Protect Your Resources from Insider Theft

Here's what lack of internal controls can do. Don't let it happen to you.

BY MELANIE L. HERMAN

Frank Fundraiser was a well-respected employee of the Good Deeds Society,[1] an organization providing emergency assistance to financially disadvantaged citizens. Since joining the staff a year ago, Frank has successfully managed the society's annual 10K Run, with proceeds exceeding prior records.

As a member of Good Deeds' management team, Frank has a "company" credit card. When he was issued the card, he signed a statement that he would use the card only for approved business purposes.

In December, Frank, who with payday two weeks away was running short on cash, used the card to purchase $150 worth of groceries at the supermarket. When Good Deeds paid its December credit card bill in January, Frank was surprised that no one mentioned his personal use of the card. So, when his cash flow situation remained precarious in February, Frank used the company card to pay a long-overdue installment payment at a furniture store. By the time Good Deeds' new CFO realized Frank's theft, this beloved employee had charged more than $15,000 in personal expenses, all of which had been dutifully paid by Good Deeds.

> Theft by insiders is a risk that every nonprofit should understand.

Beatrice Bookkeeper joined the staff of Good Deeds in early 2001. She left shortly before the end of the year, indicating that she found a new position offering "greater opportunity for advancement." In the spring of 2002, the new bookkeeper was asked to catch up on the prior year's backlog of bank reconciliations. She discovered forged checks totaling $80,000, apparently written by Beatrice during her tenure with Good Deeds. During the criminal investigation of the matter, Good Deeds learned that Beatrice had previously been convicted of embezzlement, spending five years in prison for stealing from another employer.

Victor Volunteer-Director was the most charismatic and popular director of volunteers ever employed by Good Deeds. Since joining the organization, he doubled the number of volunteers and increased the amount of hours they worked. He also seemed to be making judicious use of outside consultants.

When the new bookkeeper was preparing the annual 1099s, she noted a series of large payments to Super Consultants. The address for the firm looked familiar. When she compared the list to W-2s mailed a week earlier, she discovered that Victor's home address was also the address of Super Consultants.

An investigation determined that Victor had established the phony firm to collect the amount allocated for consultants in the volunteer services budget. By the time his theft was discovered, the entire $30,000 budget was exhausted.

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Eight Reasons to Have Internal Controls

Thankfully, few nonprofits ever face as much employee fraud as Good Deeds. Yet, theft by insiders is a risk that every nonprofit should understand and guard against.

Whether you're collecting millions in donations or handfuls of change at your bake sale, you don't want a financial loss to compromise your mission. Although internal controls aren't a fail-safe way to catch a thief in the act, they do provide a system which can dissuade would-be thieves or detect fraudulent schemes before your assets are fully eroded. Internal controls will help you do the following:

1. **Meet the demand** for accountability to your stakeholders.
2. **Assure that management** of your organization fits the board's expectations.
3. **Exercise proper care** and oversight of your organization's vital assets.
4. **Guard against loss of funds** caused by carelessness.
5. **Prevent** or detect fraud.
6. **Ensure that your records** match your assets.
7. **Make life for your staff** easier, less stressful, and more efficient.
8. **Spend less time worrying** and more time on mission-critical activities.

Four Types of Internal Controls

Fortunately, establishing good internal controls requires an investment of attention more than money. Thus, small nonprofits—even all-volunteer groups—can create appropriate controls and reap the benefits.

Much of what you're already doing to track and protect your assets likely falls within four categories of internal controls:

1. Authorize and Approve

Activities falling under the first category of internal controls ensure that your organization isn't obligated for expenses or commitments beyond its desires or financial means. Try these strategies:

- **Establish an annual budget,** and give the board enough time to review it. Make certain that budgets are approved before the fiscal year begins.
- **Develop a process that tracks purchases** from the request to the delivery. This system will help avoid surprises when invoices arrive in the mail. It will also help demonstrate that commitments are consistent with an approved budget.
- **Make certain** that employees—paid and volunteer—know who has authority to spend your organization's funds. Provide explicit instructions about purchasing authority. This tactic will help you avoid embarrassing—as well as disastrous—situations.

2. Document

Documenting your financial transactions will help you track resources and use financial information to make good decisions. It will also reduce the time and money you spend on your annual audit. Here are ways to assure that you have the documentation you need:

- **Require vendors and consultants** to submit detailed invoices. An invoice should be self-explanatory: Someone in your organization or an outsider (such as a representative of your audit firm or regulatory agency) should quickly understand the nature of the services or products provided and the time period to which the bill applies.
- **Keep comprehensive** employee files. Include documents such as the employee application, hire letter, Form W-4, disciplinary or commendation letters, and notices of salary or wage changes.
- **Obtain written agreements** with all independent contractors and consultants. Be sure the documents specify all the terms and conditions of the relationship.

3. Adopt Security Measures

An elaborate system of surveillance cameras would be considered an extreme security measure, even for a nonprofit with unlimited resources. Instead, consider these approaches:

- **Keep blank-check stock** locked up, under the control of someone other than the person responsible for cutting checks or signing checks. When blank stock is needed for bill paying, the accounts-payable employee must sign out and log the check numbers.
- **Use passwords to prevent access** to your accounting software by anyone without a need to view these records. Effective passwords are "easy to remember and hard to guess" and should be changed periodically. (Every 60 to 90 days is a good rule of thumb.)

4. Ensure Prompt Detection

No measure can prevent, with absolute certainty, the theft of your assets by a determined embezzler or burglar. However, there are things you can do to ensure the prompt detection of ongoing fraud and minimize the total loss to the organization. Try the following ideas:

- **Be sure the executive director** or other senior manager reviews the monthly bank statement before another staff member performs the bank reconciliation. The person checking the statement should account for all canceled checks.
- **Appoint a senior manager** to complete the monthly bank reconciliation or review the reconciled bank statement for errors or irregularities. This manager should not be the same person who writes checks or controls blank-check stock.

- **Ask back-up staff members** to make bank deposits and perform other essential accounting duties when the regular accountant is out sick or on vacation. Instruct the back-up staff to report any irregularities immediately.
- **Hire a CPA firm** to conduct an annual financial audit. Provide time on the board's agenda for the auditor and board to meet.[2]
- **Ask a CPA firm to conduct a fraud audit** if you suspect theft. A financial-statement audit (unlike a fraud audit) isn't designed to detect fraud and is unlikely to detect many common types of fraud, such as:
  - payment to bogus vendors
  - use of the nonprofit's credit card for personal expenses
  - theft of cash receipts by a cashier at a special event.
- **Verify credentials** (college degrees, CPA status, etc.) and check references for all incoming employees. Every year, nonprofits waste money on employees who don't have the credentials stated on their resumes or the skills required to do the job, or worse, were fired from previous positions for gross misconduct, such as lying or stealing.

Four Things to Do Next

1. **Begin** with a positive attitude. Don't begrudge the time you spend setting up controls, as you will enjoy the dividends later. Remember that good internal controls can free up resources needed to achieve your mission.
2. **Decide** what steps you can take in the four areas described above. Choose those measures that make sense for you, given the nature of your operations and resources available for internal controls.
3. **Educate** your staff about the importance of adhering to the internal control system.
4. **Monitor** the effectiveness of your controls, and make adjustments as necessary. ■

Footnotes

[1]Although Good Deeds is a hypothetical nonprofit, the losses described in this article are based on actual nonprofit fraud claims.

[2]See Curry, Dalsimer, O'Neil, and Ross in "Resources."

Resources

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These resources are available from the Society for Nonprofit Organizations' Resource Center, www.snpo.org, 800-424-7367.

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