Trust is not an internal control: Certified Public Accountant
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TRUST IS NOT AN INTERNAL CONTROL

By Julie L. Floch and Cheryl R. Olson

"We trusted our finance director; how could she steal from our organization?" This is an all too common lament after a nonprofit organization uncovers embezzlement. Fraud studies show that, given a change in personal circumstances, such as need or opportunity, or a change in beliefs and perceptions, a high percentage of people will steal. Given the statistics and the fraud stories, it's important to understand why internal controls, which decrease a nonprofit's vulnerability to fraud, are so important. Trust, unfortunately, is not among them.

Strong internal controls require training and careful planning, but the payoff is worthwhile. Segregation of duties is fundamental, and includes ensuring that financial responsibilities are spread over a number of people. For example, individuals that approve invoices should not sign checks. It also includes employee policies, such as mandating regular vacations so that a normal flow of transactions occurs in an employee's absence. An accounting manual that details the financial division's responsibilities is an excellent tool that helps minimize the potential chaos caused by staff turnover.

Timely reporting is another effective control. Monthly financial statements should be presented and discussed with management and the board or finance committee. Even if the finance committee and board do not meet each month, they can review financial statements and monthly cash flow projections and be prepared to act on them at the next meeting. These statements are more effective when compared to the prior year and to the budget, with variances explained.

Officer Roles

The executive director is charged with fiduciary oversight of the organization (including the finance department), and should have a basic understanding of financial statements, internal controls, and the budgeting process, as well as awareness of marketplace issues that may affect the organization.

A knowledgeable and competent finance director is another essential part of every organization. This individual should have a degree and professional experience in accounting; experience in the nonprofit industry is preferable. The finance director must also have communication skills for working with staff, board and committee members, vendors, and service providers. The finance director's responsibilities generally include establishing and maintaining internal controls, financial policies and procedures, budgets, financial statements, projections, and forecasts. Compensation must be competitive; typically this position commands the second- or third-highest salary in an organization.

The finance director's performance should be evaluated annually by a compensation committee (which in small organizations might be only the executive director), and the salary level reviewed and adjusted when appropriate. Important evaluation criteria include timely and accurate financial reporting to both management and the board; timely preparation for the audit process; accurate filing of tax and informational returns and the resolution of comments received in the auditors' management letter. The external auditor can assess the finance director in terms of both skills and the ability to work with the audit process.

> The audit commitee should have responsibility for the board's interaction with its auditors, including discussions of the auditor's management letter.

To monitor priorities and staffing needs, the executive director should understand and monitor the workload of the finance director and finance department. Within budget constraints it is important for the finance area to have enough staff to ensure the appropriate segregation of duties.

The board members have a fiduciary duty to the organization as well, and as such they are a part of the internal control process. Typically, much of this oversight is carried out by the finance committee and its members. Finance committee responsibilities typically include the following:

- Developing long-range financial plans
- Reviewing annual operating and annual capital budgets

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■ Developing and reviewing financial policies
■ Interfacing with external accounting
■ Reviewing internal financial controls
■ Interfacing with investment firms and monitoring their performance
■ Reviewing financial statements and monitoring them as compared to budget
■ Reviewing and monitoring cash flow projections.

Committee members should have sufficient financial sophistication to provide this oversight. The organization's treasurer is usually a member of the finance committee, but for the committee to function most effectively, it should report to the board, not the treasurer. In addition, there should be a path of communication between the finance director and the finance committee that allows the finance director clear access for discussing any issues regarding the executive director's oversight. In turn, the finance committee chair should be able to obtain information from sources other than the executive director.

The organization should have an audit committee that has oversight of the management of the reporting, control, and audit processes, and responsibility for the organization's adherence to ethical standards. The audit committee consists of members who are independent of management and can ask the tough questions. It should report directly to the board. This committee should have responsibility for essentially all of the board's interaction with its auditors, including discussions of the management letter emanating from the audit process.

Ultimately, the board of directors is responsible for the organization's oversight and management. Without a strong and involved board, the internal control process will be diluted. The board must avoid micromanaging, yet still be involved enough in the organization's daily operations to be able to spot and resolve small problems before they become large ones. ❑

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SURVEY SHOWS RESTATEMENTS CONTINUING TO RISE

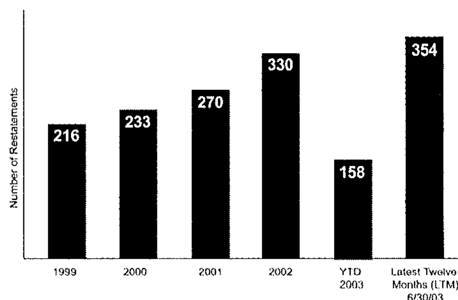
The past year has seen a continuing increase in the number of public companies restating their earnings because of accounting errors. During the 12 months ending June 30, 2003, 354 public companies filed restatements, an increase of more than 30% over the previous 12-month period. Problems applying accounting rules, human and system errors, and fraudulent behavior are the three primary causes for accounting errors, according to the Huron Consulting Group.

The number of restatements has continued to rise each calendar year, from 216 in 1999, to 330 in 2002 (see *Exhibit*). This trend has continued even though the number of registered companies has fallen, from over 10,500 in 1999 to around 9,000 in 2002. The number of restatements filed during the third and fourth quarters of 2002 was the most recorded during the past five years. The data were compiled from a report titled "Rebuilding Investor Confidence, Protecting U.S. Capital Markets, The Sarbanes-Oxley Act: The First Year," released by the House Committee on Financial Services.

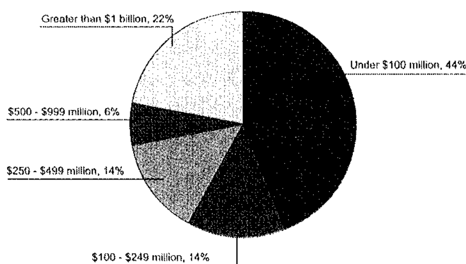
In the 12 months ending June 30, 2003, 22% of the restatements were filed by companies with greater than $1 billion in revenue, and 44% were filed by companies with under $100 million in revenue. Improper revenue recognition was the leading cause of restatement during this period. Huron tracks restatements based on filing date, not announcement date. Some companies announce a restatement but do not file amended financials due to bankruptcy or delisting. (More information is available at www.huroncosultinggroup.com). ❑

EXHIBIT
RESTATEMENT TRENDS

2003 Restatement Activity as of June 30, 2003



Restatements by Company's Revenue Size
Latest Twelve Months as of June 30, 2003



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