



reduce your losses from

Errors and Fraud

A simple system of internal controls can save you money by decreasing risk.

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As a nonprofit leader, you're responsible for reducing risk in your organization. One inexpensive way to do so is to improve your internal controls. Here are suggestions:

1. DON'T DEPEND ON TRUST ALONE.

Most nonprofit leaders trust that people will “do the right thing.” But errors and fraud do occur if proper controls aren't in place. Internal controls prevent and detect errors and fraud by providing a system of checks and balances.

Keep an Eye Out for Errors.

Errors can be acts of commission (such as honest mistakes in cash handling) or omission (such as failing to get grant applications in on time and thereby losing out on funding). Monetary losses can mount up when there is no system of internal controls to catch and correct errors before they get out of hand.

Watch for Fraud.

Damage from fraud can be even more disastrous than losses from errors, as these examples show:

The local police fraternal organization's treasurer, a 15-year police officer, embezzled \$200,000 over six years. He was responsible for check authorization, check signing, and bank reconciliations. He admitted writing checks to himself to pay off his credit cards, among other personal reasons.¹

Similarly, the financial director of the American Cancer Society state chapter wrote 58 checks to herself

over a 13-month period and was charged with embezzling \$85,000. Cancer Society officials failed to investigate her background before entrusting her with their financial matters. If they had, they would have discovered that she was on probation for embezzling \$800,000 while an accountant at a real-estate firm.²

In Calgary, Alberta, a nonprofit organization's treasurer deposited members' checks but pocketed their cash payments. Many members were thus reported as having large balances due. The board asked the treasurer about these balances and was told that everything was “in hand.” The board's finance committee failed to investigate the problem further.³

In the aftermath of these frauds, board members explained that they trusted the person and had no reason to believe anything was wrong. In all cases, however, they could have avoided embarrassment and loss of public confidence by instituting a system of internal controls.

2. REMOVE THE OPPORTUNITY.

To commit fraud, a person needs motive, opportunity, and rationalization.⁴ Under the right circumstances, no one is immune to the lures of motive and rationalization. For even the most trustworthy person, then, the important thing is to eliminate the opportunity.

Segregate Duties.

To reduce the opportunity for error and fraud, make sure you separate the duties of authorization, access, and recordkeeping. Separating these duties ensures that one person doesn't have access to assets (such as cash), the ability to authorize transactions involving those assets, *and* the ability to change records pertaining to the assets. Thus, no one has the opportunity to take assets and hide the loss by altering the records.

The treasurer in voluntary organizations typically has too many duties: The treasurer authorizes expenditures, has custody over cash receipts, makes deposits, signs checks, performs recordkeeping functions, and reconciles the bank statements! It would be more appropriate to have the treasurer serve as a controller, or recordkeeper. To prevent errors or fraud, other officers must have some involvement in the accounting process.

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For example, the vice president—*not* the treasurer—should sign checks (separation of access from recordkeeping). The secretary or other third party not responsible for check signing should reconcile bank statements to verify that bank records agree with the organization's records (provision of oversight separate from recordkeeping and access). The president or executive director should approve reimbursement requests before the vice president writes checks (separation of authorization from recordkeeping).

Also be sure to separate the duties of people who are related to each other. Otherwise, one person can cover up for the other or pressure the other to do something unethical because of their special relationship. For example, if the president is the treasurer's spouse, the organization doesn't have proper separation of duties. Furthermore, the president and treasurer shouldn't have a supervisor-supervisee work relationship.

Use Physical Controls.

Another way to eliminate opportunity is with tangible controls. For example, require pre-numbered receipts or checks. It's easier to tell if funds have been misappropriated or misplaced if serially numbered documents are used. It's also important to limit access to assets—not only to cash but also to fundraising assets such as cookies or raffle tickets.

3. RECONCILE ACCOUNTS.

Reconciliation is important to check for errors and provide oversight of the recording function. Such tasks

How to Prevent Common Internal Control Problems

Segregation of Duties

- Separate authorization, custody, and recordkeeping functions.

Cash Receipts

- Give receipts for dues or donations of cash.
- Use pre-numbered cash receipts book.
- Keep membership application/dues remittance advice.
- Immediately place restrictive endorsements on checks.
- Make deposits daily.

Cash Disbursements

- Have authorization procedure for cash disbursements.
- Require documentation to support cash disbursements or petty cash payments.
- Do not write checks for an amount that exceeds supporting invoice.
- Pay from original invoices to prevent duplicate payments for items.
- Institute a policy prohibiting purchase of personal items with organization funds.
- Require two signatures on checks over a pre-specified amount.
- Don't permit organization checks to be made out to "Cash."
- Have a designated check signer or signers.
- Be sure the payee is listed in check register for each check.
- Classify expenses for control purposes.
- Enter bank service charges in check register.

Procedures

- Provide written procedures for cash receipts or cash disbursements.
- Make sure current officers know about written procedures.
- Prepare periodic (annual, at least) financial statements.
- Put large checking balances into a short-term CD.
- Periodically analyze whether bank charges on the account are excessive.

Physical Controls

- Limit access to unused checks or unused cash receipts books.
- Limit access to petty cash.
- Have only specific people be responsible for cash box at fundraising events.
- Limit access to fundraising assets: raffle tickets, T-shirts, cookies, etc.

Reconciliations

- Reconcile cash deposited for dues to dues application/remittance advice.
- Reconcile raffle tickets, etc., with cash receipts.
- Perform bank reconciliation monthly.
- Keep the bank statements or canceled and voided checks.
- Trace (match) bank deposits to amounts in the checkbook.
- Reconcile money transferred to or from national organization/organizational network.
- Have an audit performed by an external auditor.

include reconciling fundraising assets, such as raffle tickets, with cash receipts, and performing a monthly bank reconciliation. A person who doesn't authorize transactions, have custody of assets, or keep the records should perform the reconciliations.

4. BE SURE THE BOARD FULFILLS ITS DUTIES.

The board is responsible for ensuring that the organization is run in accordance with its charter and legal requirements. Board members also hold ultimate responsibility for managing the organization's financial risks. They must see to it that an internal control system is in place and that an annual audit is performed by an unbiased external consultant. They may either review the audit themselves or create an audit committee to do so.⁵

5. KEEP GOOD RECORDS.

Written procedures are essential in minimizing errors, exposing fraud, reducing risk, and helping people carry out their duties effectively. Adequate records provide information on proper procedures as well as historical information on your organization's activities. In addition, employee and officer transitions will be more efficient if you have good records.

6. GET HELP.

Professional accountants can help you tighten your internal control system. If you can't afford an accounting firm, look for free or inexpensive assistance. Contact the local chapter of your state CPA society, which may provide pro bono services for charitable organizations. Also, call the accounting department of your local university. Many universities require students to provide accounting services to nonprofits as part of their course assignments. In their coursework at the University of New Orleans, for example, auditing students evaluate the internal controls of small voluntary and professional organizations.

No matter whom you get to advise you, don't leave your control system to chance. A system of internal controls need not be burdensome. But such a system is essential to improve the integrity of your organization's financial statements, reduce the potential for errors and fraud, maintain public confidence, control your activities, and achieve your goals. ■

Footnotes

¹ *New Orleans Times-Picayune*, 5/1/96 and 6/12/96.

² *New Orleans Times-Picayune*, 6/7/96.

³ *Internal Auditor*, April 1989.

⁴ See Messina in "Selected References."

⁵ For details on conducting audits, see Dalsimer, O'Neil, and Ross in "Selected References."

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