Humanities Texas
Internal Controls
Grants

INTERNAL CONTROLS

Use this resource document, provided by the Texas Commission on the Arts, and the Internal Control Questionnaire to learn about what internal controls are, why they are needed in nonprofit organizations, and best practices to establish them in your institution.

WHAT ARE INTERNAL CONTROLS?

Internal controls are financial management practices that are systematically used to prevent misuse and misappropriation of assets that may result from error, theft, or embezzlement. Internal controls are generally described in written policies that detail the procedures that an organization will follow, as well as who is responsible. The goal of internal controls is to create business practices that serve as "checks and balances" on staff (and sometimes board members) or outside vendors in order to reduce the risk of misappropriation of funds/assets. Good internal controls will take away the opportunity needed by desperate people to commit a crime.

The top priority for any nonprofit is to put in place at least the basic internal controls that address who has access to the nonprofit's bank accounts, and who has authority to spend money on the nonprofit's behalf, whether via check, cash, credit card, or some other means.

HOW IS THIS DONE?

- Implement those steps that make sense for your organization, given the nature of your operations and extent of resources available for internal controls.
- The most effective procedures are those that have the greatest segregation of duties. The more people involved in the process, the less likely it is that errors or irregularities will occur. This can be very challenging for very small organizations and may require enlisting board members to serve in some roles. For example, the person who writes the checks should not be the person signing the checks. Payments should never be issued without appropriate documentation approved by a different individual. You may need to assign several people to these different roles but make sure no one individual can approve an expense and pay it without other people being involved.
- Generally, management establishes the system of controls and procedures. It may be helpful to have an accounting manual detailing the steps and procedures to follow.

THE THREE TYPES OF INTERNAL CONTROLS

A good set of internal controls will include some of each of these types of controls.

- Preventative: Designed to keep errors or irregularities from occurring in the first place.
- Detective: Designed to detect errors or irregularities that may have occurred.
- Corrective: Designed to correct errors or irregularities that have been detected.

COMMON EXAMPLES

Perform background checks on employees with fiscal responsibilities, prior to hire and periodically throughout employment.

- Develop and adhere to written policies and procedures outlining, among other items:
- Which staff positions are responsible for which activities in a given fiscal process?
- Who is authorized to approve expenditures, contracts, checks, new accounts, time sheets, etc.?
- How does the organization physically process the receipt, deposit, recording, and reconciliation of cash, checks, electronic payments, etc.?
- Where does the organization's sensitive information, such as legal, tax, payroll, personnel, and banking documentation, reside? Who has access to it?
- What information and documentation (purchase orders, invoices, receipts, statements, work logs, timesheets, etc.) is required to purchase goods, contracts for services, reimburse staff and volunteers, etc.?
- Requiring double signatures on checks is a common internal control. Know that banks will not always honor this rule and will cash checks with single signatures. It is still a useful procedure to put in place for internal perception.
- Forbid pre-signing checks, making out checks for cash, issuing payments not included in the budget
- Require that the board sees proof of IRS payments on a regular schedule.

Segregate Responsibilities: Ensure no single individual performs all tasks in a particular financial process. It can be helpful to diagram out the key elements required for each payment process and chart out who can play a role or potential role for each step. (see questionnaire below)

Educate your Board and Staff:

- Communicate a zero-tolerance policy for fraud.
- Require employees sign to a written Code of Conduct that outlines expectations and specifies that the consequence of not adhering to the written policies and procedures around Internal Controls is termination of employment.
- Invite the nonprofit's Directors and Officers liability insurance carrier, bank, or even local law enforcement, to make a presentation at a staff or board meeting to raise awareness about ways fraud is often carried out.

Physical and Data Security Controls:

- Keep valuable assets under lock and key (including your blank numbered checks)
- Restrict access to computers and servers, fiscal accounts, etc.
- Implement permissions on files, folders, and programs that limit what different users can do with specific programs and files (i.e., read versus edit).
- Keep critical data secure using passwords, firewalls, encryption, etc.
- Perform a fixed asset inventory annually to ensure that no equipment or other goods are missing.
- Ensure the board has authority over securities, real estate and other valuable property.

Early Detection:

- Establish a safety net to detect errors or irregularities and minimize the total loss to the organization.
- Use electronic notifications to alert more than one senior member of the organization of bank account activity, balance thresholds, positive pay exceptions, and wire notifications.
- Have one person independent of the payment issuing (director or board member) review the unopened monthly bank statement, credit card statement, endowment statement, before a different person performs the reconciliation.
- Have an objective person perform periodic reviews of all vendors receiving fees/checks from the organization (because a common scheme involves creating a fictitious vendor).

- Cross-training staff so they can make bank deposits and perform other essential accounting duties when the regular bookkeeper or accountant is absent.
- Insist on mandatory time off for the regular bookkeeper or accountant during a time when payments are typically processed and look for inconsistencies.
- Review, prepare, and approve formal reports, reconciliations, and/or inventories of revenues and expenditures related to particular accounts, grant awards, donations, endowments, etc. on a monthly/quarterly/annual basis as appropriate.
- Engage the services of a certified public accounting firm to conduct an annual financial statement audit that is reported to the board without staff present.
- Encourage whistleblowers by clarifying how and to whom employees should raise concerns about financial mismanagement. This should be spelled out in the *Whistleblower Policy* and provided to all staff and board members. Many organizations designate the chair of the audit/financial committee as the nonprofit's "ombudsperson" for purposes of receiving and investigating complaints.

Quick Response:

- Identify the board committee responsible for responding to or investigating allegations of fraud, theft, or embezzlement.
- Decide in advance that the organization will pursue criminal charges against an employee who engages in fraud. (Check with your insurance company because often insurance coverage is dependent upon the nonprofit involving law enforcement in prosecuting criminal behavior.)

Based on materials and articles from: American Nonprofits, Emerson & Church (Andy Robinson and Nancy Wasserman), Greater Washington Society of CPAs, National Council of Nonprofits, Nonprofit Times, Venable LLP. Internal controls document provided by the Texas Commission on the Arts.

10 minute Board Exercises — Get your board talking about some very important issues

Introductory Worksheet in Internal Accounting Controls:

Internal Control Questionnaire

Purpose

This board exercise will clarify methods being used by your organization to process financial transactions. It will identify who currently handles different accounting tasks and indicate if there is adequate segregation of duties. By evaluating and strengthening your nonprofit's internal accounting controls, organizational financial assets will be better protected against theft.

Instructions

Step One Select one person from your board who is willing to compile the answers to this short questionnaire. This person should not be involved in the financial processes of your organization in any way (doesn't write checks, sign checks, prepare financial statements, reconcile bank accounts, etc).

Step Two Make a copy of the questionnaire for each board member and take 10 minutes during your board meeting to have everyone complete it. Return completed questionnaires to the person selected above. **Note: Do not distribute this instruction page with the questionnaire.**

Step Three Either before your board meeting or after, distribute this same questionnaire to:

a. **All staff.** If you are a large organization limit this to individuals who are involved in the financial process. Be sure to include those individuals who handle other financial activities as well (i.e. opening the mail, if you receive payments this way).
b. **Any committee members** who handle financial activities (you may need to check to determine if committees have their own checking accounts).
c. **Any volunteers** who handle financial activities.
d. **Any subcontractors** or others outside your organization who handle any of your financial activities.

NOTE: Make sure the completed questionnaires go directly to the person above. This can be accomplished by providing an addressed, stamped envelope for this purpose.

Follow-Up

The answers to the questionnaire will give you the first opportunity to see an overview of "who handles what part" of your accounting process. Check on such best practices as:

- Not having the same person writing and signing checks;
- Not having the same person handling many aspects of the process;
- Not making debit cards available (which are much higher-risk than credit cards); etc.

Your organization's board needs to annually discuss how much risk is acceptable and alter your system accordingly. You may need professional help with this. There may be someone with a financial background in your community who would be willing to help with this activity.

CNS will be continuing this topic in future eNewsletters.

CENTER FOR NONPROFIT STEWARDSHIP

Disclaimer: This information is not a substitute for competent legal and accounting advice rendered on your particular fact situation and planning goals. Laws and procedures change frequently and are subject to different interpretations.

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10 minute Board Exercises — Get your board talking about some very important issues

Introductory Worksheet in Internal Accounting Controls:

Internal Control Questionnaire

Your Name: _____ Today's Date: _____

Your Title: _____ How long have you been in this position? _____

Your Role: ☐ Employee ☐ Volunteer ☐ Board Member ☐ Independent Accountant / Bookkeeper

☐ Other (describe): _____

Do You…	Always	On Occasion	Never
Disbursements:			
• Approve invoices	_____	_____	_____
• Write checks: ☐ Regular ☐ Payroll	_____	_____	_____
• Sign checks: ☐ Regular ☐ Payroll	_____	_____	_____
• Mail / distribute checks after they are signed	_____	_____	_____
Bookkeeping:			
• Handle day-to-day bookkeeping	_____	_____	_____
• Prepare financial reports / statements	_____	_____	_____
• Receive & review bank statements	_____	_____	_____
Electronic banking:			
• Pay bills electronically	_____	_____	_____
• Transer funds between accounts	_____	_____	_____
• Handle other online banking (describe below)	_____	_____	_____
Revenue:			
• Handle incoming revenue (describe below)	_____	_____	_____
• Prepare deposit slips	_____	_____	_____
• Make bank deposits	_____	_____	_____
Compute payroll	_____	_____	_____
Open the mail	_____	_____	_____
Have an organizational: ☐ Credit Card ☐ Debit Card	_____	_____	_____
Handle cash (describe below)	_____	_____	_____

Please list your other financial and nonfinancial duties here *(use back if needed)*:

_____

_____

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