BEST PRACTICES FOR

Not-for-Profit Internal Controls –
Enhancing Your Internal Control Environment

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Whatever their mission or size, all not-for-profit organizations should establish policies and procedures to assure that (1) boards and officers understand their fiduciary responsibilities, (2) assets are managed properly, and (3) the charitable purposes of the organization are carried out. Failure to meet these obligations is a breach of fiduciary duty, and can result in financial and other liability for the board of directors and the officers.

Due to the recently revised AICPA audit standards, external audits will closely examine and consider an organization’s internal control environment in the annual audit plan and management report. Consequently, effective internal controls will not only help protect an organization’s assets and assist in their proper management, it will also address the concerns raised during the next external audit.

INTERNAL CONTROLS

One of the primary responsibilities of directors and officers is to ensure that the organization is accountable for its programs and finances to contributors, members, the public and government regulators. Accountability requires that the organization—

- Comply with all applicable laws and ethical standards
- Adhere to the organization’s mission
- Create and adhere to conflict of interest, ethics, personnel and accounting policies
- Protect the rights of members
- Prepare and file its annual financial report with the Internal Revenue Service and appropriate state regulatory authorities
- Make the report available to all members of the board and any member of the public who requests it

The development and maintenance of the organization’s internal controls will help to ensure accountability.

What are Internal Controls?

Internal controls are policies and procedures that protect the assets of an organization, create reliable financial reporting, promote compliance with laws and regulations, and achieve effective and efficient operations. These systems relate to accounting and reporting, and to the organization’s internal and external communication processes. Internal controls typically include procedures for (1) handling funds received and expended by the organization, (2) preparing appropriate and timely financial reporting to board members and officers, (3) conducting the annual audit of the organization’s financial statements, (4) evaluating staff and programs, (5) maintaining inventory records of real and personal property and their whereabouts, and (6) implementing personnel and conflicts of interest policies.

IMPLEMENTATION AND MONITORING OF INTERNAL FINANCIAL CONTROLS

Procedures for Monitoring Assets

Every organization should have procedures to monitor and record assets received, held and expended. These financial controls should be described in an accounting policies and procedures manual. The manual should be reviewed with and distributed to all directors and officers, trustees, employees and volunteers.

Representative procedures addressed by the accounting manual typically include the following controls. These limited examples do not constitute a complete internal control environment. Rather, they are meant to illustrate highlighted example controls.

### The Prevalent, Top 5 Not-for-Profit Internal Control Risk Concerns

1. **Accounting Policy Manual**
2. **Sarbanes-Oxley Act Not-for-Profit Considerations**
   - Whistleblower channel and compliance monitoring
   - Document destruction and retention policies
3. **General Entity-Level Controls**
   - Conflict of interest and ethical code of conduct
   - Segregation of duties
   - Delegation of authority
4. **IT General Controls**
   - User access
   - System/Application/Data Security
   - System/Application change management
   - Use of spreadsheets
5. **Key Internal Controls – by significant transaction cycle**
   - Cash management
   - Payroll
   - Accounts payable
General Entity-Level Controls – Preparing an annual income and expense budget and periodic reports -- at least quarterly, preferably monthly -- comparing actual receipts and expenditures to the budget with timely variance explanations.

Information Technology General Controls – Accessing, inputting and changing electronic data maintained by the organization. Preserving electronic records and ensuring data compatibility when systems change and creating an appropriate records retention policy are part of this process. Providing procedures for approving contracts to which the organization is a party, including securing competitive bids from vendors.

Segregation of Duties – Writing and signing checks or vouchers and receiving, recording, securing and depositing cash and other receipts. Such procedures should ensure that no single individual is responsible for receiving, recording and depositing funds, or writing and signing checks. Checks and balances are essential to make embezzlement more difficult. For example, the same person should not be responsible for handling cash receipts and bank reconciliations. These functions should be assigned to different individuals.

Sarbanes-Oxley Act – All not-for-profit organizations should establish a confidential and anonymous mechanism to encourage employees to report any inappropriateness within the entity’s financial management. At the same time, organizations should develop procedures for handling employee complaints so that no punishment for reporting problems -- including firing, demotion, suspension, harassment, failure to consider the employee for promotion, or any other kind of discrimination -- is permitted.

Revenue – Ensuring that grants and contributions received are properly recorded, accountings required as a condition of any grant are completed and restrictions on the use of such funds, such as contributions given for a restricted purpose (e.g. building fund, scholarships) and prohibitions on the use of the principal of an endowment, are obeyed.

Purchasing & Accounts Payable – Requisitioning, authorizing, verifying, recording and monitoring all expenditures, including payment of invoices, petty cash and other expenditures. In addition, such procedures should ensure that no single individual is permitted to request, authorize, verify and record expenditures.

Various Roles in the Organization

There should be written job descriptions for directors, officers and trustees, employees, volunteers and consultants. The work of the organization will be more easily accomplished and problems will be avoided if all involved understand what is expected of them and the limits of their authority.

Likewise, all other employees should have written job descriptions and be advised of what is expected of them. Volunteers are no exception. They should be given job descriptions that clearly describe what is expected of them. For many organizations, volunteers are the only people who conduct programs and have contact with the public. If they do not understand their responsibilities or do not act professionally, the organization could be at risk.

Personnel Policies

Personnel policies, including vacation and sick leave, health insurance and other benefits, evaluations, ordinary and overtime compensation, conflicts of interest and code of ethics, and grievance procedures (including protections for whistleblowers), should be in writing and given to all employees prior to hiring. Changes in policies should be communicated on a regular basis.

Conflict of Interest Policy and Code of Ethics

Directors, officers, trustees and others who serve a not-for-profit organization should not have any personal or business interests that may conflict with their responsibilities to the organization. To avoid such conflicts, it is wise to have a conflict of interest policy that clearly states the procedures to be followed if a board member’s personal or financial interests may be advanced by an action of the board.

The conflict of interest policy should require an individual to fully disclose any interest the individual and/or the individual’s family has in any entity that does business with the organization, and that any change in the information concerning a potential conflict should be provided to the organization immediately. The policy may be set forth in the organization’s by-laws. It must require that such individuals may not participate in any decision to approve doing business with the individual or any entity in which the individual has an interest. It should state that such decisions must be made by a disinterested majority of the board of directors or trustees.

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The organization should also have a code of ethics addressing issues such as transparency, disclosure in fundraising solicitations, integrity in governance and diversity.

All board members, employees, volunteers and consultants should be given copies of both policies, and be required to sign a statement acknowledging that they have read them.

SUMMARY

In carrying out their responsibilities, board members should realize that they need not do it alone. Instituting and relying upon an effective internal control environment is a sign of proper governance and proactive management. Moreover, a strong internal control environment can be leveraged as a non-physical tool/asset which assists not-for-profit organizations in fulfilling their fiduciary duties.