Segregation of Duties: A Critical Issue for Nonprofit Organizations of All Sizes

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Abstract

This white paper will define separation of duties and will demonstrate why instituting sufficient internal controls has always been vital for the success of small and large nonprofit organizations. There will be suggestions on how a nonprofit organization can develop the appropriate procedures to ensure proper segregation of accounting and administrative roles and responsibilities even with limited resources and staff available.
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1. Defining segregation of duties in the nonprofit community.

The definition of segregation or separation of duties (these are interchangeable terms) is the same across all business whether for profit or not for profit. Simply put, it is the concept of having more than one person required to complete a task. The term most often applies to administrative or managerial activities where various tasks are distributed across multiple employees.

Duties which are typically impacted fall into four main categories: authorization, custody, record keeping and reconciliation. When the size of the staff allows, it is ideal to arrange the work load so that no one person handles more than one type of function. In the ‘real world,’ however, most nonprofit organizations run very lean operations. With just a few employees assuming administrative responsibilities, the duties can be spread across the team as they each assume responsibility for a portion of the job. This accomplishes much the same goal in terms of dissecting the tasks and ensuring that no one ‘owns’ an entire process.
2. Why segregation of duties is an essential practice for a nonprofit organization.

The reality cannot be avoided - nonprofits are vulnerable to fraud. In a robust economy, as well as during times when the economy is greatly challenged such as is occurring today, small and large organizations are in danger from both loss of cash as well as the potential loss of reputation if fraudulent activity is detected.

The statistics from the Association of Certified Fraud Examiners (ACFE) are frightening. The cost of fraud in both for profit and nonprofit organizations in the U.S. is more than $400 billion annually. In most of the situations, the fraud is committed by the company’s own employees – and specifically those placed in positions of authority, trusted and respected within the organization. Because of their status, they have access to the organization’s resources and are in a position that enables them to take advantage of their authority.

It is an interesting fact that most of the abuses occur in organizations with fewer than 100 employees – which means that small to mid-size nonprofits are not exempt from these types of occurrences. Board members and others in a leadership role who are lulled into thinking that fraud could not occur in their nonprofit may be in for a surprise. Fraud examiners say that red flags are raised in those very circumstances when the leadership feels the safest: long time employees, loyal employees who refuse to take vacations, employees who take on extraordinary roles and those who agree to assume responsibilities in excess of others on staff.

Research has shown that nonprofits are more likely to be victims of fraud, often because, unlike the situation in the corporate world, there is no owner, CEO or President around to maintain a watchful eye over the assets. The Board members, including the chair, are volunteers, with their primary commitment being focused on their own company or firm. It is also more difficult for board members, who are not on site, to be watchful over the day-to-day activities in the organization’s office, and they are less likely to interfere out of fear of micromanaging or because they do not have the time to become involved with a hands-on approach. Other obstacles exist as well: with volunteer board members and audit committee members distracted, there is no one to provide oversight for the implementation and maintenance of internal controls, nor is the need for such always taken seriously.

There is a traditional assumption that no one would steal from a nonprofit. In other words, the good works of the organization prevail, discouraging anyone from stealing or engaging in other types of fraud. If this line of thinking is acceptable, only corrupt and selfish corporations would be targets for fraud, but unfortunately, this is not a fact that can be substantiated at all! To the
contrary, fraud is actually a common occurrence in the nonprofit sector and in Weakening economy, fraud becomes even more probable. Nonprofits that are diligent about internal controls can safeguard the organization before damage is done!

This means that nonprofits, like their for-profit counterparts, need to be extremely vigilant, guarding both their tangible valuables and their standing in the community where they are trusted and highly regarded for the integrity or their mission and vision. The cost of fraud therefore includes the possible damage to donor relationships, negative publicity, loss of employees or volunteers and legal costs or costs associated with an investigation.

To avoid or deter the possibility of fraud, nonprofits must heed the rules regarding separation of duties, no matter how difficult it may be in a small office that is understaffed and over worked. This is because proper separation of duties is one of the essential components necessary for the implementation of strong and effective internal controls.

Segregation of duties enables a nonprofit to have confidence that their organization’s internal controls will:

- Increase internal and external integrity
- Provide a positive public opinion of the organization (especially for volunteers and donors)
- Protect the board and key employees from scrutiny
- Maintain high morale
- Protect the organization from the potential of theft or other types of financial loss or fraud

Irregularities and proven fraud happen to a nonprofit simply because the opportunities are there. Whether a laptop 'disappears' or checks end up in the wrong account, if the conditions make it possible, fraud may occur. It is also important to note that it may be harder to detect fraud in a nonprofit organization than in a for-profit company because 'lower profits' may not raise a red flag the way it might in a traditional corporation.

There are some situations that should raise concern, though, such as abnormal changes in bank account balances, shortages in cash, missing documents, complaints from members or donors that checks are not clearing, infrequent or late financial reports, significant changes in the organization's assets or changes in either an employee's behavior or financial situation or even the sudden departure of an employee.

While the nonprofit's leaders should be on the look out for these clues, the presence of a system of internal controls and a consistent separation of
duties can be helpful in minimizing the occurrence of fraud rather than identifying it after the fact!
3. How small to mid-size nonprofit organizations can achieve segregation of duties.

In spite of the size of the nonprofit organization, establishing separation of duties is critical - and the first step is for everyone in a leadership role to adopt a positive attitude and a commitment to embrace the concept of separation of duties. There are some additional key concepts that can serve as a guide for every organization regardless of size.

1. Understand how important it is to hire the best staff you can. Sound hiring practices, in-depth interviews, clear communications regarding expectations of the staff and conscientiously checking references will provide some level of confidence that new employees are trustworthy. However, since situations can change, even employees that appear to be exemplary can become a problem under specific circumstances. So, beyond taking precautions in the hiring phase, continuous monitoring of existing employees can give the leadership some additional assurance.

2. Have the appropriate type of insurance. For most organizations, this includes fidelity insurance, or bonding, to cover theft by an individual as well as coverage for general theft, disappearance or destruction, theft of checks or credit cards, property and casualty loss and board of directors' insurance as well.

3. Implement a process for separating responsibilities in the area of finance (maintaining adequate financial records, including a budget, which can create a watchful environment that eliminates the possibilities of fraud) with a special focus on oversight for bank accounts, credit cards, cash management, investments, capital purchases, record retention and endowments.

Given the significance having structured and consistent processes, here are some practical and inexpensive ideas for those organizations that experience monetary and staffing limitations when attempting to establish internal controls and a true separation of duties as a result of their size or limited resources:

-Consider involving volunteers or board members in office procedures, giving them assigned roles to augment the responsibilities of the paid staff and ensure a viable separation of duties.

-In an office with less than three employees, consider outsourcing some selected accounting duties (leverage an outside service or even a local paraprofessional) as an alternative.

-Include internal controls for the nonprofit's information systems along with its financial systems, enforcing password protection for all computers and limiting access to the nonprofit's donor database and other confidential records.
-Make sure that no individual has custody of both the organization's assets and the record keeping process for those assets at the same time.

Even in offices comprised of fewer than four people, separation of duties can be instituted. For example, the nonprofit can reinforce a policy whereby the Executive Director can sign checks and review bank reconciliations but the office manager/bookkeeper is the person who processes vendor invoices. A board member or the chair of the finance committee can reconcile the bank account, make deposits and manage the petty cash and accounts receivable. With a scenario similar to this one, there is a true segregation of roles with each person relying on the other to complete key functions.

-Provide proper training for volunteers, members, or others who are asked to take on additional roles in order for the organization to implement internal controls procedures.

-Ask the bank about using their lock box services, which provide total control of all receipts deposited directly into a designated bank account. With donations remitted directly to a post office box, the bank, not the nonprofit, is responsible for collecting the receipts, posting the amounts to the nonprofit's account, and sending all documentation to the organization.

-Create written processes and procedures and share these with the board and employees to gain acceptance.

-Provide time at each board meeting to carefully review financial statements, budgets and external audit reports.

In large nonprofits and especially in smaller ones, the board should expect to review cash receipts, accounts and loans receivable, contribution income (including pledges), service fee income, cash disbursements and accounts payable, payroll and related taxes, fixed assets, investments and related income.

To execute its full fiduciary responsibility, the board should be at the forefront of the organization, demanding internal controls, appropriate procedures and the assurance that the assets (both tangible and in tangible) are well protected. To do their job, board members should consider asking these top ten questions as suggested by Board Source in their E-Book Series:

1. When was the last time we reviewed our internal controls?
2. Are all our employees bonded?
3. Are the volunteers who sign checks, transfer funds, or otherwise have access to significant assets bonded?
4. Do we have a fraud policy statement in place?
5. Do our employees know what is expected of them ethically?
6. What procedures do we use when checking potential new hires?
7. Who is watching for unusual fluctuations in our financial records?
8. Do we keep an eye out for unusual employee behavior?
9. When will we speak to our auditors next about our internal controls?
10. Do we have clear written policies and procedures for each staff position?
4. Conclusion

Nonprofits, just like for-profit companies, must maintain a watchful eye, being ever aware of the potential for fraud in their organizations. No group is immune to the threat of financial misconduct, least of all the nonprofit community!

Despite the dismal statistics and dire warnings, solutions do exist that can help the leadership and Board of Directors limit the potential for fraudulent activity. To accomplish this, nonprofit groups of any size can establish a structured process of internal controls that set guidelines to maintain the separation of duties necessary to sustain the integrity of the organization, and ultimately, its reputation and its mission.

Regardless of whether the nonprofit administrative team is comprised of two, twenty-two or two hundred employees, processes and procedures can be implemented to reduce the opportunity for fraud to take place by using an innovative approach and outsourcing some functions.
5. Footnotes, Citations and Resources

The following websites and documents were used to provide background information for this white paper and to support its premise:

www.thenonprofittimes.com
www.enewsbuilder.net
www.nonprofitaccountingbasics.org/internal-reporting-good-management

Board Source - Preventing Fraud: How to Safeguard Your Organization by Andrew S. Lang and Tammy S. Ricciadrella
6. About the Authors

Bridget Hartnett
Bridget Hartnett, CPA, a member of the Firm at Sobel & Co., has more than thirteen years of experience in public accounting which she draws on to provide high level services for clients.

Experience in the Nonprofit Niche
Bridget spends most of her time working closely with clients in social services and nonprofit areas, including educational institutions. As a member in the firm’s Nonprofit and Social Services Group, Bridget supervises the audit engagements conducted by Sobel & Co. for the Cerebral Palsy Association of Middlesex County, the Youth Development Clinic of Newark and Catholic Charities of the Trenton, Metuchen and Newark dioceses, Freedom House, and C.J. Foundation. In addition, she handles all of the firm’s education audits and holds a Public School Auditor’s license. Bridget is also responsible for reviewing and overseeing the preparation of nonprofit tax returns.

Philanthropic and Social Service Commitment
Bridget carries her commitment to social services beyond the workplace to include her personal involvement in several areas, such as at St. Benedict’s school in Holmdel where she is always available for volunteering for projects and special events as needed as well as giving her resources and time to various children’s charities, such as the New Jersey Chapter of Make-A-Wish and others. She is also a volunteer with professional business groups in the New Jersey community, including Monmouth Ocean County Nonprofit Committee and the Western Monmouth Chamber of Commerce where she helped to found the successful Young Professionals’ Group and currently serves as Co-Chair and founder of their newly formed Nonprofit Committee. Bridget is also an active member of the New Jersey CPA Society’s Nonprofit Interest Group.

Professional Credentials
As a licensed Certified Public Accountant in New Jersey, Bridget is a member of both the American Institute of Certified Public Accountants (AICPA) and the New Jersey Society of Certified Public Accountants (NJSCPA).

Educational Background
Bridget graduated with her Bachelor of Science degree from Montclair State University.
Ron Matan
Ron Matan, member in charge of Sobel & Co.'s Nonprofit and Social Services Group, brings a unique blend of public accounting and business acumen to every client engagement. A key member of Sobel & Co.'s Leadership Team since joining the firm in 1997, Ron works primarily with non-profit organizations, including United States Department of Housing and Urban Development (“HUD”) projects, A-133 engagements, and low income housing tax credit programs (“LIHTC”).

Experience in the Nonprofit Niche
As member in charge of the firm’s Nonprofit and Social Services Group (A-133 and HUD audits and LIHTC programs), Ron is responsible for the firm-wide quality of this practice area and is the firm liaison for the AICPA's Government (Nonprofit) Audit Quality Center. With over 35 years experience in public and private industry and accounting experience with all types of nonprofit and social service organizations, Ron brings a unique blend of knowledge and insight to these specialized engagements. Ron is a Certified Tax Credit Compliance Professional and is listed in the Guide which is circulated to all State Agencies Allocating Tax Credits as well as the Internal Revenue Service. He has also taken courses in advanced training for peer reviews and performs peer reviews of other accounting firms.

Philanthropic and Social Service Commitment
Ron is a member of the Board of Directors of First Occupational Center where he serves as Treasurer and is a member of the Education Committee for the Mid-Atlantic Chapter of the Society of Association Executives. Ron is a member of both the Plainfield Neighborhood Health Center Board (where he serves as Treasurer) and Union County Educational Services Foundation Board. Ron was the former treasurer and board member of Kids Peace Treatment Centers for emotionally disturbed children, located in Bethlehem, Pennsylvania.

Professional Credentials
Ron is a Certified Public Accountant licensed to practice in New Jersey, New York and Pennsylvania. He is a member of the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants (NJSCPA). Ron has been elected as Vice-Chairman of the PKF North America’s Nonprofit Committee, and in June 2004, Ron was appointed to the New Jersey Society of Certified Public Accountants Peer Review Executive Committee. Ron is also a member of the NJSCPA's Nonprofit Interest Group.

Educational Background
Ron is a graduate of Kings College in Wilkes-Barre, Pennsylvania, where he received a Bachelor of Science Degree in Accounting.

Sobel & Co. is a middle market accounting and consulting firm with headquarters in Livingston, New Jersey that has been providing nonprofit and social service organizations in the New York/New Jersey metropolitan area with audit, accounting, tax and advisory services since its inception in 1956.

The firm is distinctive in its approach to the nonprofit community because of its sincere passion for serving this sector. As it says on the Sobel & Co. website, “We work with the nonprofit sector because we feel good about helping those who do good; we have a passion for helping nonprofit organizations achieve their mission of helping the world's most vulnerable.”

The firm currently works with more than 175 nonprofit organizations with revenues ranging from $100,000 to over $60,000,000. Based on this depth of experience, the professionals in the nonprofit group are keenly familiar with the issues facing nonprofits and they will apply this knowledge to bring added value to every engagement.

As a further demonstration of the firm’s commitment to the nonprofit community, several complimentary programs are offered throughout the year. These include quarterly webinars, roundtable discussions and an annual symposium on timely and relevant topics. Newsletters, articles, benchmark reports, surveys and white papers are also distributed to the nonprofit sector to provide them with access to cutting edge information.