FOR NONPROFITS

SIMPLE INTERNAL CONTROLS THAT PROTECT YOUR ASSETS

Perfect For Small and Medium Organizations

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Overview

“We can’t pay our bills this month”, the Executive Director of Helping Hands mumbled in a meeting room occupied with three of the nonprofit’s board members. The eerie silence that followed his announcement was deafening. The Executive Director leaned back in his chair, took a deep breath and proceeded to explain: “We only had enough funding to hire one Accountant, so I hired Tim and put him in charge of everything. Tim was responsible for accepting the cash from our clients, depositing checks, posting daily transactions to financial records, and reconciling monthly banks statements. Now Tim is missing along with $50,000 from our organization’s bank account. It turns out that he’d been manipulating the accounting records for months, and when I finally realized what was going on, it was too late. Tim is gone, and our organization can’t survive this big of a hit. If we can’t raise the money by the end of the week, we’ll have no other choice but to cease operations.”

The story you’ve just read is fictional, but the underlying concept behind what can happen when one individual handles numerous phases in an accounting cycle is quite real. Though the scenario emphasizes the importance for non-profit organizations to establish internal controls, it also reveals how organizational size will greatly influence the degree to which controls can be implemented. I’ve personally audited over one-hundred non-profit organizations, with staff ranging from five to several hundred employees. My observations highlight the obvious: smaller non-profits generally lack adequate internal controls, and therefore struggle to safeguard their organization’s assets. Fortunately this does not have to be the case! With just a little creativity and time-investment, organizations of any size can successfully achieve adequate controls.

I’ve been an Auditor with Los Angeles County for over 16 years, so my knowledge of the subject matter is mostly from an auditing perspective. For that reason the benefits of reading this book are two-fold: you’ll not only learn how to safeguard your organization’s assets, but my goal is to also help you obtain a good rating during an audit review of your nonprofit’s internal controls (i.e. no deficiencies). I should make it clear, however, that even the most sophisticated internal control systems have been successfully manipulated by the craftiest of crooked minds. Thus, you may never be able to prevent theft completely no matter what system you put in place. Nevertheless, this book will cover the most essential control procedures that even the smallest of nonprofits can employ to reasonably ensure that assets are kept safe from misappropriation.

The Benefits of Establishing Internal Control Procedures

We've all applied internal controls to some extent in our day-to-day activities. We lock up our homes or install security systems to prevent unwanted entry; we keep social security cards, bank cards and credit cards in a secure location to prevent identity theft; and we even have passwords for our cell phones or computers to deter unauthorized access to sensitive information. Well internal controls developed for organizations have very similar objectives. They are procedures put in place by an organization to ensure that assets are adequately safeguarded, and financial transactions are accurate, reliable and executed as authorized. Put simply, they are the actions taken to make sure that no one with direct ties to your nonprofit (i.e. employees, volunteers, consultants, etc.) steals your organization's stuff!

Some nonprofits complain that establishing and implementing internal controls takes up too much time—and in their words "time is money". I do agree that the cost of implementing internal controls should not exceed the expected benefits. However, I can assure you that in most cases the benefits of establishing internal controls will far outweigh the time/money it takes to implement them. Two of the most obvious benefits of establishing internal controls are: (1) to help safeguard organizational assets, and (2) to ensure the integrity of financial reporting. But there are a third and fourth benefit that are less obvious but just as detrimental to the success of your organization: (3) increased funding and (4) operational efficiency. Let's take a look at both the obvious and less obvious benefits in more detail, and you'll gain a better understanding as to why your organization needs control procedures in the first place.

Helps safeguard assets: What if you discover that an employee in charge of receiving check payments from clients has been endorsing the checks in a way that allows for deposit into his/her own personal bank account? Or say one day during an internet surfing session you run across your nonprofit's furniture or computer equipment for sale on EBay or Craigslist. Unfortunately nonprofits are not immune to the deliberate theft and misguided intent of others to use funds or assets (equipment, furniture, etc.) for unauthorized purposes. Establishing adequate controls will help to prevent your nonprofit's money and physical assets from being stolen, misused, or accidentally destroyed.

Ensures the reliability of financial records: What would happen if your Accountant/Bookkeeper neglects to log in a $50,000 purchase of computer equipment at the beginning of the month? The most damaging effect is that your nonprofit's cash balance would be grossly overstated; giving the false appearance that there is more cash available then there actually is. This mirage of money will induce further spending, and if left undetected, the mistake will land your organization in the red before month's end. So what can management do to ensure that accounting transactions are properly recorded, and that all of the assets and liabilities presented in the organization's financial statements actually exist? You guessed it….establish internal controls at the bookkeeping level. By doing this, you can reasonably expect that revenues and expenses have been authorized and recorded, and that financial statements adequately represent the financial position of your organization.

Increases funding opportunities: If you operate a public charity nonprofit, then you know the struggles of relying on donor contributions, grants and fund-raising activities to achieve your organization's mission. Perhaps your organization is funded through membership fees or maybe even from one large substantial donor. Regardless of the source of support, one underlying fact remains the same—in one way or another someone is giving your organization money to sustain its operations. If you're not able to provide a reasonable assurance that assets are being safeguarded, why would anyone relinquish their hard-earned money or approve the spending of tax-payer grant funding? Think of it like this: would you give your teenager $500 to go shopping at the mall if you knew he/she didn't have a wallet, purse or at least a pocket to put it in? I certainly hope not! The bottom line is that your reliance on support makes it beneficial for contributors to feel confident that your organization is capable of keeping their donations safe.

Promotes operational efficiency: Operational efficiency is a measure of your nonprofit's ability to maximize its funding in order to deliver quality services, and increase public support for its mission. Numerous financial reporting errors and occasional instances of theft can drain organizational assets and therefore decrease operational efficiency. Internal controls help identify and eliminate asset-draining elements by ensuring that management/board policies, procedures, and practices are being executed by support staff as intended. And by spending less money to run your nonprofit, you can reach more people, gain more financial support, and ultimately increase the number of lives positively affected by the good service of your organization.

5 Essential Components of Internal Controls

There are five essential components that make up an effective system of internal controls: (1) control environment, (2) risk assessment, (3) control procedures, (4) information and communication, and (5) monitoring. These components are developed from a combination of how management provides organizational services and how he/she plans and controls organizational activities. Although smaller organizations may implement these components differently, they can be affectively applied to organizations of all sizes (small, medium and large). As you read through the five components described below, you'll notice that a few of them appear to be separate and guided by their own set of rules and processes. As such, you may be misled into believing that your organization can establish effective controls by just implementing one or two of the components. Do not fall victim to this misconception. All five components are interrelated, and it's only by their collective implementation that a total system of internal controls can be established.

Control environment is the tone set by management that promotes a conscious awareness of controls at all levels of the organization. Factors of this environment include ethical values, integrity, leadership philosophies, and professional standards. The control environment set by your organization will be the foundation for all other components of internal controls. If you're unsure of the tone set within your organization, try using this control environment questionnaire to evaluate your organization's current environment. If you've answered "no" to any of the questions, you may want to consider implementing new practices to create a stronger control environment.

Risk assessment is the identification and analysis of potential risks (i.e. possibility of error, fraud, and mismanagement) that may impair your organization's ability to carry out its mission and objectives. Once an assessment is conducted, it becomes the basis for developing your organization's internal control procedures in order to manage the risks.

Control procedures are the activities put in place to address the risks uncovered in your assessment. They include a range of procedures that are performed at all levels, phases and functions throughout the organization. Without control procedures it will be difficult (if not impossible) to achieve organizational objectives and secure company assets.

Information and communication focuses on the need for management to communicate relevant and quality information to all personnel. Basically, you need to inform your organization's staff of their roles and responsibilities in the internal control system. It is essential that instructions are clear and concise so that employees can understand their role and its importance in maintaining effective internal controls.

Monitoring is an ongoing process that evaluates whether or not your internal control system is doing what it's supposed to do. This phase involves on-going monitoring activities such as supervision, reconciliations, checklists, comparisons, performance evaluations, and status reports. Internal control weaknesses uncovered through monitoring activities should be addressed and reported immediately so that necessary modifications can be made in a timely manner.

Our Focus

In this book I've chosen to focus primarily on the "**control procedures**" component of internal controls for two reasons: (1) controls procedures are the "meat and potatoes" of an internal control system; and (2) they are also the most verifiable component of an internal control audit. Consequently you'll learn how to develop and implement the most important component of an internal control system while gaining a bird's eye view of the internal control auditing process. Still, my focus on control procedures should not take away from the significance placed on the other four components. As I previously stated, using the five components collectively is the best and most effective way to establish a complete system of internal controls for your organization.

Within our focus are two primary types of control procedures – preventive controls, and detective controls:

(1) Preventive controls are aimed at preventing irregularities from occurring. They are proactive measures that help to ensure that departmental objectives are being met. Examples of preventive controls are:

a. Separation of Duties: The most important process in developing sound internal controls is to establish a "separation of duties." A separation of duties refers to a system of checks and balances in which no financial transaction is managed by only one person from beginning to end. There are many rules that govern how responsibilities should be separated within an organization. In general, policies should be implemented that do not allow for any one person to have control over the authorization, custody and review functions in any accounting cycle.

b. Approvals, Authorizations, and Verifications: These three procedures include a thorough review of supporting information to verify the accuracy and validity of organizational transactions (i.e. purchasing, hiring, posting financial transactions, etc.). For example, a supervisor's signature of approval signifies that he/she has verified and validated that a specific transaction meets the organization's established guidelines and procedures. Approval authority should be proportionate with the nature and significance of any given transaction. In other words, you would not want a supervisor approving an asset purchase of $50,000. A purchase of that size should be approved by upper management or a member of the organization's Board of Directors.

c. Security of Assets: The process of securing organizational assets is both detective and preventive. It's preventive when access to equipment, inventories, securities, cash and other assets are restricted. The process becomes detective when assets are periodically counted and compared to amounts shown on inventory or control records. While it is important to take both preventive and detective control measures when safeguarding assets, my personal opinion favors the preventive side of the securing process. My justification for this is quite simple—if someone steals your organization's cash, equipment or inventories, then there is nothing left for you to count!

(2) Detective Controls are the reverse of preventive controls in that they are designed to find irregularities after they've already occurred. Detective controls also function as a counterpart of preventive controls because they provide evidence that preventive controls are functioning as intended. Here are some examples of detective controls:

a. Reviews of Performance: Performance reviews are designed to measure the extent to which goals and objectives are being achieved. This process is necessary because it allows your nonprofit to pinpoint which areas within the organization are not operating efficiently. Reviews can be accomplished by comparing information about the organization's current operations to budgets, forecasts, prior periods, or other benchmarks. Unexpected results or unusual conditions requiring follow-up should be addressed immediately to prevent further inefficiencies.

b. Reconciliations: Reconciliation is the process of ensuring that two sets of records are in agreement and are accurate. It involves comparing information that exists in two systems or locations and analyzing/correcting any exposed differences. For example, reconciliation is the key process used to determine whether the money leaving your organization's bank account (per monthly bank statements) matches the cash disbursement transactions recorded in the accounting records. If the accounting records are missing any cash transactions that are being reported on your organization's bank statement, the variances should be investigated and corrected right away so that the information is accurate, complete and consistent in both sets of records.

c. Physical Inventories: It is necessary to periodically conduct a complete count of your organization's existing fixed assets (property, equipment, furniture, vehicles, etc.). The primary purpose of a physical inventory is to verify the existence, condition, and usability of your organization's assets. An inventory should be conducted either monthly, quarterly or annually to ensure that all fixed assets are accounted for and maintained in proper working condition.

d. Audits: A financial audit is a careful evaluation of your organization's accounting operations, fiscal controls, contract budgets, internal controls, cost, revenue and payroll, to ensure that your financial data is reliable and complete. If your organization's annual gross income exceeds $500,000, then it is generally *recommended* that you hire an independent auditor (an external auditor having no personal or professional ties to your nonprofit or its personnel) to audit your nonprofit at least annually. However, if your organization expends more than $500,000 in *federal funds* annually, then an independent financial audit is *required* by federal regulations. Of course independent audits can be quite expensive, and therefore the cost-benefit ratio may not be feasible for nonprofits challenged by limited resources. Nonetheless, financially capable nonprofits should employ this process in order to strengthen its reputation for integrity, transparency, and professionalism in the eyes of stakeholders and public supporters.