BY DESIGN:

Best Practices for Organization Governance and Operations

By Design was created by NeighborImpact after August 2021 listening sessions during which NeighborImpact partners said they needed more information on the management and operation of a nonprofit. NeighborImpact needs reliable partners to leverage its work and resources, and investing in the operational strength and capacity of our partners help us do more. By Design is distributed quarterly.

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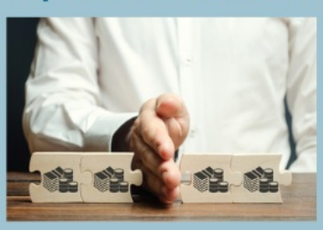
Today's Topic:

Separation of Duties



The phrase "separation of duties" is often mumbled as though part of a mysterious catechism that only accountants can truly understand. In reality, it's a simple idea. Every nonprofit needs to find ways to avoid having one person control more than one of the key functions that protect our funds and other assets. This issue of By Design—management and operating advice for nonprofit partners of NeighborImpact—discusses how small, large and medium nonprofits can implement segregation of duties.

Nonprofits Confront Challenges Maintaining Separation of Duties

What are we trying to avoid by implementing effective segregation of duties? The standard answer – errors and irregularities – sounds trivial. In fact, in accounting systems, relatively small errors pile up and can lead to big mistakes, including bad decisions based on misinformation as well as time-consuming searches for the source of the error.

In accounting-speak, irregularities are deliberate errors –for example embezzlement, misuse of the nonprofit's assets, or more commonly misstatement of your organization's revenues, expenses, assets, liabilities, or net worth.

While we all know why letting our funds or other assets be stolen or misused can harm our nonprofit, the damage done by misstatement is both more common and, in some cases, more extreme.

The systems, policies, and procedures we put in place to prevent and/or detect and correct errors and irregularities are referred to as internal controls. Developing and implementing effective internal controls starts with understanding the need to ensure that four key functions are performed by different people in the organization.

Asking or allowing one person to perform more than one of these key functions exposes the organization to errors and irregularities, and equally importantly, exposes that person doing the work to false accusations and suspicions about their honesty and competence.

The big 4 functions:

Authorization or approval:
Example: authorizing a new person to be added to the payroll, a pay increase, the opening of a bank account or credit card, a major purchase, or a new contract for services

Custody of assets:
Example: serving as a check-signer, controlling access to key donor information, safeguarding property titles or other essential documents, being authorized to open or close bank or investment accounts.

Recording transactions:
Example: recording payments made or received and/or posting journal entries in the accounting system to record financial events that have not yet impacted the organization's bank account such accounts payable or receivable.

Reconciliation and control:
Comparing the organization's internal records to outside information sources such as bank statements or vendor invoices or to separately maintained internal records such as receiving reports or donor acknowledgements. Identifying and resolving the source of any differences

Test:

Place the initials of the person in your organization who performs each of the four functions. Do not enter the same set of initials twice:

Authorization and/or Approval	
Custody of assets	
Recording transactions	
Reconciliation and control	

If you are unable to put four different initials in the above boxes, it's time to re-think your internal controls. How can you share duties? Involve board members? Pay an outside consultant?

Separating responsibility for performing each of the big four functions creates the opportunity for one person to spot another person's error or prevent or identify a potential misuse of the nonprofit's assets or misstatement of its financial condition. Fraud research shows conclusively that the perception that one's dishonest acts will be discovered (and punished) is the single most effective deterrent to dishonest acts.

"Small nonprofits often find it extremely hard to separate all four key functions."

Small nonprofits often find it extremely hard to separate all four key functions. The Board can perform authorization functions at a high level – approving the annual budget, approving the creation of new positions and the compensation for staff positions. The Board can maintain the custody of the assets by requiring board action to open and close bank accounts and having board members function as check signers. And in small nonprofits, there may even be a board member who is able and wiling to handle recording transactions and maintaining the books, or a staff member can take on this responsibility, supported by board members performing the other three functions. A board member can take responsibility for reconciling the bank and investment account statements to be sure they agree with the records in the accounting system.

In real life the functions described above as being performed by the "board" often devolve onto the shoulders of one board member who handles all the banking, signs all the checks, maintains the books, and then reconciles the bank statements. This *one-woman-band* approach leaves both the nonprofit and the board member's reputation almost completely unprotected. Whether the person performing multiple functions is a board member or a staff member, the *one-woman-band* approach offers no real separation of key duties.

Sometimes nonprofits "grow out" of the *one-woman-band* problem by having a staff member perform the recording functions while allowing the Executive Director to handle some, but not all authorization and custody of assets functions – for example, signing checks but not being able to open or close bank accounts or authorizing compensation levels for staff, but not their own compensation. *Adding a small contract with an outside accountant to do the bank reconciliations may result in more effective performance of the*

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function than shifting the job among unprepared board members. Adding an independent audit or review can provide even more in-depth oversight, providing assurances to the board that authorization, custody, recording, and reconciliation functions are being performed effectively and separation of duties is being maintained.

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The *one-woman-band* staff member may both collect the mail and feed checks into the remote deposit devise provided by the bank to allow funds to be deposited directly into the account with no time-consuming trip to the bank required. In doing so, the *one-woman-band* has taken custody of the assets (checks sent to the nonprofit) and deposited them. *She also may well be the only person in the office, the only custodian of a mailbox key, and the only person responsible for ensuring that donor records and accounting system records agree with the bank's records of deposits.*

At the end of the month, she may use the accounting software to perform automated reconciliation of the bank statement, with no board member or supervisor ever examining the payments made or received, the bank statement itself or the reconciliation report.

"Just because it is possible to speed up processing through implementing newer electronic tools, the need for consistent separation of duties has not disappeared."

Apps designed to streamline processing of credit card charges allow staff to submit receipts for credit card purchases electronically. The *one-woman-band* can save even more time by downloading credit card charge information directly from the credit card processor. In some systems, expense codes are automatically applied to most purchases based on past coding. Virtually all of apps for electronic transfer of credit card purchase data have procedures to enable review by supervisors, but time pressures can lead to eliminating the review function or allowing *the one-woman-band* to complete it when a supervisor has not.

All of these steps and tools save time but can undermine controls by allowing one person to handle both recording and review functions. Often that one person has very little time or sufficient knowledge of program operations to provide meaningful review of the credit card transactions, focusing instead on ensuring smooth integration of the various apps and speeding up the processing of financial reports.

Long ago, when nonprofits first began computerizing accounting systems, auditors cautioned managers and boards to remember that just because financial information is computer-generated does not mean that its reliable. Today's warning more often focuses on the reality that just because it is possible to speed up processing through implementing newer electronic tools, the need for consistent separation of duties has not disappeared.

So how can we get maximum benefit from new processing tools while ensuring effective internal controls and maintaining essential separation of duties concepts. Some answers lie in using the new technology effectively – being sure to implement authorization and review procedures as we set up of our new electronic tools and regularly monitoring whether the procedures are being followed or circumvented to speed things up. For most nonprofits, the *human component* may actually prove more important. Start with a quick check-up for what your organization may already be doing.

Check the ones that apply to your organization:

☐ Board approves and reviews of Executive Director compensation, corporate credit card charges, and other substantial personal expenses. (In large organizations, credit cards may be reviewed by a staff member who is not connected to the user.)

☐ Reconciliation of all bank and investment account statements is completed by an individual who is not responsible for recording and financial reporting and who does not control opening or

What can you do if you spot holes in your controls?

✓ Focus on how you can ensure that no one person has taken primary responsibility for more than one of the four key functions.

✓ Consider what functions Board members can perform meaningfully and consistently.

✓ Explore options for contracting with a local

closing the accounts or have authority to make withdrawals or transfers.

☐ Board or Finance Committee reviews monthly financial statements which include comparison of actual revenues and expenses to the Board approved budget. Review includes exploration of significant discrepancies between the budget and the actual results.

☐ An independent CPA annually audits or reviews the organization's books and meets alone with the board with no staff present at the end of the engagement to discuss the process and findings of the audit.

☐ The organization periodically consults with a knowledgeable accountant to review internal controls. While an audit involves consideration of your controls as part of the auditor's responsibility for determining whether your financial statements should be relied upon, the audit itself is not designed to be an in-depth study of your internal controls. A separate consulting engagement can be focused on both spotting weaknesses and offering practical suggestions for strengthening controls.

accounting service to perform one or more of the functions, starting with bank reconciliation and moving on to periodic review of whether internal review procedures are being followed.

✓ Avoid turning either the Executive Director or a single fiscal staff person into the *one-woman-band*.

✓ Identify the most meaningful roles that the ED can play - typically in the areas of authorization and review, and structure your processes to avoid having the ED perform the other functions.

✓ If there simply aren't enough responsible individuals to fully separate the functions in your nonprofit, focus on separating the review function, contracting with a knowledgeable accountant to reconcile bank and investment account statements, and other key accounts.

A favorite saying among accountants is "trust is not an internal control." From a separation of duties viewpoint, the statement points to the reality that assuming that one very honest, completely trusted person can perform multiple key control functions without risk is not an effective control. The best way to demonstrate our respect and concern for that honest, trusted person is to support them with strong controls to ensure that mistakes are spotted and corrected, and that tangible proof of their honesty and integrity is continuously documented.

About NeighborImpact: NeighborImpact is a private non-profit governed by a board of directors drawn from across the community. Since 1985, NeighborImpact has led the region in developing solutions and bringing resources to Crook, Deschutes and Jefferson counties and the Confederated Tribes of Warm Springs. We help meet the basic needs of Central Oregonians, build economic security and create a community where everyone thrives. To learn more about NeighborImpact please visit www.neighborimpact.org.

About The Author: Kay Sohl has provided training and consultation for Executive Directors, CFOs, and Boards of Directors of over 8,500 nonprofit organizations throughout the United States. Kay founded and lead TACS, now known as the Nonprofit Association of Oregon. She is a licensed CPA and a frequent consultant and presenter. She is co-author of the Oregon Nonprofit Corporation Handbook.

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