The Importance of Internal Controls

Nonprofit Accounting

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Introduction

Nonprofit organizations aren't immune to fraud. The Washington Post found that among approximately 1,000 nonprofits, losses due to fraud, theft, and embezzlement amounted to close to half a billion dollars in total.[1]

The report, based on tax returns from over five years in which nonprofits indicated losses due to fraud, is just the tip of the iceberg. The Association of Certified Fraud Examiners report in 2005 linked 12% of the fraud cases they had studied to nonprofit organizations.[2] No organization is immune to theft.

Among nonprofits, taking finances for personal use is perhaps the most commonly reported theft. And it's the easiest to prevent. Unlike larger for-profit companies who report intentional errors made on financial reports as their biggest problem, nonprofits face a problem with a clear solution: internal controls.

Internal controls are the safeguard against temptation for your employees and volunteers. While simple in concept and execution, they can prevent many instances of fraud and theft.

In this paper, we'll examine the importance of internal controls. We'll share practical tips and advice for implementing strong controls throughout your organization. We'll also talk about the use of technology for accountability and control.

With losses at nonprofits ranging from $200 to $17 million and a median loss of $100,000 reported,[3] you can't afford to wait to enact internal controls.

Section 1: The Importance of Internal Controls

In the world of nonprofit financial management, internal controls are the steps organizations put into place to guard against theft, loss, and fraud. Think of internal controls as locks or safeguards against temptation. With the right internal controls in place, you're less likely to find yourself in the uncomfortable position of discovering employee fraud.

These tips or best practices for internal controls can help your organization take good care of its finances.

The Need for Internal Controls

Some organizations may question the need for internal controls. After all, you trust your employees, right? Trust has nothing to with good nonprofit financial management. They are an important step to remind employees of your organization's commitment to ethics and integrity.

Internal controls provide a shared set of guidelines that outline exactly what procedures should be followed when employees handle the organization's finances. This shared set of expectations avoids guesswork and builds a common understanding of the way in which you expect finances to be handled. By making things clear to all, you're avoiding gray areas which can be exploited as loopholes.

[1] http://www.pbs.org/newshour/bb/nation-july-dec13-stephens_10-27/
[2] https://nonprofitquarterly.org/2007/12/21/how-to-steal-from-a-nonprofit-who-does-it-and-how-to-prevent-it/
[3] https://nonprofitquarterly.org/2007/12/21/how-to-steal-from-a-nonprofit-who-does-it-and-how-to-prevent-it/

Best Practices for Nonprofit Financial Management and Internal Controls

Some organizations have multiple steps when outlining internal controls, but these four steps have been found to be quite effective at helping to avoid fraud and mistakes. Use these four nonprofit financial management tips to outline expectations around internal controls with your team.

- **Document the process:** The first step is to document all of the procedures that you want to be followed around the handling of donations, checks, cash, and other financial assets. When information is in writing, it is easy to share and use to train others. A simple, streamlined process for nonprofit financial management is best since it is easier for people to remember and follow. Outline the process for each task, and use bulleted lists of steps. Share the documentation, post it publicly in your company, and train everyone on the steps so that the entire team has a shared understanding of the expectations.
- **Segregate duties**: One person should not be assigned the job of handling money. Anytime money is counted, transferred, or prepared for a bank deposit, two people should be present. The person who signs the checks should be different from the person who writes the checks. Separating or segregating duties around money makes it difficult for one person to perpetuate fraud.
- **Monitor operations**: Keep a close eye on your bank statements, credit card charges, and accounting system. Review accounting reports monthly. Do not wait to reconcile bank and credit card statements as reconciliation can uncover problems quickly such as unauthorized charges or withdrawals. When you keep a close, attentive eye on your finances, it is harder for someone to sneak money out of an account without getting caught.
- **Stay consistent**: Maintaining a consistent amount of money in your checking accounts helps you watch the financial situation. Sudden changes in the account balance may signal a problem unless you anticipate paying large bills or receiving hefty donations. Consistently paying bills at the same time each month, reconciling bank statements on the same day or week, and monitoring charges are all part of keeping a healthy eye on your financial situation.

The Cost of Poor Internal Controls:[1]

Big Problems

Nonprofit organizations employ 13.5 million people in the USA

Expensive

Losses annually from theft average $425,000

Five Years

The average embezzlement continues for five years before detection.

Internal Controls Help

Minimizing risk through internal controls can significantly deter embezzlement and fraud.

Nonprofit Financial Management Starts with Vigilance

The best tool for nonprofit financial management is vigilance. Monitoring your organization's finances signals to all that not only do you care about it but that you are going to take steps to intervene if something goes wrong. Hopefully, nothing ever will. But with the right internal controls, you can be sure.

Section 2: Laying the Foundation: Systems & Best Practices

It's good to remember the old adage, "If anything can go wrong, it will," especially when it comes to handling money. Enacting specific systems and best practices for handling and processing any financial information ensures that you are safeguarding your finances and preventing theft.

Best Practices for Nonprofit Internal Controls

Accounting for nonprofits includes handling payroll, donations, accounts payables, membership fees and dues, and other financial tasks. There should be routine controls in place for all common tasks including:

- **Storing checks for bank deposits**: If you store checks in the office until someone can take them to the bank, have safeguards in place to secure the uncashed checks. Keep them locked in a safe or in a desk drawer. Make sure that only one or two people have access to the safe or drawer. Have two people present whenever each is opened so that one can verify the items removed or placed inside.
- **Handling petty cash**: Cash may be the most tempting item since it is difficult to trace if stolen. To prevent thefts or even mistakes, have at least two people present when petty cash is counted in or out. Verify the amounts by having the second person count out the cash, too. Make sure that employees sign receipts for petty cash and provide receipts for items purchased for petty cash, including receipts for services such as a taxi or car service.
- **Fundraising events:** Raffles, sales and other events may generate a lot of cash in small bills. Volunteers working raffle and sales tables may handle cash and store it at the event in a cash box or other unsecured box until it's time to finish the event. Train volunteers and workers to never leave cash unattended at the booth or table. Instruct them to place all cash into the secure box or official cash register, never in their pockets or purses. Reconcile ticket sales with cash that night before everyone goes home to make sure no one has made mistakes.
- **Payroll:** Padding timesheets with unworked hours is another form of theft that needs internal controls to prevent. Ask all managers to authorize employee overtime, and have a supervisor sign off on manager's overtime reports if they are not salaried workers.

The idea behind internal control policies is to trust yet verify. You must have a witness when handling money, and spit up cash responsibilities and duties among several employees to prevent anyone from being tempted. The more controls you can put into place and make a regular part of your company's policies, the easier it will be to prevent problems.

The Top Internal Controls for Smaller 501(c)3 Organizations

Protecting your data, information, and financials should be your top priority as a 503 (c) organization. Raising funds and winning grants is not an easy process, and you should be doing everything you can to safeguard your funds and financial information. Misuse, fraud, theft, and embezzlement are common occurrences, and if you don't have the proper policies and procedures in place to protect your financials, you could put your organization at great risk.

Smaller 501(c)3 organizations, in particular, have a difficult time maintaining the proper controls to protect their organization. Because their staff is limited (some organizations have fewer than 3 staff members) and their time is precious, many smaller organizations have difficulty segregating duties and implementing a system of checks and balances. Even if they don't have the staff to maintain the same internal controls as larger organizations, smaller organizations can implement a few key controls to ensure that their financials are protected.

We've created a list of the top internal controls small 501(c)3 organizations should implement in order to properly protect their funds and financial information. Keep the following in mind as you begin to create your financial policies and procedures:

- **Educate and train**. Make sure your entire staff is aware of the policies and procedures you have in place. Everyone should be expected to follow these policies; there should be no exceptions. Excluding even the top person can set a negative (and even unethical) tone among your staff and lead to your staff ignoring procedures and cutting corners.
- **Implement physical controls**. Lock up your files, password-protect your computers, and always keep checks in locked drawers. Simple security measures with your physical assets can go a long way in protecting your organization.
- **Define roles and responsibilities**. Roles and responsibilities need to be written down even in small organizations. Determine who is responsible for what and make sure every staff member is aware of their duties. Failure to do so can cause things to slip through the cracks and place your organization at risk.
- **Reconcile your bank statements.** This may seem obvious, but it needs to be said. Reconciling your bank statements is crucial to protecting your financials. If you reconcile your bank statements regularly, embezzlement can't – and won't – go on for very long. We recommend someone other than the bookkeeper (or whoever handles the money) reconciles the bank account; however, some smaller 501(c)3 organizations do not have a bookkeeper or only have one person who does everything. In this case, we would recommend having a board member (or someone else in a similar role) receive and review the bank statements before handing it over to the staff.
- **Use the buddy system**. Always have two people present when counting cash. Cash handling is extremely risky, and you need to implement strong policies and procedures for dealing with cash. Hold your staff accountable with all cash that flows through the organization.

Section 3: Segregation of Duties

The most effective procedures are those that have the greatest segregation of duties. This is the concept of having

MINIMIZE THE RISK

To minimize the risk of embezzlement and fraud, Munich Reinsurance[1] suggests the following:

- Conduct background checks during the hiring process.
- Create an audit committee.
- Require independent directors.
- Endorse all checks "for deposit only."
- Separate financial duties so no one person is responsible for all finances.
- Beware of employees who never take a vacation. Require vacation time to be taken.
- Establish internal controls and review them periodically.
- Hire an independent auditor who understands the nonprofit sector.

more than one person required to complete a task.

The separation by sharing of more than one individual in one single task is an internal control intended to prevent fraud and errors. The more people involved in the process, the less likely it is that an error will occur. For example, the person who writes checks should not be the person signing them. The person who orders the service or product should approve the invoice. The person with budget responsibility should also approve the expenditure and code the invoice.

Typically, internal controls are written policies that detail agreed-upon procedures that the nonprofit will adhere to, as well as outlining who the responsible parties are. The goal of internal controls is to create business practices that serve as "checks and balances" on staff or outside vendors in order to reduce the risk of misappropriation of funds.

Common Separation of Duties for Internal Controls

- Requiring two signatures on a check.
- Establishing safety protocol ensuring all doors are locked when no one is monitoring the entrance.
- Preapproving spending, as a prerequisite to guaranteed reimbursements.
- Requiring multiple persons to be present when collecting and counting cash donations.
- Regularly reviewing vendors who are receiving money from the nonprofit for services or supplies.
- Ensuring that the same person isn't authorized to write and sign a check.
- When opening mail, endorsing or stamping checks "For Deposit Only," listing checks on a log before turning them over to the person responsible for depositing receipts, and periodically reconciling the incoming check log against deposits.
- Requiring that cash is stored in a locked drawer or safe.
- Requiring background checks for employees or volunteers who handle money.

Another facet to consider is the actions of executive staff and leadership to adhere to internal controls. Leading by example is the best way to ensure compliance with rules by the rest of your staff and volunteers.

Additionally, acknowledging that these controls are being implemented as a measure to protect the staff and organization and not due to mistrust. If you are wondering where to begin establishing internal controls for your nonprofit, a good place to start is with:

- Any person who has access to your bank accounts or
- Any person with permission to spend money on your organization's behalf.

Without establishing these procedures, your nonprofit is vulnerable to misuse and misappropriation of assets.

Section 4: Documentation

Fraud occurs more than you think, and it often goes unnoticed until it's too late. Fraud can come in a variety of forms, including check fraud, credit card fraud, and employee theft (the most common types including check tampering and billing schemes). Stealing inventory, claiming undue overtime, setting up payments to fictitious vendors, skimming cash, and embellishing an expense account are all fraudulent activities that can occur within a company or organization. These activities threaten the stability of the business and can result in a significant financial loss. In fact, according to the Association of Fraud Examiners (ACFE), the typical business loses an average of 7% of revenues due to employee theft alone.

Consider the reasons you may want to create strong internal controls:

- Internal controls can solve current business problems and help prevent fraud from occurring.
- Businesses with strong internal controls in place have the potential to go public.
- If you are working with a Sarbanes-Oxley (SOX) compliant customer, you may be required to show proof of strong internal controls.
- Strong internal controls improve financial reporting accuracy and ensure assurance that your financial statements are correct.
- Future investors, bankers, and accountants will want to see how you are protecting your financial assets.

Keys to Effective Financial Reporting: Setting Internal Controls

Since the passing of the Sarbanes-Oxley Act of 2002, businesses and corporations have had to reevaluate their financial reporting processes and procedures to comply with more restrictive federal laws. In an effort to protect businesses and organizations against costly errors and fraud, the government is cracking down on financial reporting and the storage of electronic financial documents. Business accounting software can only get you so far. While the software is certainly helpful in tracking and auditing your financial transactions, you need to develop sound internal controls to establish the required "separation of duties" (or "checks and balances system"). Financial responsibilities should be separated from a business or organization, and there should be policies implemented that discourage one person to have complete custody over the financial decision-making and review process.

Setting internal controls ensures compliance with Sarbanes-Oxley and protects the financial integrity of your company or organization. Below are several tips designed to help you set effective internal controls and increase the effectiveness of your financial reporting:

- Do not let the person (or persons) managing your company's bookkeeping functions handle cash.
- Reconcile bank statements on a monthly (30-day) basis. Make sure this is done by someone who is not responsible for bookkeeping, cashiering, or depositing. When complete, these bank reconciliations should be reviewed by supervisors for accuracy and completeness. Make sure both the reviewer and preparer signs off on each monthly reconciliation so you can track who reviewed it.
- Do not allow employees who handle cash have access to accounting records.
- Reconcile all receipts with deposits made into the company account to verify that all collections are accounted for in the system (and bank). This task should be performed by someone who is not responsible for making the purchases or deposits.
- All cash disbursements need to be approved by an employee who is not involved in the check preparation, bookkeeping or bank reconciliation process.
- Checks need to be written and/or printed by someone who is not responsible for disbursement approvals, check distribution, or maintaining the company's accounts payable ledger.
- As soon as checks or cash is received, a receipt of payment needs to be prepared; all checks need to be endorsed immediately upon receipt.
- The frequency of the deposits into your company or organization's bank account should be determined by the volume of funds you receive. If your receipts total more than $500 (or a reasonable amount for your organization), they should to be deposited within a day. For amounts under the threshold, the funds can be properly secured in your office for a week or until the amount reaches the threshold.

- Require two signatures on all checks for cash disbursements, and make sure at least one of the signers is not responsible for any cash receipt or disbursement functions.
- Mark all paid documents (invoices, receipts, purchase orders, etc.) “PAID”, and write the check number and payment date on each document. This will ensure the integrity and help you track when you paid what outside of your accounting system.
- Setting internal controls is important to your company’s reputation. It can help ensure financial integrity, as well as help you create more effective (and accurate) financial reports. Stay tuned to our blog for more effective financial reporting tips.

Strong internal controls are essential no matter how small or large your company or organization. Just as you wouldn’t leave money lying out in the open for anyone to take, you shouldn’t leave your financial information open for all to see. Creating procedures and policies detailing employee responsibilities and tasks is a step in the right direction when it comes to safeguarding your assets.

Section 5: Accountability through Monitoring

While accounting and financial management may not be your area of expertise, you still need to play an active role in the process. Having a clear understanding of the accounting process and what is occurring with your finances is always a smart idea.

Too often we hear of business managers and non-profit leaders putting too much trust in their employees and taking a hands-off approach to bookkeeping. While it’s good to trust your staff, you can never be too trusting (as recent fraud statistics have shown). By taking the following simple steps, you can reduce the risk of fraud and create a culture of responsibility among your management team:

- **Take an interest in the books.** Make it a point to review financial reports periodically and ask questions about any discrepancies you may see. If you don’t understand financial reports or need help identifying key figures, seek the help of a certified public accountant. They can train you on everything you need to know about creating and reading these reports, as well as help you understand how this information impacts the everyday operations of your business or organization.
- **Create an ethics policy.** If you want to set your employees up for success, make sure they have a clear understanding of what you will and will not tolerate as an organization. Create a written policy that outlines your policy for ethics and business integrity and ensure that all of your employees sign it. Perform an annual review of this policy to adjust for changes in the work environment.
- **Check in on your employees regularly.** The most successful business managers and non-profit leaders have established a clear presence among their teams. Employees who know they are being constantly checked in on are less likely to engage in fraud and theft. By establishing a culture of oversight and review, you are protecting your business or organization from substantial losses.
- **Perform random reviews of important reports and financial documents.** While it’s always a good idea to review financial reports on a monthly basis, management should also choose other reports to spot check. Since your employees won’t be able to predict what you’re looking at, you will have a more honest assessment and be able to identify fraud quickly and easily.

Internal Controls in Your Accounting System

Limiting who has access to your accounting system is the first step you should take when implementing internal controls in the accounting process. Many software systems will even allow you to limit users’ access to certain areas of the system so you can more effectively manage who has full access to your financial information.

Assign software rights according to each employee's responsibilities. For example, if a particular employee is in charge of Accounts Payable, they should not have access to Accounts Receivable or be able to balance the bank statement. Clearly defined roles protect your assets and encourage accountability among your staff.

Here are a few more internal controls to consider implementing:

- Perform regular backups of your financial accounting database
- Hire an outside CPA to review your books on a periodic basis
- Set up an audit trail in your accounting software system
- Password protect all financially-sensitive documents
- Create a separate sign-on for each user of the system

Internal Controls for Financial Management

Protecting your finances should be your number one priority as a business or non-profit. Keep these methods of strengthening your financial security in mind as you reevaluate your current internal controls:

- Create a deposit slip for any cash or checks that come through the door. This could include creating a separate log for all cash and check receipts that are then passed on to the bookkeeper and business owner. Once deposits have been made, the owner can then compare the receipts log to the bank deposits.
- Create an approved vendor list and a vendor approval policy. Each vendor must be approved prior to any business being done with that vendor.
- Check preparers should be different than the people signing the checks.
- Consider having two people sign all checks over a certain threshold.
- Avoid issuing emergency checks whenever possible.
- Create a policy for submitting employee reimbursements and make sure all employees follow the same policy.
- Require receipts for all credit and debit transactions.
- Maintain separate cards for different users for accountability.
- Reconcile bank accounts and credit card statements monthly.
- Monitor online banking activity on a monthly basis.
- Require documentation for any payroll changes.
- Implement a timesheet approval process before payroll can be completed.

Section 6: Using Technology for Internal Controls

As nonprofits, we focus on expanding programs and services, reducing costs, increasing return on mission, and strengthening donor loyalty – all of which is good stewardship. That's really what automation of processes is all about: doing more and creating greater impact with less.

If you want to ensure high program efficiency metrics, you have to create the productivity savings, via automation, to reduce the proportional costs of overhead to program investment.

Here's a specific example – let's say you want to improve internal controls and reduce the inefficiencies of your manual purchasing system. By utilizing automated workflows in a best in class fund accounting solution, you will save time, paper, and frustration.

Automated purchasing workflows will give you notification (on any device) that you have a pending electronic purchasing requisition or PO for approval. As you approve vendor payments, you can drill right into the original document to see the invoice. Payments are point and click. Reporting and visibility are instant.

Another example might be your audit. Is it taking too long and costing too much? In an automated environment, you can create a dashboard for your auditors that give them view only access to key reports and documents – right from their office. They can drill right into the source documents and you save travel, delays, and costs.

When you begin identifying your goals, priorities, and strategies, select some best practices to implement in your organization. It's extremely helpful to define, track and measure results so that you can identify your savings and efficiency gains. Get familiar with the technology tools available to help you increase stewardship while decreasing costs.

Conclusion

There are many things to consider when structuring internal controls for your organizations. Protection against theft, fraud, and embezzlement begins with awareness and continues with written policies and procedures. Training employees on how to handle cash using a 'buddy' system and leading by example solidify your internal controls. Lastly, using technology, such as a state of the art nonprofit accounting system, can help you automate many processes to prevent gaps leading to fraud.

While no one likes to think about their employees or valued volunteers committing theft, fraud, or embezzlement, anyone can be tempted by lax security procedures in the accounting office. Internal controls close gaps that can lead people to poor choices. It's an ounce of prevention that is worth much more than a pound of cure.