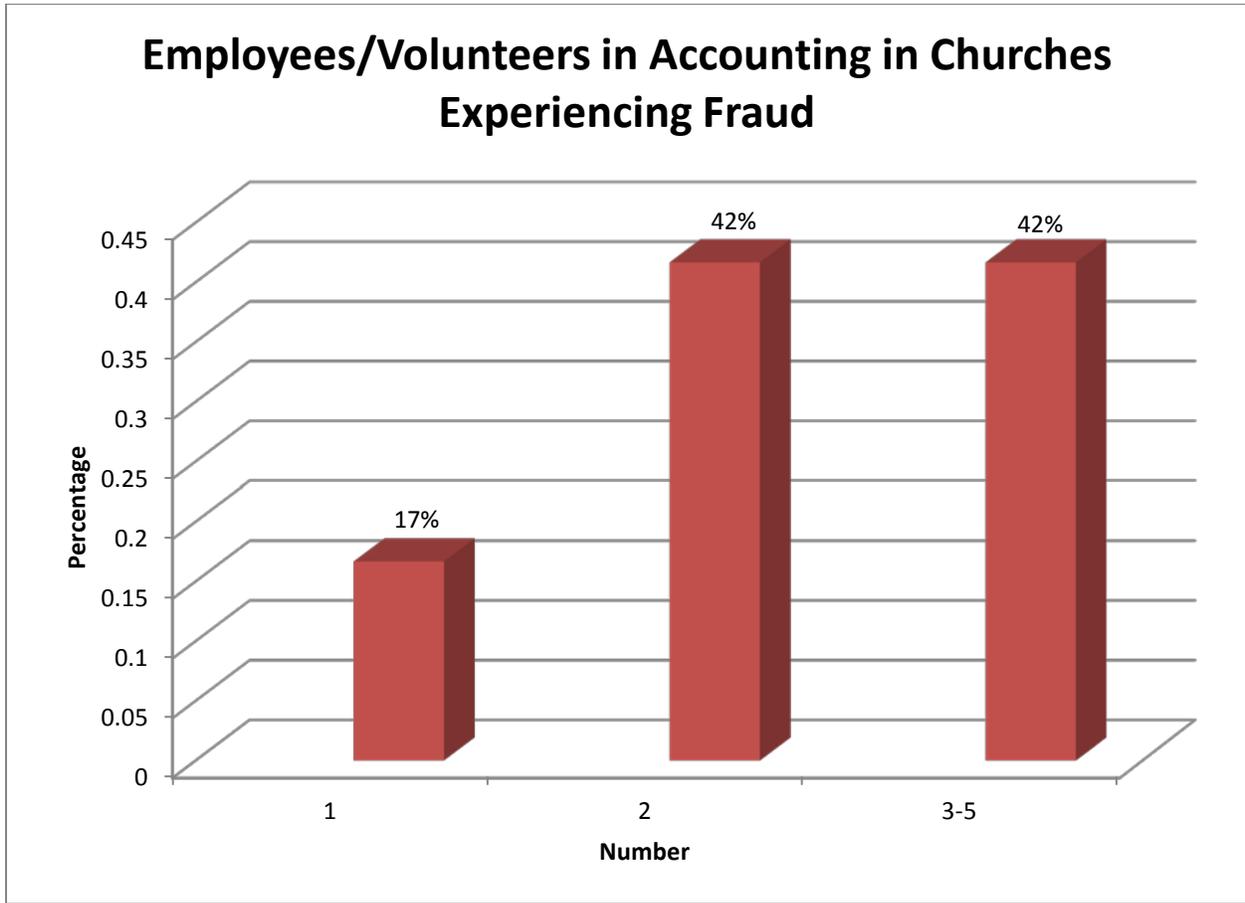
Average Sunday Worship Attendance of Churches Experiencing Fraud



Average Annual Budgeted Revenue of Churches Experiencing Fraud



Overall our survey found that almost 80% of participating churches² reported that 3 or more persons played an active role in the accounting and finance activities of the church while 8.4% used only one person in these critical roles. However, as the graph below shows, 59% of churches that experienced fraud reported having only 1 to 2 people assisting in these areas underscoring the importance of the internal control principle of adequate segregation of duties.



² Includes respondents reporting fraud and reporting no fraud

Financial Fraud Defined

Financial fraud is commonly known as “occupational” fraud. Donald R. Cressey, PhD renowned behaviorist scholar and researcher defined occupational fraud as “The use of one’s occupation for personal enrichment through deliberate misuse or misapplication of the employing organization’s resources or assets.”⁴ Often this type of crime also benefits third parties such as family members or friends.

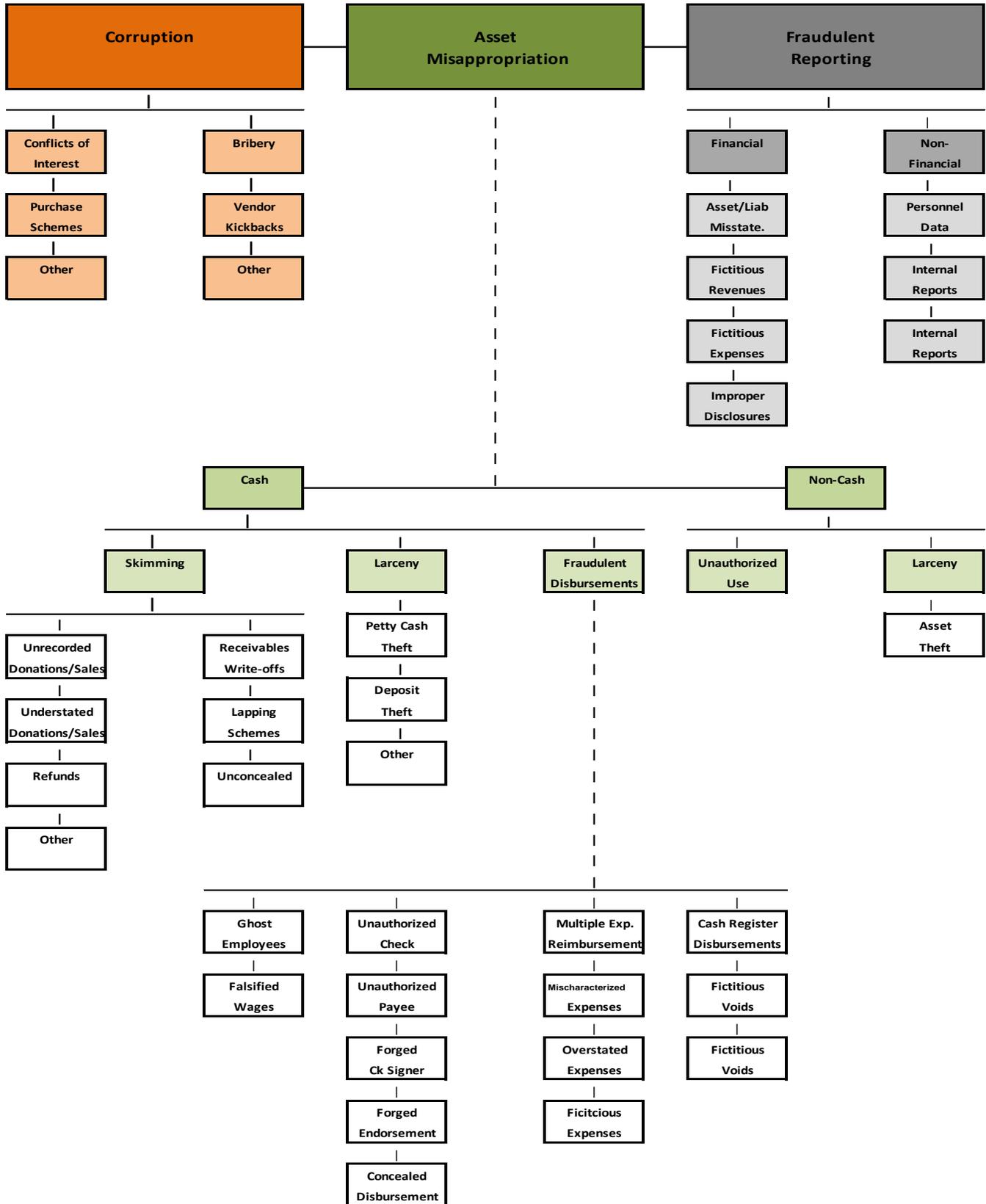
Dr. Cressey classified occupational or financial fraud into three primary categories: corruption, asset misappropriation and fraudulent statements. These three categories of fraud are defined as follows:

- Corruption is the wrongful use of influence to procure a benefit for fraudster or another person contrary to the duty or rights of others. A conflict of interest scheme where the church purchases goods or services from a company owned by a board member or key employee at greater than market prices is an example of corruption.
- Asset misappropriations are by far the most common of all financial fraud schemes and usually involve the theft of cash through skimming, fraudulent disbursements or unauthorized use or theft of non-cash assets.
- Fraudulent financial reporting is intentionally making false assertions relating to financial statements, false statements re: compliance with specific requirements of funding sources or other false reports to users data. Accepting donor restricted or designated contributions, using them for other undesignated purposes such as operations and reporting them as used as stipulated by the donor is an example of this type of fraud.

⁴ *The Fraud Examination Handbook, 2012 Edition*, Association of Certified Fraud Examiners

The following chart illustrates these three categories in greater detail.

FINANCIAL FRAUD SCHEMES BY TYPE



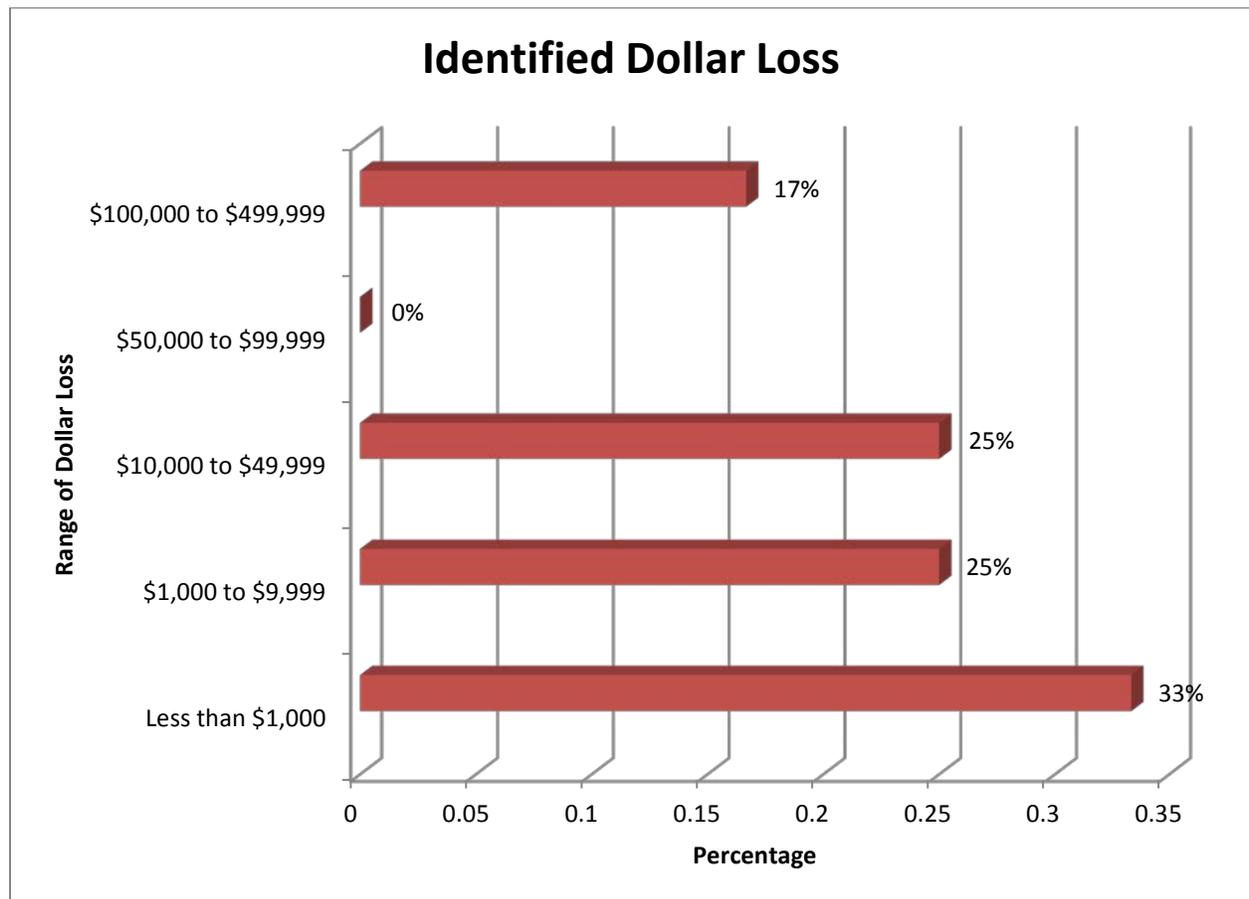
REPORTED INCIDENTS AND THEIR COSTS

Many occurrences of occupational fraud in churches may go both undetected and, even if detected, often go unreported. An article authored by Oklahoma State University (OSU) Professors Robert M. Cornell and Carol B. Johnson reported that “Houses of worship are particularly vulnerable to fraud, but most feel they are impervious.”⁴ The authors suggested that because “trust among employees and volunteers fuel church engines... they feel bulletproof.”⁴ Consequently, such churches don’t establish policies and procedures including proper internal accounting controls or consistently follow them. Cornell and Johnson believe that the level of controls reported in their studies “were so poor that they probably harbored many undetected frauds.”⁴

The Keller & Owens survey found that approximately 10% of the responding churches reported that they experienced financial fraud. This is slightly less than the 13.4%⁴ reported in the Cornell and Johnson study.

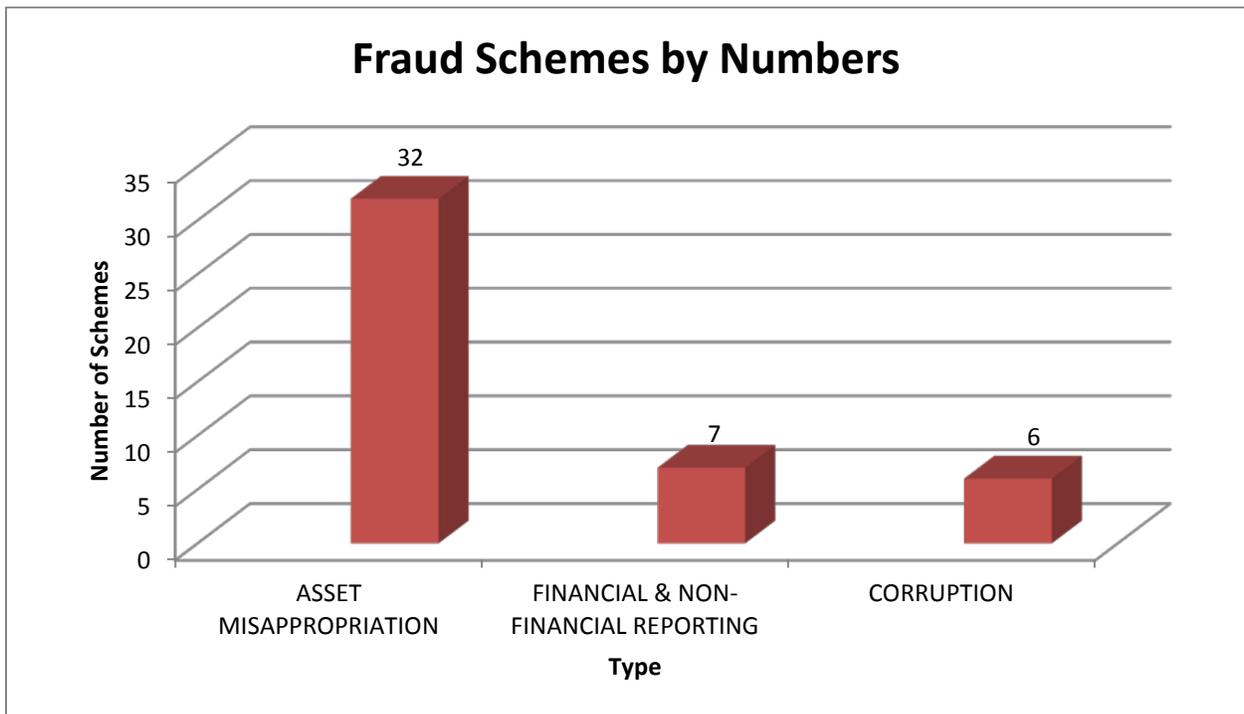
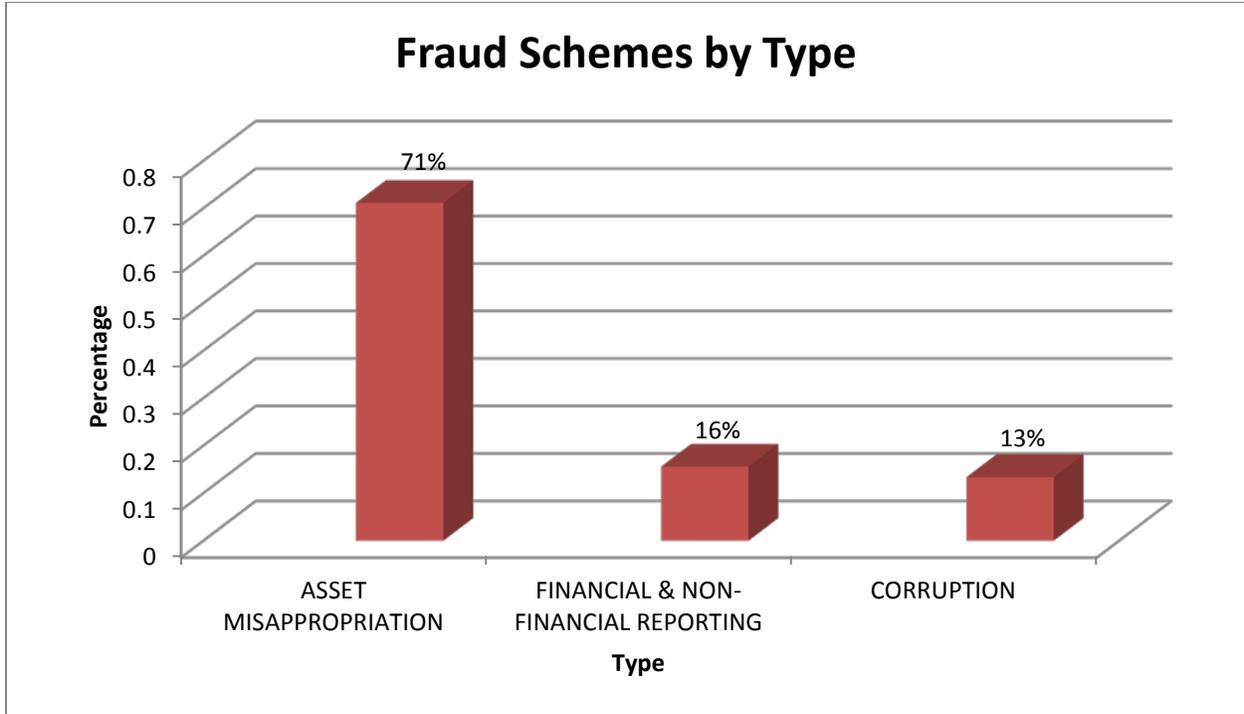
The OSU professors’ study reported that “the estimated size of the frauds ranged from a few dollars to \$35,000.”⁴ The following graph shows the Keller & Owens survey found that estimated losses ranged from less than \$1,000 to a high of approximately \$400,000 with a median loss of \$40,000.

⁴ *Fraud in Houses of Worship: What Believers Do Not Want to Believe*, January/February 2012, *Fraud Magazine*



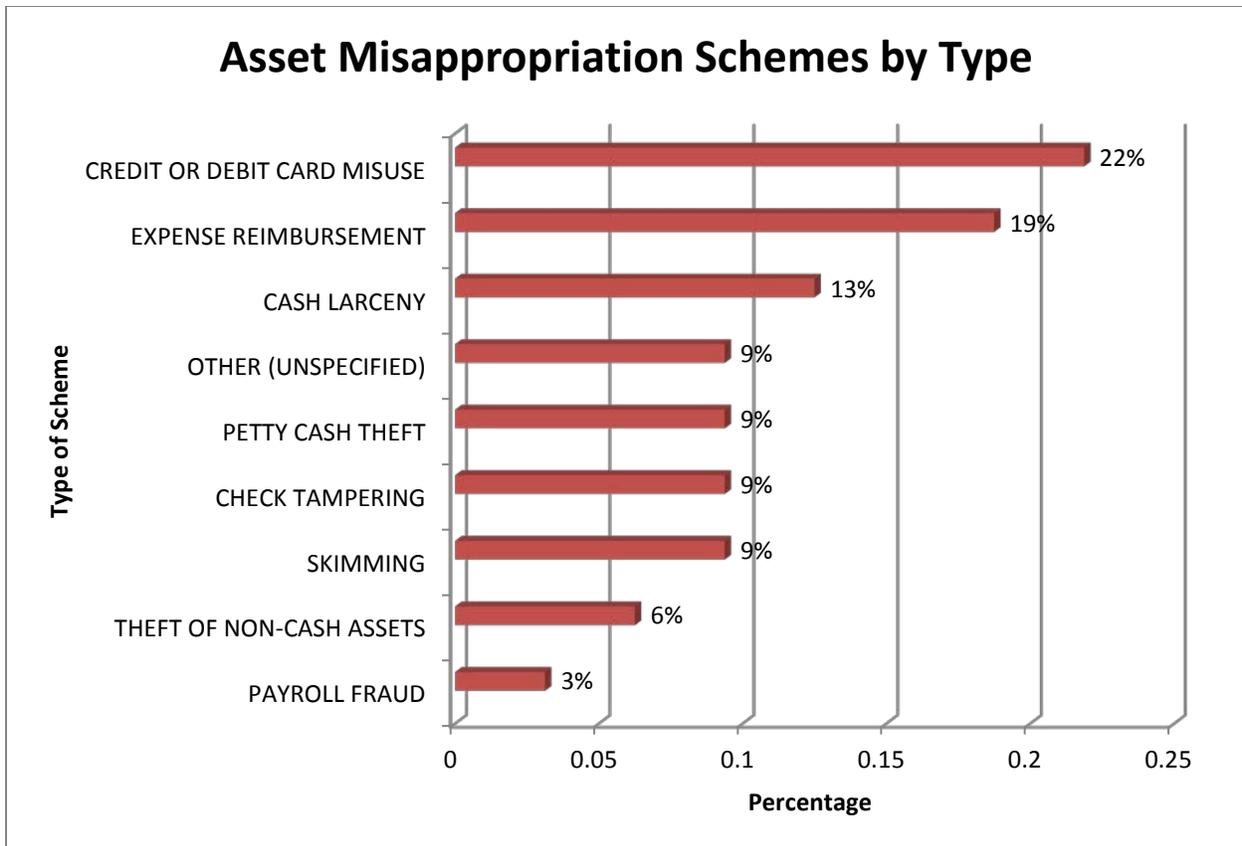
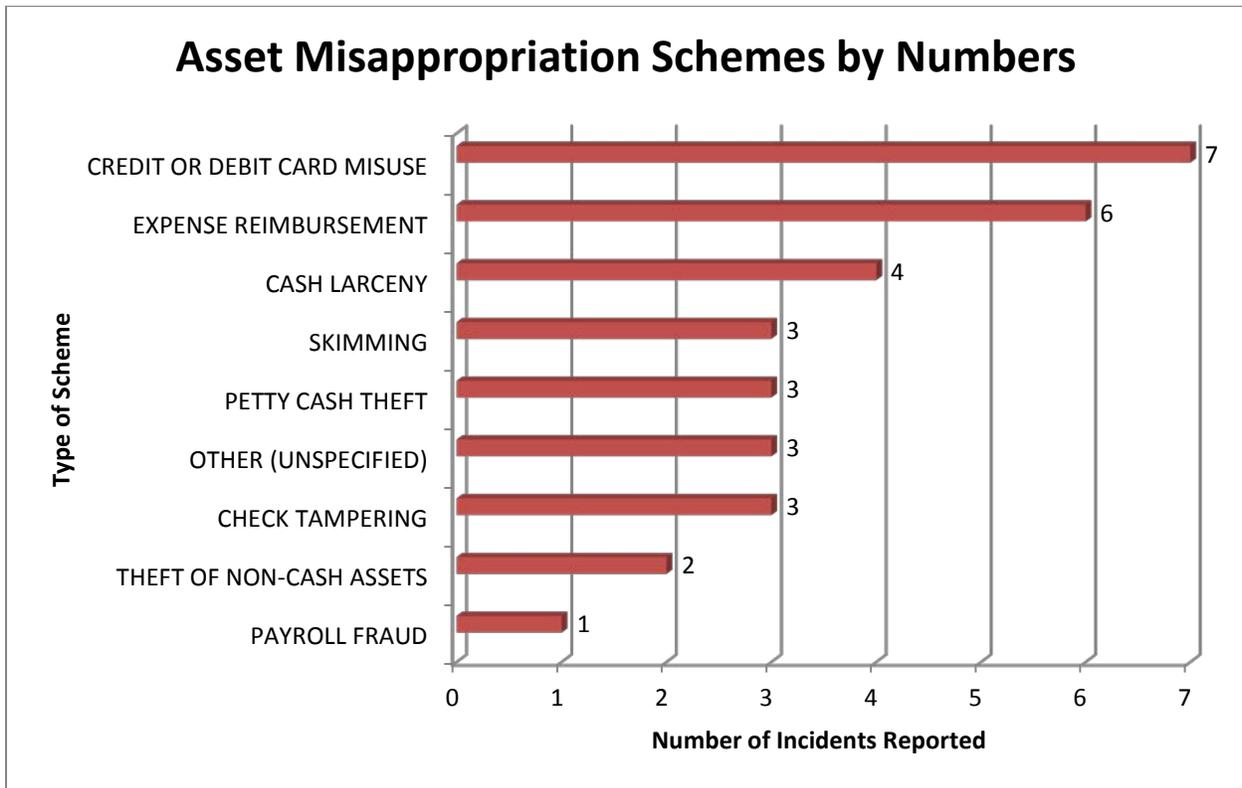
IDENTIFIED FRAUD SCHEMES BY TYPE AND OCCURRENCES

The ACFE has consistently reported in its bi-annual *Report to the Nations ...* study that **asset misappropriation** is the most common type of financial fraud.³ The Keller & Owens survey reported similar findings as shown in the graphs below.



³ *Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey*, Association of Certified Fraud Examiners

Respondents to the Keller & Owens survey reported 32 incidents of asset misappropriation fraud. The following graphs show the number and proportion of schemes by type.

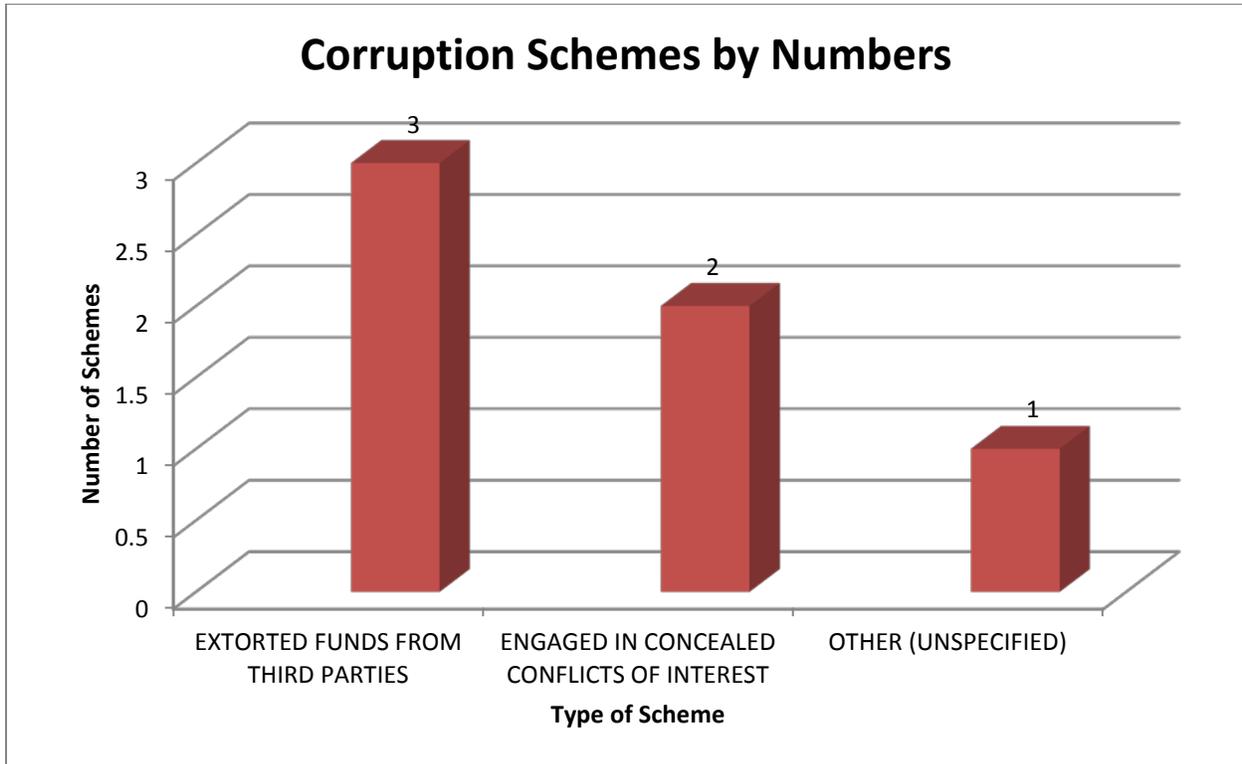


The following table describes the type of asset misappropriation schemes identified in our survey and gives an example of each type of scheme. The examples given may not represent the actual schemes that were reported.

Asset Misappropriation Schemes as Reported

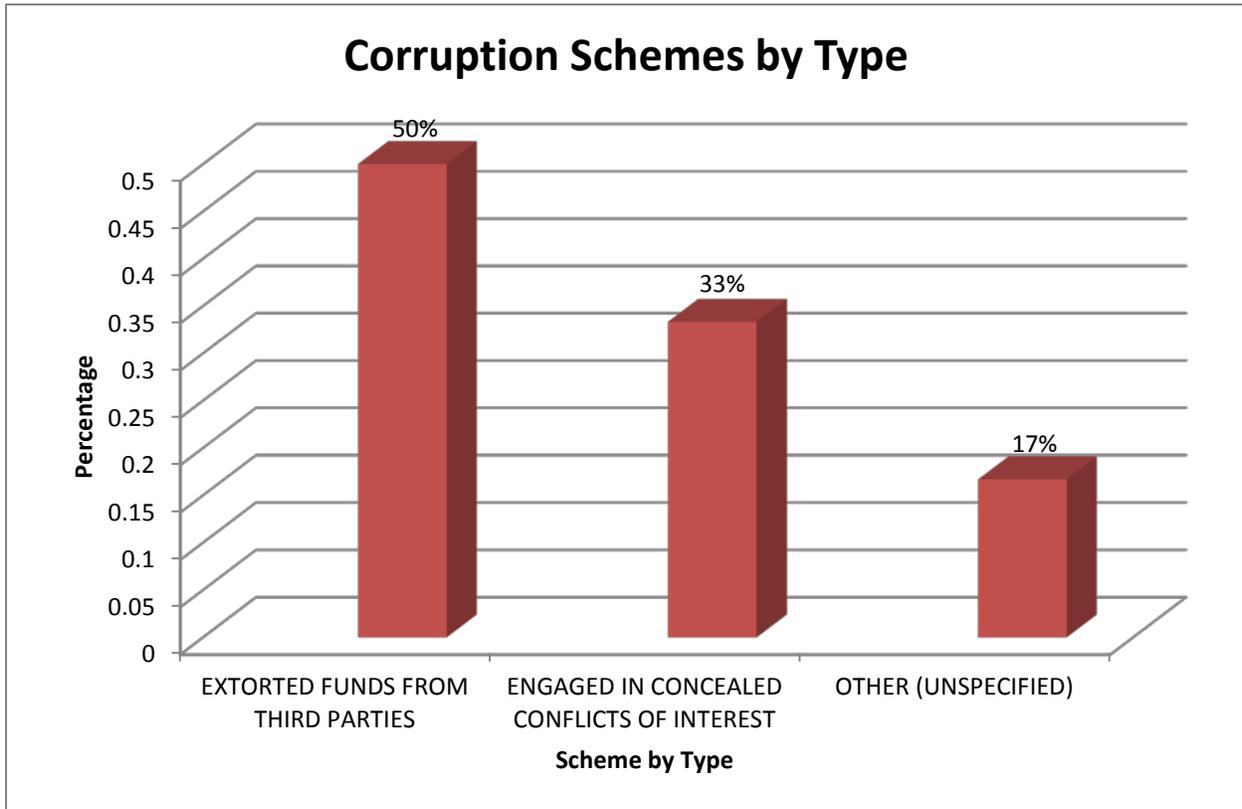
Category	Description	Examples
<u>Schemes Involving Cash Receipts</u>		
Cash Larceny	Cash receipts are stolen after they have been recorded in the records of the Church.	Bookkeeper steals checks from visitors and loose cash/currency before they can be deposited.
Skimming	Cash is stolen before it is recorded in the records of the Church.	Cash paid to a volunteer for activity fees is stolen before it is recorded.
<u>Schemes Involving Cash Disbursements</u>		
Misuse of Credit or Debit card	Unauthorized disbursement such as a forged maker scheme using checks.	Facilities manager adds personal items to credit card purchases of Church maintenance supplies.
Expense reimbursement	Claim for reimbursements of fictitious or inflated business expenses.	Employee files a fraudulent expense report claiming fictitious car rental and meals or charges personal expenses.
Petty Cash Thefts	Cash on hand misappropriated.	Employee "borrows" money and fails to repay.
Check Tampering	Employer checks forged or altered; check to legitimate Payee stolen.	Volunteer Treasurer steals blank checks and makes out to self or accomplice.
Non-Cash Misappropriations	Employee steals or misuses non-cash assets of the Church.	Employee "borrows" church van to take family on vacation.
Payroll Fraud	Employee issues an inflated or fictitious payment for a false claim for compensation.	Payroll clerk continues to create payroll checks in the name of a former employee and deposits in own account.

The ACFE 2012 *Report to the Nations...* again identified asset misappropriation schemes as the most common.³ However, the Report also indicated that **corruption** schemes are much more costly. The Keller & Owens survey respondents that experienced corruption fraud usually also experienced asset misappropriation and/or reporting schemes and did not segregate their dollar losses by type of scheme. Accordingly, the corruption related graphs below show only schemes by number of incidents or type of scheme.

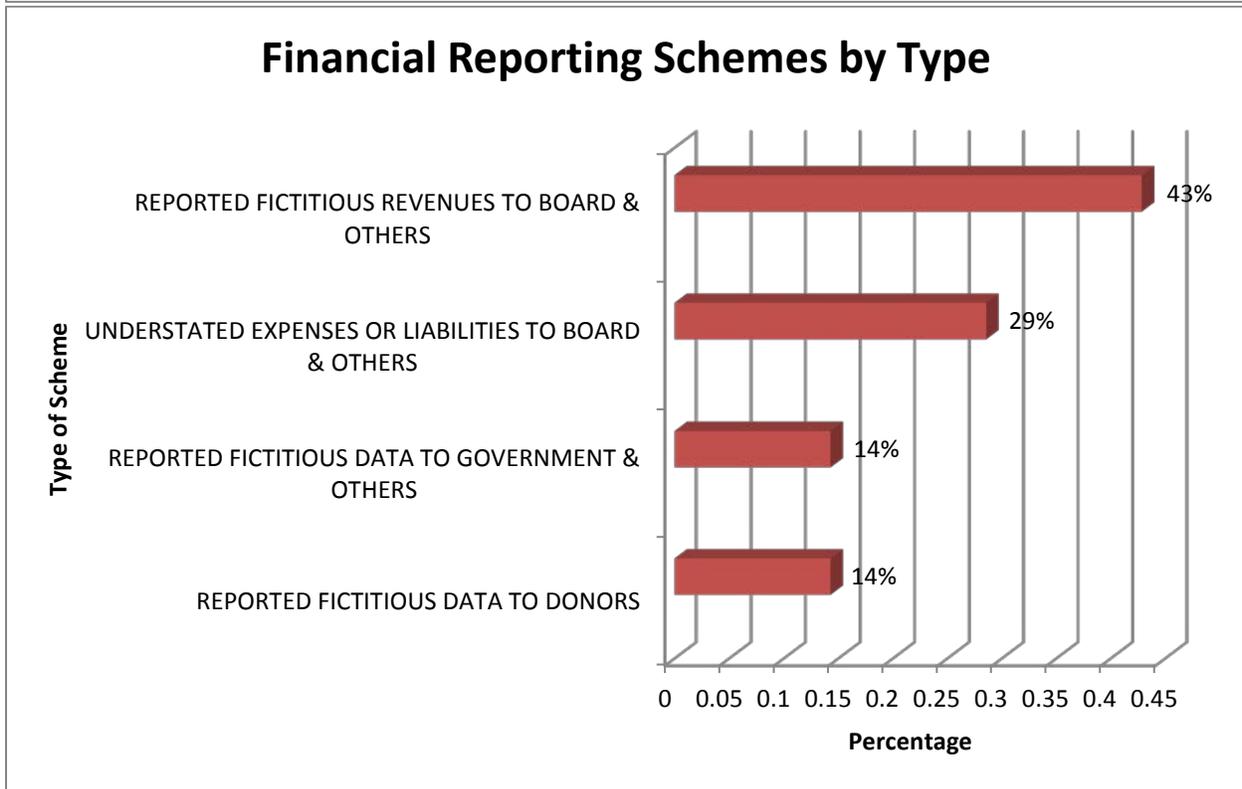
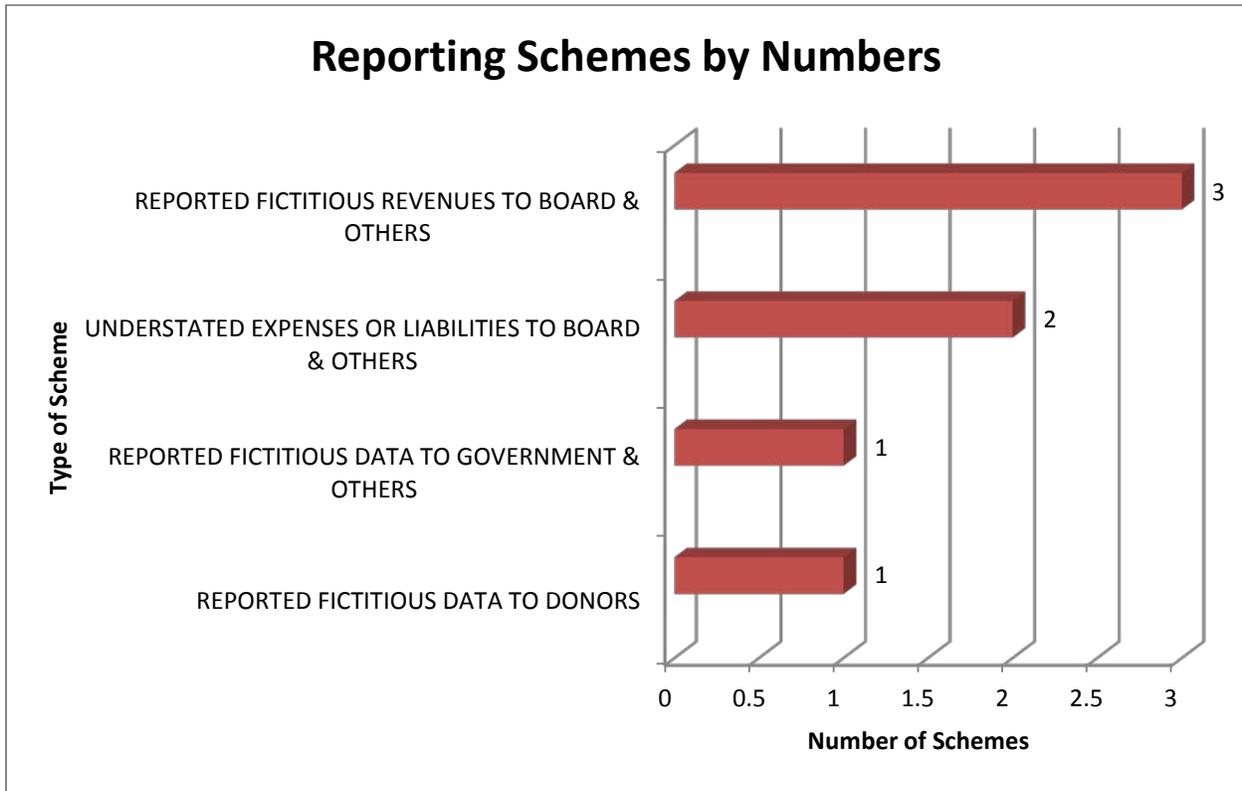


³ *Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey*, Association of Certified Fraud Examiners

One of the three corruption schemes reported in our survey resulted in a \$200,000 loss when a member of the pastoral staff “solicited” insurance proceeds from two parishioners under false pretenses and kept the funds for personal use.



Financial reporting schemes are the third type of occupational fraud. The fraudster, usually management, intentionally makes false assertions relating to financial information intended to deceive internal or third party users. The following graphs report the survey results by number and type of financial reporting fraud.

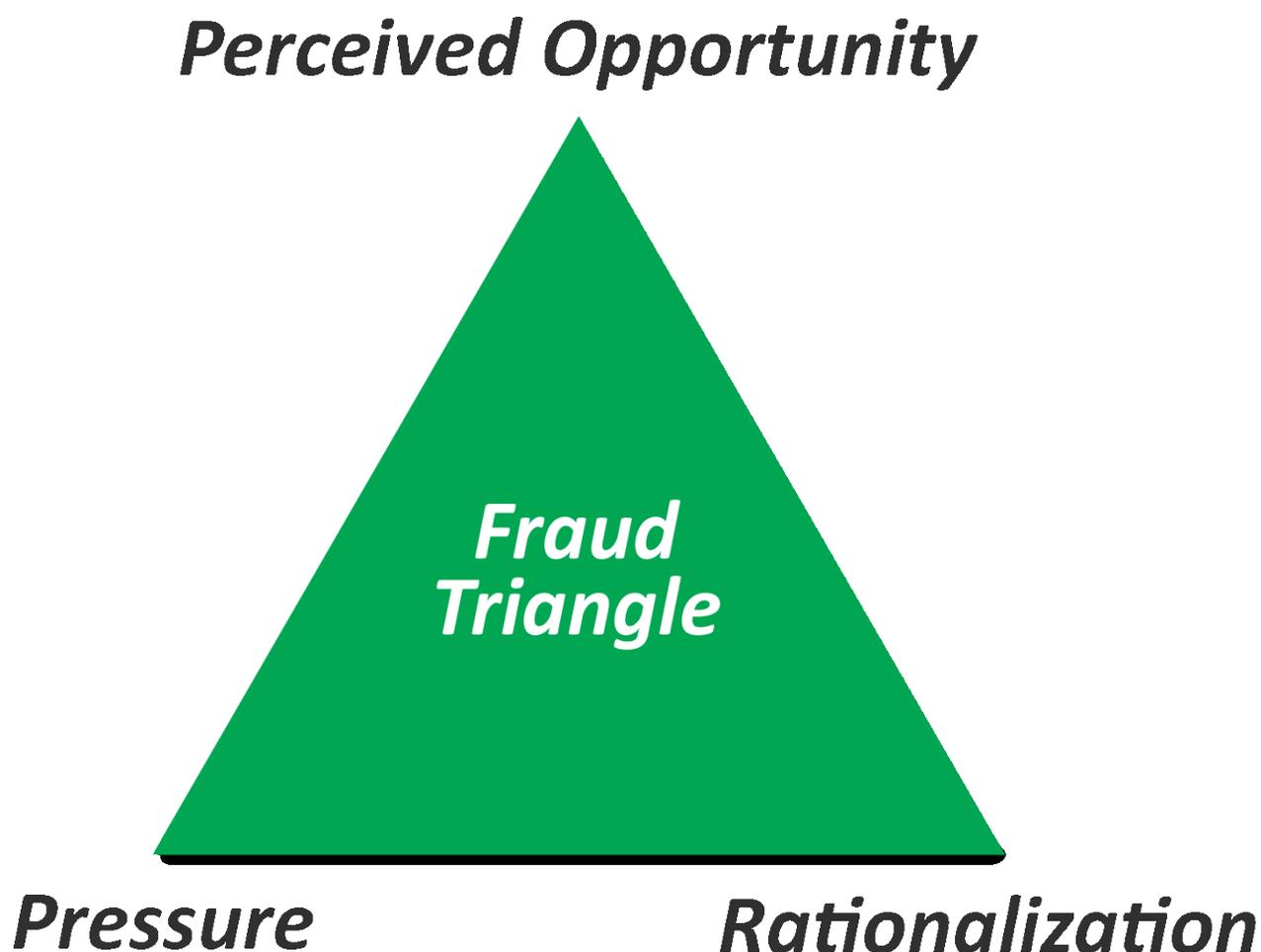


THE ELEMENTS OF FINANCIAL FRAUD

The Perpetrator and the Fraud Triangle

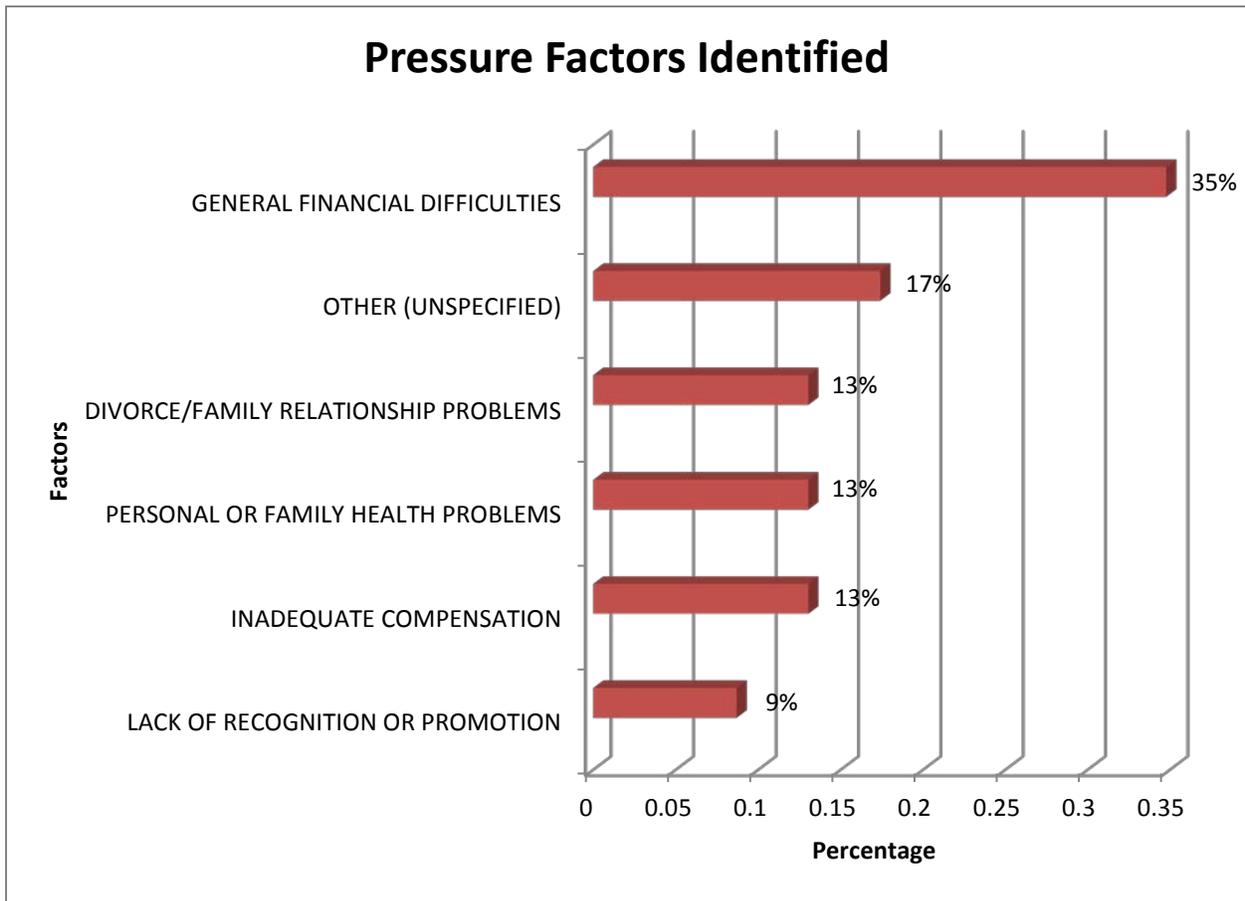
Though some perpetrators are perpetual criminals who continue their actions because they aren't prosecuted or there are inadequate background checks by employers, most frauds are committed by trusted employees or ordinary persons who never thought they would engage in fraud.

There are three elements present in every fraud which are commonly known as the fraud triangle as illustrated in the following diagram.



Pressures

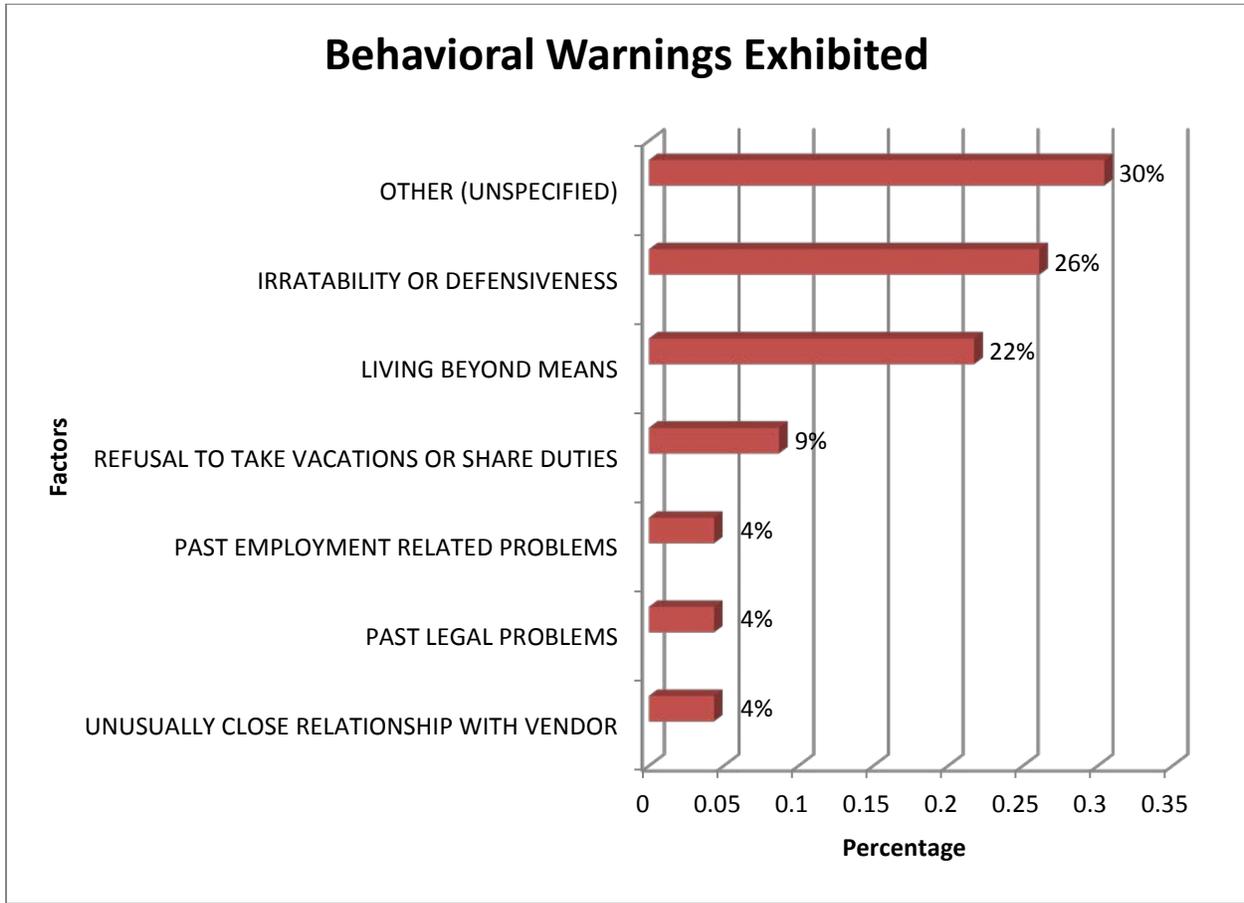
Management or other employees may have an incentive or be under pressure, which provides a motivation to commit fraud. The individual could feel financial pressures for themselves or others, have a drug, gambling or spending addiction, believe that they are “underpaid”, or that the funds are just borrowed. For some, the incentive may be nothing more than the fact that the perpetrator wants to see if they could get away with fraud. The KO survey identified the following pressure factors in the frauds reported by churches.



Since 2008, the U.S. economy has experienced significant financial difficulties. Those financial stresses have resulted in diminished revenues, reduced compensation and even unwanted staff cuts. Consequently, churches and their employees are more vulnerable to financial frauds, especially asset misappropriations, than in favorable economic times. The graph above reports financial pressures as the factor for nearly 50% of the frauds that occurred.

Rationalization

Those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess an attitude, character or set of ethical values that allows them to knowingly and intentionally commit a dishonest act. The KO survey respondents were not able to report the actual justifications of the fraudsters but did indicate that the perpetrator displayed one or more red flags often associated with fraudulent conduct.

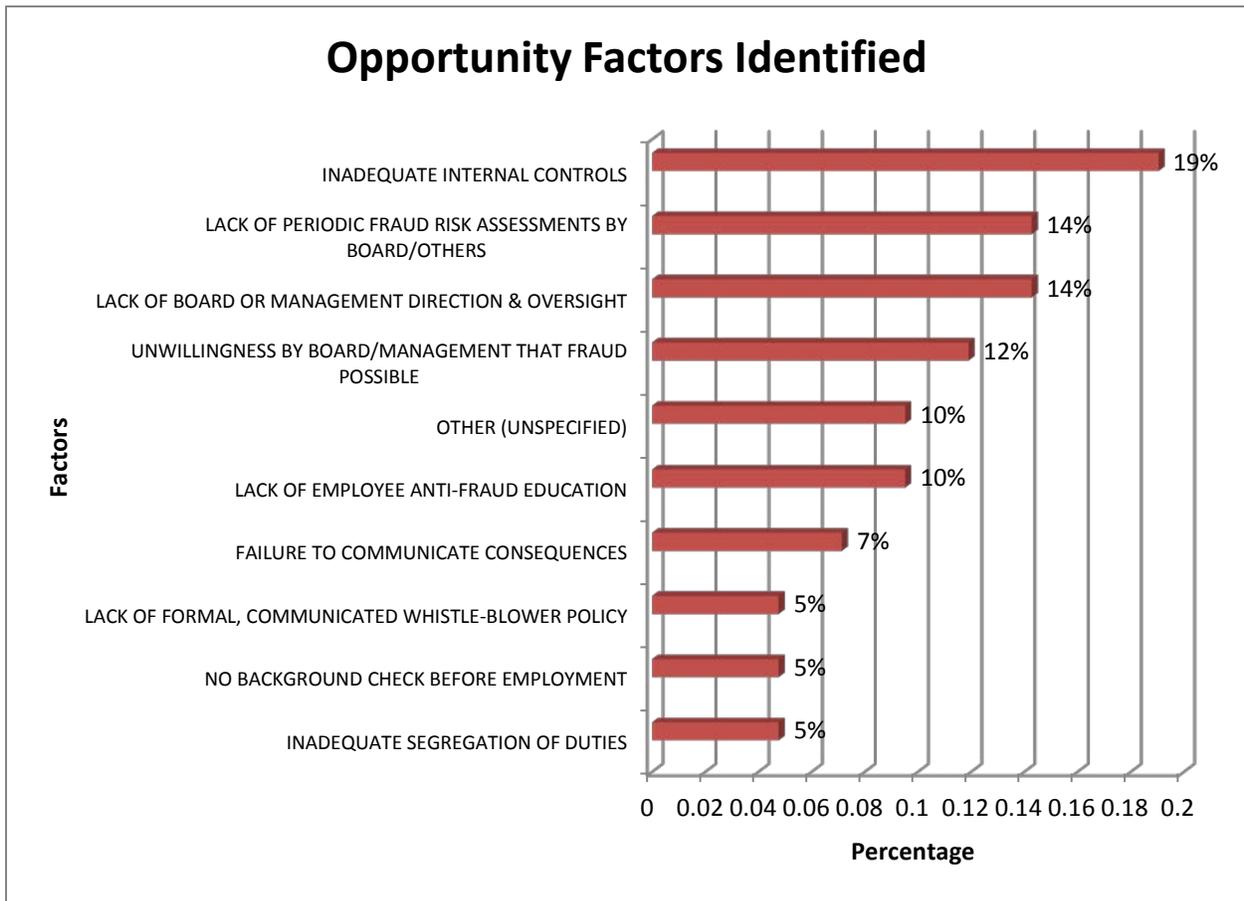


Seventy percent of the respondents in the KO survey reporting incidents of fraud identified “red flags” that might have given observers reason for concern, such as defensiveness, living beyond means or refusal to take vacations. The *ACFE 2012 Report to the Nations...* reported living beyond means, financial difficulties and close association with vendor/customer as the top three red flags with defensiveness and refusal to take vacations well down the list.³ While a reasonable level of trust is necessary, observers of these types of behaviors, especially over an extended period, should not ignore what might be indicators of potential problems.

³ *Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey*, Association of Certified Fraud Examiners

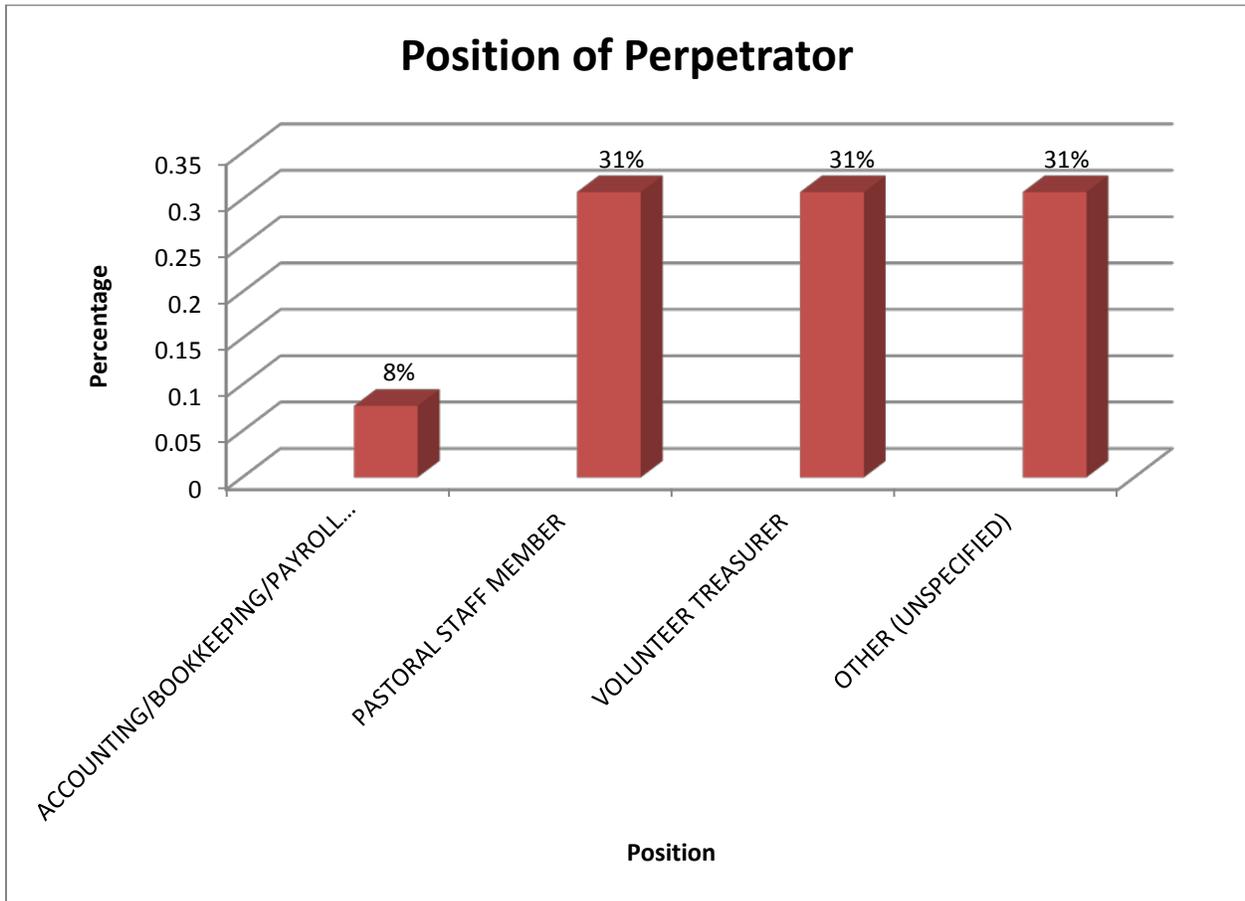
Perceived Opportunity

Circumstances exist – for example, the absence of controls, ineffective controls, or the ability of management to override controls – that provide opportunities for fraud to be perpetrated. This is the crucial ingredient without which the fraud can't occur even if the pressure and rationalization factors are present. The KO survey found that poor or non-existent oversight or inadequate internal controls provided the fraudster with the most frequent opportunities to commit fraud.



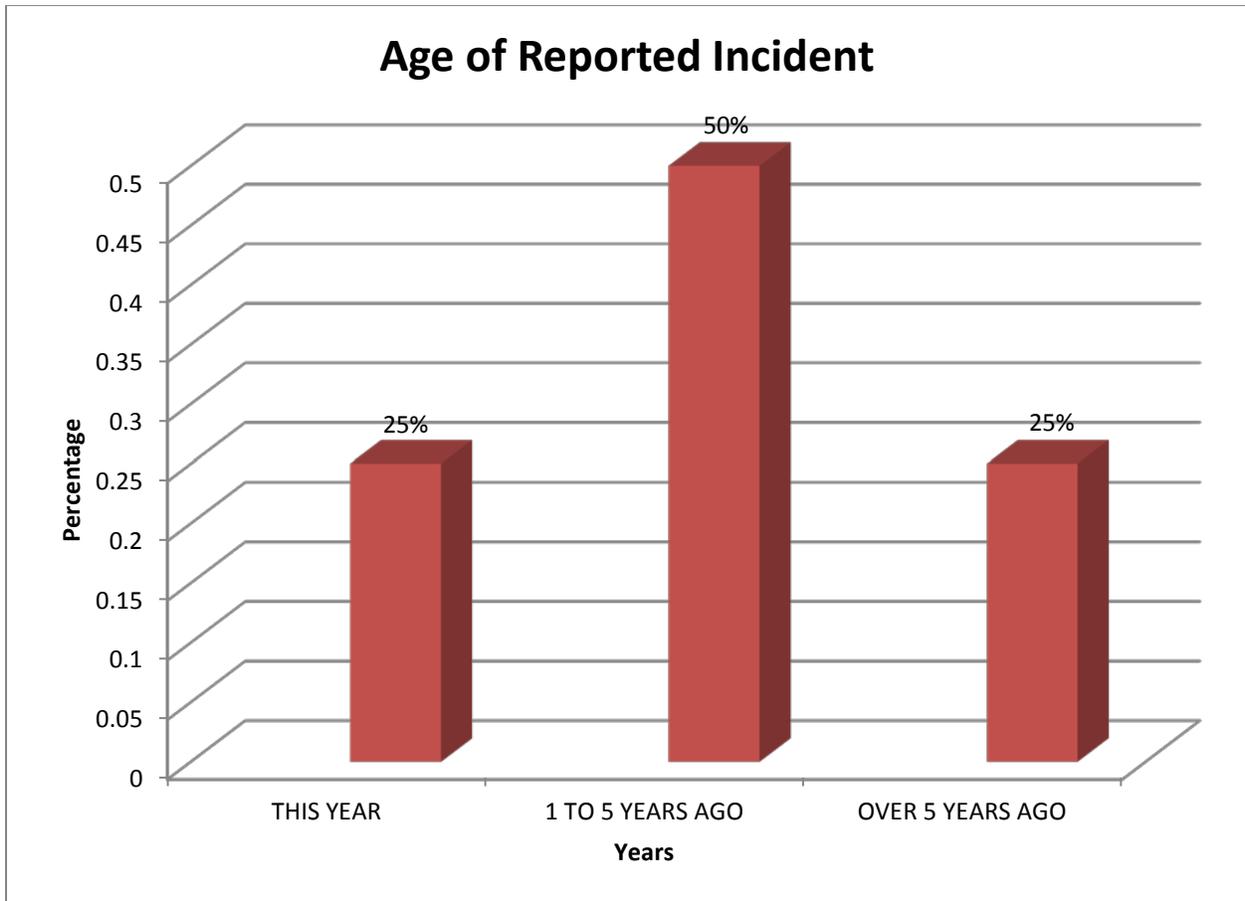
THE PERPETRATOR

Fraud studies by others, including the ACFE, found that employees commit the greatest number of frauds as opposed to those in management. The KO survey found that employees, i.e., non-pastoral staff, when combined with volunteers committed only slightly more of the reported frauds that did management or pastoral staff. However, a large portion of the respondents did not identify the position of the perpetrator.



DURATION OF THE FRAUD SCHEME

The ACFE *2012 Report to the Nations ...* found that the median duration – the amount of time from the inception of the fraud until it was discovered – for all cases in their study was 18 months.³ While precise data was not provided, the age of the frauds reported in the KO survey would suggest an average duration of about 2 ½ years. As noted earlier, Cornell and Johnson believe that the appropriate safeguards “were so poor that they [churches] probably harbored many undetected frauds.”⁴

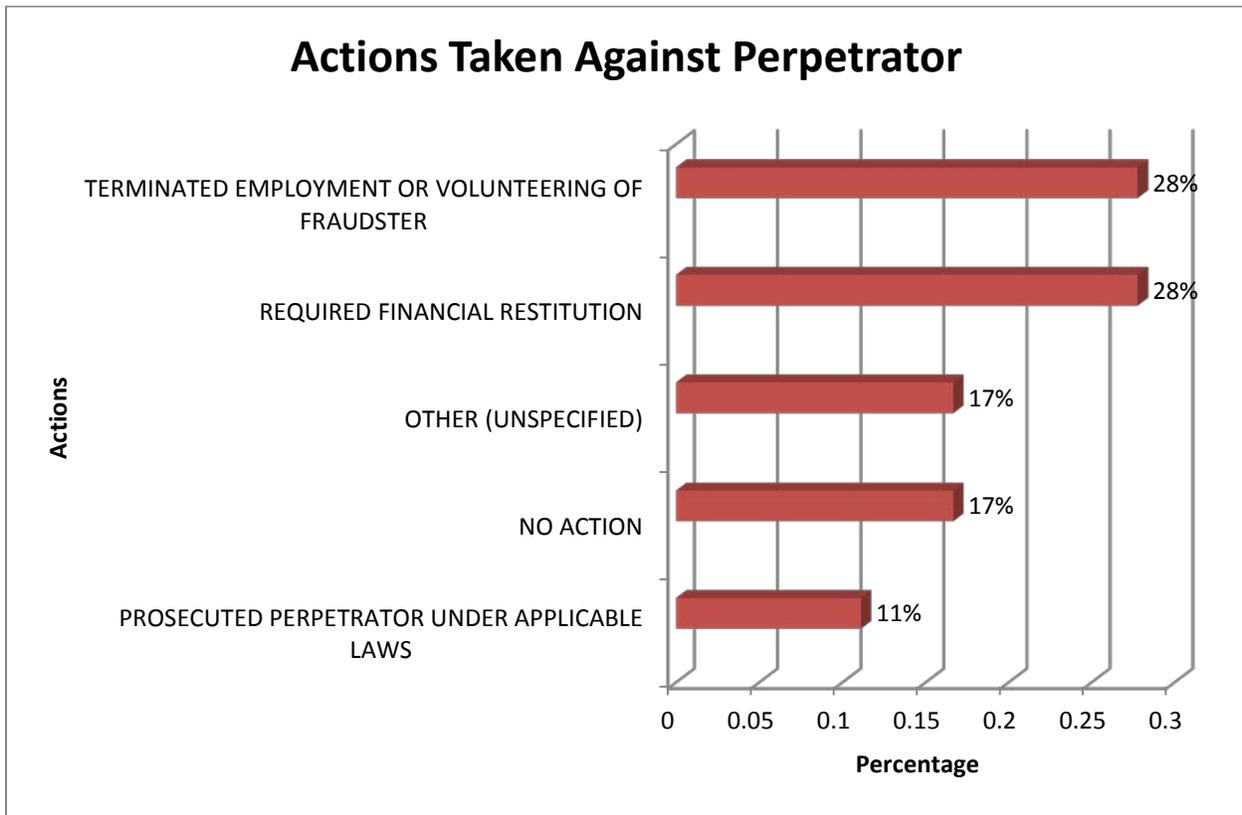


³ *Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey*, Association of Certified Fraud Examiners

⁴ *Fraud in Houses of Worship: What Believers Do Not Want to Believe*, January/February 2012, *Fraud Magazine*

ACTIONS HAVE CONSEQUENCES - SOMETIMES

Actions taken by churches varied from doing nothing to referring the matter to law enforcement. All victims informed the church's governing body of the alleged fraud. Less than half indicated that they contacted legal counsel (which should be a **must** to protect the church and the alleged fraudster). Most interviewed the alleged fraudster and took steps to preserve the evidence of alleged fraud. A smaller portion of the victim churches took specific action to correct the weakness(es) that permitted the fraud to occur. About 25% of the churches engaged an expert to assist them in fully uncovering the details of the fraud. Surprisingly, only one in six informed their insurance carrier of the loss.



LESSONS TO BE LEARNED FROM CHURCHES REPORTING NO FRAUD

Most respondents to the KO survey indicated that they had not experienced financial fraud in the recent past. When asked to what they attributed their good fortune, they replied as noted in the chart below.



The responses of these churches support KO's strong believe that the "tone at the top" when evidenced by a formal and communicated code of conduct and regular fraud risk assessments by the governing body and church management is the critical foundation to fraud prevention. A close second in importance must be sound internal controls, including reasonable segregation of duties among employees (and volunteers). We also believe that an important part of any church's insurance portfolio should be theft and dishonesty coverage amounting to no less than three months cash receipts. Finally, even though most respondents above did not so indicate, many fraud prevention experts believe that a credible threat to detect and prosecute the fraudster is a key factor in successful fraud prevention.

KELLER & OWENS, LLC

Who We Are

Keller & Owens, LLC was founded in 1980 with the needs of clients in mind. The founders believed individuals, commercial and not-for-profit organizations wanted and deserved the opportunity to obtain high quality, timely, broadly-based services from trained and experienced professionals at a reasonable cost. They were convinced that these attributes combined with close, personal services of management level personnel would mean success for clients and the firm. As a result, Keller & Owens, LLC has become one of the larger independent local firms in the greater Kansas City metro area specializing in serving churches.

Keller & Owens, LLC is a full service public accounting firm providing accounting, auditing, consulting and tax services to our clients. The firm specializes in services to not-for-profit organizations and has one of the largest not-for-profit client bases in the city. The firm consists of seven management level personnel, including three owners, and twenty-three full and part-time professional and clerical personnel. Most of our professionals are CPAs and average about 10 years of experience in public accounting and business.

For more information about Keller & Owens, LLC visit our website at www.kellerowens.com.

Serving the Needs of Churches

Our firm offers a wide variety of services to churches and church-related organizations. We tailor our accounting, assurance, consulting, payroll and tax services to your specific needs.

Accounting

Meaningful, well-organized financial records help you manage your operations more efficiently. Our firm provides a full range of cost-effective accounting services including the following:

- General ledger and financial statement preparation
- Bookkeeping
- QuickBooks® and other software consulting
- Accounting policies and procedures manuals

Assurance

Many times you need an expert's report on matters of significance to your operations or for your stewardship to others. We offer a variety of services designed to provide the desired level of assurance on such matters. The following is a partial list of the assurance services we offer:

- Audits of financial statements
- Reviews of financial statements
- Internal control system examinations
- Other nontraditional examination situations

Consulting

In addition to acting as a ready resource to the Board and management, we provide a variety of consulting services including the following:

- Cash flow and budgeting analysis
- Compensation and benefit planning
- Financial forecasts and projections
- Fraud and forensic accounting services
- Training financial and accounting personnel
- Training effective board and finance committee members

Tax

By specializing in non-profit organizations, we are in a position to identify key issues and needs for tax exempt organizations and clergy. We offer the following services, among others:

- Tax exemption application and Form 1023 preparation
- Clergy tax planning and return preparation
- Unrelated business income consulting
- Charitable giving consultation

Payroll

Our Payroll Partners Plus division offers a full range of payroll services customized to the unique needs of churches and their employees. The following are some available options:

- Preparation of payroll checks (including laser signature), reports and federal forms
- Direct deposit of employee checks
- Electronic payment of payroll taxes
- Consulting on payroll matters, including for clergy

For more information about the services we offer or the experienced professionals serving churches and church-related organizations ask us or visit our website at www.kellerowens.com.

Financial Fraud Deterrence Services

Our team of professionals, led by Certified Fraud Examiners, is available to provide the following services:

- Train your governing body on the risks of financial fraud in churches and how to combat it.
- Train your employees on how to identify financial fraud and steps to take if it's detected.
- Review your internal policies covering such areas as conflict of interest, code of conduct, whistleblower and others with recommendations for improvements.
- Work with you to document your anti-fraud internal accounting controls and make recommendations for improvements.
- Work with you to develop tailored fraud risk assessment tools for use by the governing body and by management.
- Assist you in developing an internal audit program to help detect fraud and provide other important financial oversight for the church.

Other Fraud Prevention and Detection Resources from KO*

Preventing and Detecting Fraud in Not-For-Profit Organizations, 2012 Revised Edition

2012 Fraud Risk Assessment Materials for Church Governing Bodies

Video of an Interview with a Whistleblower in a Major Church Financial Fraud – for Church Governing Bodies

* These resources are available for viewing or download free of charge at www.kellerowens.com/not-for-profit organizations/religious organizations.



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