

Accounting Fraud at Deercreek Country Club

Linda A. Hong, MBA, CPA

Instructor

Department of Accounting and Finance

Coggin College of Business

University of North Florida

4567 St. Johns Bluff Road, South

Jacksonville, Florida 32224-2675

Email: lahong@bellsouth.net

Jeffrey E. Michelman, Ph.D., CPA, CMA (contact author)

Associate Professor of Accounting

Department of Accounting and Finance

Coggin College of Business

University of North Florida

4567 St. Johns Bluff Road, South

Jacksonville, Florida 32224-2675

Phone: 904-620-1541

Fax: 904-620-3861

Email: jmichelm@unf.edu

January 14, 2007

The authors developed the case for class discussion rather than to illustrate either effective or ineffective handling of the situation. The case is based on actual events, yet all names and places been changed in order to mask the true identity of both the organization and individuals involved. Any similarity between people, places and events is by coincidence. ©2006 Linda Hong and Jeffrey Michelman. Contact person: Jeffrey E. Michelman, Coggin College of Business, University of North Florida, 4567 St. Johns Bluff Rd., Jacksonville, FL, 32224, 904-620-1541, jmichelm@unf.edu.

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A HISTORICAL PERSPECTIVE

Claudia Martinez was hired in November 2001 to replace Paul Tenny as General Manager for Deercreek Country Club (the Club) in Wilmington Delaware. Within a few weeks of her arrival, Claudia was playing golf on the Club's private 18-hole golf course when she was approached by Randy Barnes, the head of the Club's Budget and Finance committee who said, "Watch out for that guy in accounting. We've never been able to get our construction loan accounts to balance."

The person he was referring to was Cole Dunlap, the Controller at the Club since 1996. New to her position at the Club, Claudia didn't know how to take Randy's comment. She would later realize that this was just the beginning of her journey to uncover the person who committed what the District Attorney's office would later describe as "the largest embezzlement case our office has ever seen."

Deercreek Country Club was founded in 1947 and is a member-owned private club with a golf course, tennis courts, an aquatic center, a fitness center and fine dining. The Club caters to its members through sporting events and social programs geared towards all members of the family. Several renovation projects, which the Club valued at over \$12 million, were completed in 1999 and 2000. The Club is registered as a 501C (7) tax exempt, non-profit organization and is governed by a Board of Governors (the Board). Revenues are received through monthly dues, food and beverage sales and other fees.

The Club's Board of Governors is comprised of 12 elected, volunteer members serving three year terms with no consecutive terms. Expiration of the terms is staggered,

so that four members are elected each year. Board officers are elected by the Board each year for one year terms with no consecutive terms. Board meetings are held monthly. The Board at the Club consists primarily of judges, lawyers and businessmen. Based on the by-laws of the Club, the only qualification necessary to become a Board member is to be a member of the Club. Several other committees were in place at the Club, but the by-laws were not clear as to their specific purpose. See Exhibit I for a list of the other committees.

According to the Club’s by-laws, the Board is responsible for ensuring that blanket fidelity bonds are purchased. The fidelity bonds are to be in an amount sufficient in the judgment of the club’s insurance provider to indemnify the Club against loss and to cover officers, board members and employees.

THE GENESIS OF FRAUD

Early in 1995, Larry Morris, Cole’s father-in-law and a prominent Club member, recommended Cole for the position of controller for the Club. Although not a CPA, Cole’s resume’ stated that he had a BS in Business with a major in Accounting.

A summary of Cole’s work history was found on the resume’ in his Club personnel file and is shown below:

Dates	Company	Title
9/94 – 1/95	New Castle Pest Control	Comptroller and Officer Manager
10/91 – 8/94	John Sapp & Sons, Inc.	Assistant Controller
4/91 – 10/91	STA Staffing	Accountant – Temporary
1/88 – 4/91	BAS, Inc.	Comptroller and Officer Manager
4/85 – 12/87	Marks International, Inc.	Owner and President

Cole provided a list of references including his father-in-law, his insurance agent, the former controller at John Sapp & Sons and the Chairman of the Board at Delaware Life

Insurance Company—one of the largest and most prestigious employers in Wilmington at the time.

Dennis Rhodes, the general manager at the Club, hired Cole. During the hiring process, Rhodes complied with the Club's hiring policies by completing the hiring checklist by checking off that he had done the following:

- Resume' or application received
- W-4 completed
- References checked
- Drug test passed
- Medical form completed
- I-9 Form completed
- 90-day probationary signed

Paul Tenny who was Cole's general manager from mid-1997 until November 2001 later replaced Dennis Rhodes. For an organization chart of the club see Exhibit II.

CLAUDIA MARTINEZ JOINS THE CLUB

Claudia Martinez was hired as Cole's supervisor and the general manager for the Club in November 2001. Claudia had 25 years of experience in club management and had taken several accounting courses. Claudia immediately became suspicious after the Building Committee chair told her to watch out for Cole due to balancing problems in the construction accounts. She decided to keep her eyes open.

Claudia wasn't pleased with Cole's practice of downloading accounting reports to Excel spreadsheets and making accounting adjustments prior to showing the numbers to her or to the Board. Claudia liked to be involved in the business and believed that she had a good grasp of accounting and how things should be run at the Club. Claudia

remembers a conversation that she had with Cole about his practice of providing the Excel generated financial reports.

Claudia: Cole, I am not comfortable with the fact that you provide Excel reports to me and the Board rather than providing reports directly from our accounting system.

Cole: Claudia, you know the accounting system is DOS based and the percentages on the reports don't add up correctly. I have to correct the percentages manually in Excel prior to handing out the reports. Also, the format of the reports is confusing. The expenses aren't listed in the right order. I have to correct all of that.

Claudia: OK, Cole. I understand now. I know that the DOS reports are a bit difficult to interpret.

Claudia was still uncomfortable, but she was new to her position and was not well liked yet. She was hired to downsize departments that were losing money and had begun that process. People were angry with her already, and she didn't want to rock the boat. She also knew that Cole was a known commodity at the club with his wife and her family being long-time club members. She decided to leave things alone for now.

SOME THINGS JUST DON'T ADD UP OR DO THEY?

In March 2002, Claudia received a telephone call from Debbie Fagan, the fitness director. She remembered the conversation clearly.

Debbie: Do you know if the club has a credit card?

Claudia: I don't know. I'll have to check with Teri in Accounts Payable.

In a later conversation with Teri, Claudia brought up the credit card.

Claudia: Teri, Does the club have a credit card?

Teri: Yes.

Claudia: Why haven't I seen any checks paying the credit card bill? I review all of the checks.

Teri: Cole set the account up to be paid by automatic debit.

Claudia: I'd like to see the credit card statement.

Teri: No one except Cole sees those statements.

Claudia began to get nervous. What was Cole doing with a company credit card?

Did someone authorize the opening of the account?

Claudia: Do you know which bank holds the credit card?

Teri: FirstState.

Claudia decided she better call FirstState and order the statements. In a week or so, Claudia received the bank statements from FirstState. She was shocked when she saw that the name on the account was "Cole Dunlap, Deercreek Country Club." Claudia's hand began to tremble as she tried her best to hold onto the statement. Without hesitation, she called Paul Tenny, the former general manager.

Claudia: Hi Paul. I just came across something that I was hoping you could help me with?

Paul: If I can.

Claudia: Cole has a credit card in his and the Club's name. Did you authorize the opening of a credit card account?

Paul: No, I don't know anything about a credit card. That does not sound right. Are you sure about this?

Claudia asked Cole about the credit card and the automatic debit. Cole assured her that Paul had authorized the card and the automatic debit to eliminate any late charges from occurring on the credit card. Claudia decided to place a stop order on any future automatic debits to the credit card.

Claudia's patience with Cole was wearing thin during 2002, but she had her hands full with downsizing and problems in other areas. The Food and Beverage Department was losing money, so she had to lay off the head chef. Claudia then heard from the assistant chef that the head chef had been day-trading on the job. Also, the payroll clerk didn't show up for work one day, and Claudia had to jump in and help transition her duties quickly. Claudia later found out that the police had come by the office to arrest the payroll clerk due to unknown criminal activities. There were just too many areas of the Club competing for Claudia's attention.

Early in 2003, Cari, an employee at the Club, called Claudia about her 401K matching.

Cari: Claudia, my 401K match seems to be low by $\frac{3}{4}$ -1 percent.

Claudia: We have an outside company who handles the 401K matching. Cari, I don't know how that could happen.

Cari: Claudia, would you check into it? I know this is not correct.

Claudia: OK.

Claudia contacted Cole, and Cole told her he made an error. They called in the 401K specialists, who ultimately determined that Cari was right. The percentages were off by $\frac{3}{4}$ -1 percent. The Club made the necessary adjustments, which amounted to approximately \$35,000 paid to the employee 401K accounts.

Claudia was really beginning to wonder about Cole's competency. First, it was the Excel reporting issue and now the 401K error. Cole was also calling in sick far too often.

Claudia knew that she had an ally on the Budget and Finance Committee, but she also knew that the Board got irritated with the detailed questions that came from that committee. The stress of the situation was really beginning to get to Claudia. She was increasingly finding it difficult to sleep and didn't know what to do.

In the first quarter of 2003, Roger McMahon and Associates arrived to conduct the annual audit and to review the Club's internal controls. During the audit, Roger's team found several issues of concern including a check with Cole's signature and a second unrecognizable signature. This set the ball rolling toward a thorough audit by Roger McMahon's office that resulted in an adverse opinion.

On June 13, 2003, Roger McMahon issued a report on internal controls. In the report, he stated the following:

- a) Members of the Budget and Finance Committee are, at times, uncomfortable relying on the monthly financial data. Errors were noted in the financial data presented to the membership at the Annual Meeting and there are occasional mathematical errors detected in the monthly financial data. Roger recommended that "someone independent of the accounting department review the general ledger, journal entries and selected account reconciliations each month as a safeguard against noticeable errors."

- b) There were multiple versions of the current year budget in use by the accounting department. Since the Board relies upon comparisons of budget to actual in gauging current performance, using a final approved budget is critical.
- c) There was no fixed asset subsidiary ledger. Based on the records available, Roger's team had to reconstruct a subsidiary ledger that included approximately 556 separate items. The partner stated that there were several years where individual items could not be reconstructed.
- d) Since the makeup of the Board changes completely every three years and partially every year, there is a need for an orientation package for new Board members.
- e) There is no comprehensive organization chart indicating appropriate allocation of operating and supervisory responsibility. The chart should define adequate separation of duties and assure that all areas of operation receive adequate managerial attention.
- f) Vendor bills were filed in numeric rather than alphabetical order. There was no reason given by accounting personnel for why this method was used. The general manager found it difficult to review the bills due to the numeric filing method.

Late in the second quarter of 2003, Claudia placed Cole on probation for poor performance. When Cole's performance didn't improve, Claudia asked Sally Adams, the Board president, to approve her decision to dismiss Cole in August 2003. Knowing of Cole's poor performance, Sally agreed. At this point, Claudia was still unwilling to accuse Cole of stealing. Given Cole's history with the Club, she felt she needed hard evidence before sharing these suspicions with anyone. In the meantime, by firing Cole, at least things couldn't get worse.

Claudia and Sally called a board meeting and asked the Board to vote on asking for Cole's resignation. The Board had not been impressed with Cole's ability to give direct and accurate answers to their financial questions. The Board voted to ask Cole for his resignation and absent a positive response, Claudia was empowered to fire him.

In August 2003, Cole was released from employment, but Claudia had one final request. She needed to know Cole's computer password. When she asked Cole for his password, Cole told her it was "Millions."

THE SIGNS OF FRAUD

Shortly after Cole's departure, Claudia decided to review the bills coming into the Club. She noticed a bill for \$70 from Wilmington National. She approached Teri in Accounts Payable a second time.

Claudia: Teri, Do you have the account information for the Wilmington National account?

Teri: I've never received a bill on that account before. This is the first bill.

Claudia: Do you know where the account statements are kept?

Teri: No.

Claudia ordered the statements from Wilmington National. When the statements were delivered, Claudia found what appeared to be Cole wiring funds to his own brokerage accounts.

A few days later, a disturbing telephone call came in to Kelly Sessions, the membership director for the Club. Kelly told Claudia that an anonymous caller had told her to check Cole's background.

Claudia immediately called a private investigator that was also on the Board, and found out that Cole had a record! Immediately, Claudia called the Board secretary who was also a local judge and asked him to see if he could find out anything about Cole's record.

When the judge called her back that evening with more information about Cole's criminal record, her head started to pound. His research had found that Cole had stolen from a previous employer, BAS, Inc. and was put on probation for 10 years back in 1991. He was ordered to pay back the money that he had embezzled. Just prior to his employment at the Club in 1995, Cole was about to be picked up for a probation violation. It seems that Cole had fallen behind in his payments to BAS. He immediately paid back all of the money that he owed BAS after he was hired by the Club.

Claudia wondered how Cole got the money together so quickly. She suspected that Cole may have stolen from the Club to pay the money back to BAS.

Claudia's heart was pounding. First, she called a CPA and forensic accountant who had been recommended by the judge and asked him to come in to review the books. Then, she called Sally Adams.

THE INVESTIGATION

On September 23, 2003, Claudia and Sally met with an investigator from the District Attorney's Office to report a suspected embezzlement. They told the investigator that an audit of the records had uncovered that Cole had embezzled from the Club using several methods. They explained that they discovered bank statements showing that Cole had wired the Club's money to various personal brokerage accounts¹.

At the time of the meeting, Claudia and Sally thought that the funds embezzled were approximately \$201,002 dating back to July 2000. They later learned that Cole embezzled closer to \$1,000,000 dating back to October 1998.

The investigator advised Claudia and Sally to try to get the money back before Cole was arrested. He advised that one of them should be selected to work with Cole, so Claudia was wired and set up a meeting with Cole.

On September 25, 2003, Claudia and Cole met in Claudia's office behind closed doors. Claudia reviewed the unauthorized use of the credit card and the automatic debit from the club's operating account used to pay off the credit card balance. She accused Cole of using the card for his personal benefit. She also reviewed the use of the company credit card's courtesy checks, which appeared to have been used to pay off Cole's personal credit card bills.

At first, Cole denied the accusations, but subsequently admitted using the credit card for personal use. Claudia told Cole that at least \$50,000 was charged on the credit card for personal use and the Club expected the money to be repaid.

¹ In reviewing Cole's job description Claudia noted two significant responsibilities: a) audits all cash and charge expenditures and safeguards all funds in bank accounts while assuring that revenues are properly and correctly deposited and supervises the drawing of all checks and b) maintains the investment program and invests all excess revenue funds on a timely basis to provide better cash flow.

Claudia then asked Cole if he had ever signed her name to a Club check. Again, Cole initially denied that he had forged Claudia's signature. Claudia showed him the checks totaling more than \$10,000 that had her forged signature. Cole admitted that he forged Claudia's signature.

Claudia pulled out the Wilmington National bank statements and showed them to Cole. Claudia asked Cole if the wire transfers were to Cole's personal accounts. Cole admitted that yes, they were to his personal account for his personal gain and that he had acted alone. Cole later commented that all the money had been lost in the stock market. Claudia asked Cole if the money he had stolen was like his password, "Millions." Cole estimated it to be more like \$200-\$300 thousand.

Claudia asked Cole why he had stolen the money, and he said that it was easy and it was just greed. He said no one was looking at the documents necessary to uncover the fraud. For this reason, it was easy to circumvent the internal control system.

Claudia closed the meeting by telling Cole that he should come up with some money to repay the Club. Claudia told Cole that there would be a discussion with the Board and that she would call him after the meeting concluded.

At the investigator's urging, Claudia taped all telephone calls with Cole over the next several weeks. Excerpts from these conversations are shown below.

September 25, 2003

Claudia: I talked with Sally Adams regarding the meeting tonight and you know how Sally is, she's got ton of questions. When we talked, you expressed your reasons why you did it. Run those past me again.

Cole: Well, in those days my son was in trouble, and I had pressures from my ex-wife. I got a DUI.

Claudia: Yea.

Cole: The story doesn't matter, but I need to go through it. I was over at my class reunion in Indiana and we were driving back and my wife got in a wreck. She was driving but I said I was driving.

Claudia: Oh.

Cole: That was the situation that I had to work with.

Cole: Like I said, there was also a greed factor where I had the capability. It was sort of like using other people's money; make some money with the full intention of paying it back.

Claudia: Unfortunately, you got caught at the top of the market....

Cole: Yea, I was not able to do what I had planned to do.

Claudia: Did you ever think you'd get caught, Cole?

Cole: Yea, I thought the audit ... the auditors would pick up on it some how.

Claudia: I only saw one communication where they were questioning a reconciliation on the bank account for deposits and transfers that they couldn't balance. That's about all I saw from them.

Cole: Yea.

Claudia: And, it wasn't the same people that audit us every year right? There were always two new people coming in?

Cole: They were the same firm, but the two field auditors were different every year.

Claudia: So, they probably didn't do their homework and look back at last year and even try to balance stuff. Did they ever have any serious questions?

Cole: No.

Cole: When you are thinking about keeping this from happening, you always want to look at the detail reports. You know when you look at the details and especially your asset details. Those transfers were being made....they didn't just disappear. There's a record of them obviously.

Claudia: Mmm, huh.

The conversation ended with Claudia telling Cole that the Club's main interest was in recouping the funds. She told Cole she would call him back.

Sometime Between September 26 – 30, 2003

Claudia: Did the auditors really perform to where they were supposed to? In my opinion they failed to do their duty.

Cole: Yea.

Claudia: But, did they ever write us management letters?

Cole: I recall one letter.

Claudia: In what year?

Cole: Maybe 1999 or 2000, I can't remember exactly. And the early engagement when they first took over the account...they met with either the president or finance chair or both. I remember having luncheons, so I don't know if it was actually a management letter. It was maybe more of a verbal kind of thing. They did your standard letter that accompanies the....

Claudia:the audit.

Claudia: When did they stop meeting with the Board or with the Finance Chair? I know they haven't met with the Board since I joined the Club.

Cole: I think it was around 2001....maybe it's a couple of years ago. The letters ought to be in the files, if they wrote any. I only recall one out of the five years....

Claudia:that they did the audit?

Cole: Yea.

Claudia: Were you here when Jones, LLP did the audit?

Cole: Yea, they did it the first two years. Jones did it in 1995 and 1996 and the "Big 4 Firm" came in 1997.

Claudia: Was there a significant difference with how Jones audited versus the "Big 4 Firm?"

Cole: No, not really, other than there were more questions asked. I think their testing was more detailed.

Claudia: You mean Jones was more detailed?

Cole: Yea, if I remember right.

Claudia: Did the "Big 4 Firm" ever look at all these bank statements? Did they ever ask for the Wilmington National statements?

Cole: Yea, they asked for the year-end statements.

Claudia: Just year-end?

Cole: Year-end and the January of the next year.

Cole: For all the accounts.

Claudia: They never went back through the whole twelve months?

Cole: No. Neither did the other auditors. Like I said, it was there if they were looking.

Claudia: As you know, a lot of the people that come and go off these boards are businessmen but not accountants.

Cole: Yea.

Cole: You know a lot of those entries....the offsets were put into assets. I might be able to help with that.

In reviewing the audit file, Claudia found that the “Big 4 Firm” issued a clean opinion for the year ended December 31, 2000. There was no record of an engagement letter from the “Big 4 Firm,” so it is unknown whether one was ever prepared and/or received by Club management or by the Board. According to a hand-written note found on the “Big 4 Firm’s” audit report, no one on the board had ever seen the audit report. The address on the letter included only “Board of Governors,” the club’s name, the city and the state. There was no street address.

In addition to the audit report, the “Big 4 Firm” issued a report on internal control with several key findings noted below:

- The club has purchased, but not implemented its fixed asset subsidiary system to properly record all fixed assets held and to calculate depreciation expense.
- Various general ledger account reconciliations had not been prepared as of May 2001 for the year ended December 31, 2000.

Claudia later found out that Cole was also offsetting the credit to the cash accounts by splitting each theft between 100+ expense accounts and limiting the amount that hit each individual account at any one time.

October 1, 2003

Claudia called Cole to get more detail about Cole's reasons for stealing the Club's money. An excerpt from their conversation is shown below.

Cole: Well, I talked to someone who's a family friend and he advised me to go see a psychologist or psychotherapist.

Claudia: Mmm, huh.

Cole: I've analyzed this whole thing and there's really not a place that I've worked that I didn't look for loopholes. You know, obviously it happened before and it's happened again.

Claudia: Kind of like a compulsive gambler?

Cole: Yea. He was saying that there are documented cases of this....usually it's you know related to drugs or gambling.

Cole: That's pretty much it in a nutshell. We've talked about this before. There was the tremendous greed factor involved. I was trying to hit the big score and it never happened.

Claudia: OK.

Claudia tries to Gain Perspective

On October 16, 2003, Cole was located and arrested. Cole confessed that he had lost most of the money in the stock market and was unable to pay it back. He stated that he acted without collusion.

The forensic accounting investigation uncovered several avenues that Cole used to embezzle the Club's funds.

- Cole obtained a club credit card and used it for his personal benefit. Cole would then pay off the credit card bills with club monies from the Club's Wilmington National operating account.
- Cole fraudulently issued and forged Claudia Martinez's name to several of the Club's checks in order to pay the monthly bill surrounding the use of the credit card.
- Cole fraudulently used a FirstState line-of-credit account that was to be used by the Club to conduct a \$7 million renovation in 2000. Cole wired monies from the Club's account to another Wilmington National account also held by the Club and then on to various brokerage and investment accounts personally held by Cole.

At this point, all Claudia could do was stare at the forensic accounting analysis that was prepared for the Board. What happened? This was a sophisticated organization with a lot of internal controls. They were paying one of the "Big 4" auditors a lot of money. All the origins of the fraud clearly preceded her employment; Claudia couldn't help but wonder if the Board held her accountable for what had happened.

- 1) Based on the facts of the case, do you see any deficiencies in the Club's hiring practices?
- 2) Discuss the external CPA's role in detecting fraud.
- 3) From a risk perspective, discuss the environment at the Club during the year's when the majority of the thefts occurred. Were there risk factors that increased the likelihood of errors or fraudulent activities?

- 4) Based on the facts in the case, discuss the adequacy or inadequacy of the relationship between the auditors and the Board at the Club.
- 5) What procedures might the “Big 4” auditors have used to review the expense accounts? Should the review have caught the spreading of the funds through multiple expense accounts?
- 6) Discuss the audit approach of auditing the year-end and subsequent year’s cash balance. What is the purpose of this procedure? Should the auditors have done anything different with respect to their audit of cash?
- 7) Discuss the inherent control weaknesses found in small and non-profit organizations. Were they a problem at the Club? Were there any other internal control weaknesses that you noticed in the case that have not yet been discussed?

Exhibit I – Responsibilities of Special Committees

Executive Committee

- Members: 3 board members, the board president and the past board president
- Purpose: To handle minor issues between board meetings

Strategic Planning Committee

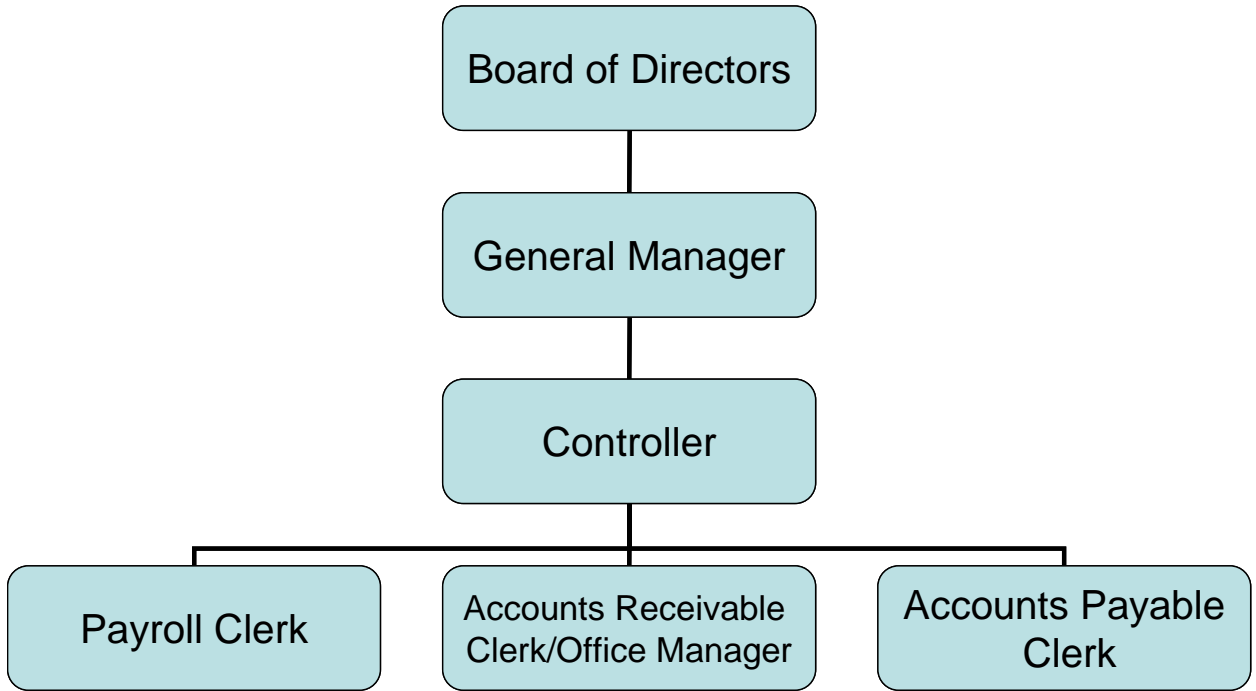
- Members: Executive Committee members plus a second past president and other members to be designated by the board
- Purpose: To study club projects

There were six other standing committees whose purposes were not noted in the by-laws.

They are:

- Golf/Grounds – 2 members
- Budget and Finance – 2 members
 - In 1998, this team included at least 1 CPA, although the by-laws did not state that a CPA was required
- Pool/Tennis/Fitness – 2 members
- Building – 2 members
- House/Entertainment/Yacht – 2 members
- Membership Review and Extension – 2 members

Exhibit II - Organization Chart



Accounting Fraud at Deercreek Country Club

ABSTRACT

The purpose of this case is to expose students to corporate governance and its impact on the audit process. Although the issues of corporate governance and internal control are involved in almost every discussion of accounting, only recently has this concept received increased discussion of their importance in nonprofit organizations. This case follows the thoughts and actions of Claudia Martinez, the general manager at Deercreek Country Club.

Claudia works to assist the local district attorney's office in bringing the controller to justice. The case helps students to understand the importance of internal controls and how controls can be circumvented to perpetuate fraud. Further, the case examines a real fraud and exposes students to the changing role of the auditor in a situation where fraud exists. Moreover, the case examines the auditor's role in communicating with the Board of Directors and the Audit Committee. As part of this examination, students are exposed to the importance of risk as a dynamic factor in the audit process.

COURSES AND LEVELS FOR WHICH IT INTENDED

The case exposes students to corporate governance, internal controls in nonprofit organizations and the expectations of the audit. Although the case could be used in graduate and undergraduate Fraud and Not-for-Profit Accounting courses, we believe that the most salient issues can be best developed in an undergraduate or graduate auditing course. It may be necessary to reference outside materials, in addition to the applicable course text, depending upon the level and depth of analysis that the

instructor requires. Web sites and relevant references are listed at the end of the Teaching Note. In using this case in a graduate class, we would encourage students to research these issues to find examples of nonprofit frauds and examine how changes in legislation at both the federal and state levels are changing the way nonprofits are governed.

LEARNING OBJECTIVES

1. To gain an understanding of the inherent weaknesses in internal control in small and non-profit organizations in particular.
2. To identify how internal control weaknesses can perpetuate fraud.
3. To encourage students to become familiar with current and relevant literature on risk, internal control and the CPA's role in detecting fraud and corporate governance problems.
4. To understand how audits of non-profit organizations present unique challenges for the auditor.