How to Strengthen Your Nonprofit's Internal Controls

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Why are internal controls important?

- Internal control is a crucial aspect of an organization's governance system and ability to manage risk.

- Effective internal control is fundamental to supporting the achievement of an organization's objectives.
  - ***Also creates a competitive advantage***

- If you are required to have an audit but do not have sufficient internal controls in place, your auditor will not be able to efficiently or even satisfactorily conduct their tests.

- Despite the existence of sound internal control procedures, it is often the implementation and application of such procedures that fails or could be further improved in many organizations.

Key questions

- What should the scope of internal control be?
- Who should be responsible for internal control?
- How should controls be selected, implemented, and applied?
- How can internal controls be better integrated into my organization?
- How should internal controls be monitored and evaluated?

The scope of internal controls

- Effective internal control can help organizations improve their performance by enabling them to take on additional opportunities and challenges in a more controlled way.

  - Therefore, there needs to be a better understanding of how organizational performance relates to effective risk management and the role and effectiveness of internal control.

- Internal control should be used to support the organization in achieving its objectives by managing its risks, while complying with rules, regulations, and organizational policies.

Internal controls responsibility

- Should reside with those who have the highest level of authority.
- Should never be delegated to staff who lack executive powers.
- The organization should determine the various roles and responsibilities with respect to internal controls and coordinate collaboration among:
  1. Board of directors (or those charged with governance)
  2. Management at all levels
  3. Employees
  4. Internal and external assurance providers

"The Ministers of Defense"

(responsible for your organization's internal controls)

- **Those charged with governance** should assume the overall responsibility for the organization's internal control strategy, policies, and system, and act accordingly.
- **Management** should *design, implement, monitor, evaluate, and report* on the organization's internal control system in accordance with internal control policies and procedures as approved by the governing body.
- **Employees** (including management) should be held accountable for proper understanding and execution of internal controls within his or her job responsibilities.

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- Staff in support functions or external experts can have facilitating or supporting roles but should not assume responsibility for managing specific risks or for the effectiveness of controls.

- **Assurance providers**, such as your independent auditors play an important role in monitoring and evaluating the effectiveness of the internal controls by reporting any deficiencies and/or best practices to those charged with governance.

NOTE: Your independent auditors will not assume responsibility for managing specific risks or for the effectiveness of controls.

Selecting, implementing and applying internal controls

- Controls are a means to an end—the effective management of risks enables the organization to achieve its objectives.
- Often, organizations implement internal controls without adequate assessment of the external and internal environment or other sources of risk.
- Controls should always be designed, implemented, and applied as a response to a specific risk, what causes it, and its consequences.
- Organizations should mandate that significant decisions are supported by risk assessment and the subsequent implementation of appropriate controls.
- Deviations from the intended outcome need to be assessed.

Considerations for adequate selection, implementation, and operation

- Factors to consider:
- The organization's limits for risk taking;
- The various types of controls (i.e. managerial or transactional controls, preventive or detective controls, and manual or automated controls);
- The suitability of the mix of controls, taking into account the organization's size, structure, and culture;
- The costs compared with the benefits of implementing additional or different controls;
- Continuous changes that can make existing controls ineffective or obsolete and drive the need for periodic assessment of controls

NOTE: *Organizations should also consider the need to avoid over-control, and not become overly bureaucratic. Internal control should enable, not hinder, the achievement of organizational objectives.*

How can internal controls be better integrated into my organization?

- Management should ensure that regular communication regarding internal controls, as well as the outcomes, takes place at all levels within the organization.
  - Ensures that the internal control policies and procedures are fully understood and correctly applied by all.
- Internal controls can only work effectively when they, together with the risks they are supposed to mitigate, are clearly understood by those involved.
- Proper documentation and communication are vital for effective internal control. When documenting and communicating controls, attention should be paid to the usability and understandability of the various policies, procedures, etc.
- It is crucial to test the design of newly implemented and documented controls, followed by monitoring their operating effectiveness.

How can internal controls be better integrated into my organization?

- The use of plain language supports effective internal control.
  - This language should still meet professional and technical standards

- Documentation is only the beginning;
  - Active communication and discussion ensures that what is written in a policy document or handbook is understood widely across the organization and consistently applied in practice by employees.
  - Regular training and department/team meetings are a natural way to actively engage people and increase the likelihood of desired behavior. This is especially important when employees' roles and responsibilities change.

How to monitor and evaluate internal controls

- Management should become aware that a problem with either an individual control or the internal control system has occurred as soon as possible.
  - Prevent or contain further damage and rectify the deficiency.

- Both individual controls as well as the internal control system as a whole should be regularly monitored and evaluated.

- Identification of unacceptably high levels of risk, control failures, or events that are outside the limits for risk taking can be a sign that an individual control or the internal control system is ineffective and needs to be improved.

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Who is responsible for monitoring and evaluating individual controls?

- Those directly involved in the execution of an internal control procedure or activity should check the effectiveness of the control as part of their day-to-day control routine

- Managers who are responsible for the continued suitability and effective operation of the related controls.
  - Ongoing monitoring via their supervision of those involved in the execution of a control activity is usually an effective practice as it is performed close to the operation of the control and relatively early in the process (as compared to evaluations that tend to be performed less frequently and/or at the end of the process).
  - This also reinforces the message that implementing effective internal controls are an integral part of their responsibilities

- Lastly, independent monitoring and evaluation (i.e. external auditors) can provide additional, and more objective, assurance on maintaining the effectiveness of individual controls.

9 Essential Internal Control Tips

Tip 1

Segregation of duties

- Require purchases, payroll, and disbursements to be authorized by a designated person.
- Separate handling (receipt and deposit) functions from record keeping functions (recording transactions and reconciling accounts).
- Separate purchasing functions from payables functions.
- Ensure that the same person isn't authorized to write and sign a check.
- When opening mail, endorse or stamp checks "For Deposit Only" and list checks on a log before turning them over to the person responsible for depositing receipts. Periodically reconcile the incoming check log against deposits.
- Require supervisors to approve employees' time sheets before payroll is prepared.
- Require accounting department employees to take vacations.

Tip 2

Bank reconciliations

- Require reconciliations be completed monthly by an independent person who doesn’t have bookkeeping responsibilities or check signing responsibilities.
- Require supervisory review and approval of reconciliations.
- Examine bank statements and cancelled checks to make sure vendors are recognized, expenditures are related to organization’s business, signatures are by authorized signers, endorsements are appropriate, and checks are not issued out of sequence.
- Initial and date the bank statements and bank reconciliations to document that a review and approval was performed. File the bank statements and reconciliations in a secure location.

Tip 3

Corporate credit cards

- Limit the number of agency credit cards and users.
- Establish a policy that credit cards are for business use only; prohibit use of cards for personal purposes; if purchases earn reward points, include policy regarding ownership and usage.
- Set account limits with credit card companies or vendors.
- Require employees to sign a statement evidencing they understand the policy.
- Require employees to submit original receipts for purchases in accordance with policy.
- Establish an appropriate member of management with the responsibility to review and approve credit card statements and corresponding receipts monthly each month.

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Tip 4

Those charged with Governance

- Monitor the organization's financial activity on a regular basis, comparing actual to budgeted revenues and expenses.
- Require an explanation of any significant variations from budgeted amounts.
- Periodically review the check register or general ledger to determine whether payroll taxes are paid promptly.
- Document approval of financial procedures and policies and major expenditures in the board meeting minutes.
- Require independent auditors to present and explain the annual financial statements and management letters (if applicable) to the Board of Directors.
- Evaluate the Executive Director's performance annually against a written job description, goals, etc.
- Participate in the hiring/approval to hire consultants including the independent auditors.

Tip 5

Policies and procedures manual (should include):

- cash disbursements
- attendance and leave
- expense and travel reimbursements
- use of organization’s assets
- purchasing guidelines (including official procurement policy)
- petty cash
- conflicts of interest
- records retention

NOTE: *All fiscal policies and procedures should be in writing, updated periodically, and be approved by those charged with governance before implementation.*

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Tip 6

Safeguarding of Assets:

- Ensure that agency assets such as vehicles, cell phones, equipment, and other agency resources are used only for official business and properly safeguarded.
- Maintain vehicle logs, listing the dates, times, mileage or odometer readings, purpose of the trip, and name of the employee using the vehicle.
- Periodically review the logs to determine whether usage is appropriate and related to agency business.
- Maintain an equipment list and periodically complete an inventory count.
- Company portable devices (i.e. cell phones, laptops, etc.) should be encrypted to prevent unauthorized access.

Tip 7

Protect checks against fraudulent use.

- Prohibit writing checks payable to cash.
- Deface and retain voided checks.
- Store blank checks in a locked drawer or cabinet, and limit access to the checks.
- Require that checks are to be signed only after all required information is entered on them and the documents to support them (invoices, approval) are attached.
- Establish a reasonable dual signature policy.
- Mark invoices “Paid” with the check number when checks are issued.

Tip 8

Protect cash and check collections.

- Ensure that all cash and checks received are promptly recorded and deposited in the form originally received.
- Issue receipts for cash, using a pre-numbered receipt book.
- Conduct unannounced cash counts.
- Reconcile cash receipts daily with appropriate documentation (cash reports, receipt books, mail tabulations, etc.)
- Centralize cash receipts whenever possible.

Tip 9

Ensure related party transactions are properly documented.

- Require that a written conflict of interest policy is in place and that it is updated annually by both the Board of Directors and employees.
- Require that related party transactions be disclosed and be approved by the Board.

Please contact me with any questions

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