

New York City Mayor's Office of Contract Services  
Capacity Building & Oversight Unit

# **INTERNAL CONTROLS FOR SMALL NONPROFITS**

*Prepared and Presented by:*

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# INTRODUCTION TO FRAUD & INTERNAL CONTROL-A TRUE STORY

- ✘ For five years, CEO & other executives
  - + Fraudulently siphoned off \$290,000 for their personal benefit
  - + Lent \$875,000, unsecured, to one executive's private business venture, without informing the Board
  - + Routinely falsified records

# INTRODUCTION TO FRAUD & INTERNAL CONTROL - A TRUE STORY

- ✘ Board was oblivious to how the organization was being managed & unmindful of its fiduciary responsibilities, which left the organization exposed to the unethical actions
- ✘ Board accepted the CEO's statements uncritically & took no independent action to monitor financial condition
- ✘ Treasurer stated that he had no particular responsibilities & took no interest in financial records & reports
- ✘ Board was unprepared to govern the organization & oversee the dominant CEO
- ✘ see [www.nyc.gov/html/doi/pdf/GW\\_Report.pdf](http://www.nyc.gov/html/doi/pdf/GW_Report.pdf)

# INTRODUCTION TO FRAUD & INTERNAL CONTROL

- ✘ Long-running frauds & abuses by not-for-profit insiders are often associated with the absence of oversight
  - + Passive boards
  - + Superficial annual audits
- ✘ The scope & depth of the annual audit are often constrained by
  - + Not-for-profit budgets
  - + Auditors' reluctance to alienate the not-for-profit executives who hire them & with whom they become familiar over time

# OCCUPATIONAL FRAUD

- ✘ SAS No. 99 states that three conditions are generally present when fraud occurs
  - + Incentive or pressure
  - + **Opportunity**
  - + Ability to rationalize committing a fraudulent act

# OPPORTUNITY TO COMMIT FRAUD

- ✘ Absence of internal controls
- ✘ Ineffective internal controls
- ✘ Management's ability to override internal controls

# OPPORTUNITY FOR FRAUD AT SMALL NONPROFIT ORGANIZATIONS

- × Lack of segregation of duties
- × Dominant leadership of the CEO or CFO
- × Negative regard for the fiscal function
- × Over-reliance on one individual
- × Less resources to support the accounting function

# OPPORTUNITY FOR FRAUD AT NOT-FOR-PROFIT ORGANIZATIONS

- ✘ Lack of financial expertise in fiscal & management functions
- ✘ Use of volunteers on the board (our culture)
- ✘ Focus on the mission, not the bottom line
- ✘ Atmosphere of trust
- ✘ Revenue sources that are difficult to control, e.g., contributions



# WHAT IS INTERNAL CONTROL?

- ✘ A process, effected by an entity's board, management & other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives
  - + Accurate & reliable financial reporting
  - + Operational effectiveness & efficiency
  - + Compliance with laws & regulations
  - + Safeguarding of assets

# ACCURATE & RELIABLE FINANCIAL REPORTING

- ✘ Accounting information systems
  - + Software adequacy
  - + Access controlled by management with limited board member access
- ✘ Adequacy of format
  - + Comprehensive, concise, understandable
  - + Orientation process for board members
- ✘ Timeliness of reporting
  - + Internal to management & the board
  - + External to funding sources & regulators

# OPERATIONAL EFFECTIVENESS & EFFICIENCY

- × Programmatic efficiency & quality services
- × Adequate staffing levels
- × Qualified fiscal staff
- × Minimal or no duplication of duties
- × Well-articulated management structure
- × Clearly written & legally compliant personnel policies
- × Clearly written job descriptions

# COMPLIANCE WITH LAWS & REGULATIONS

- × Federal, state & local reporting requirements
- × Board composition
- × Funding source requirements
- × Labor laws
- × Quality assurance
- × Client/consumer protections

# SAFEGUARDING OF ASSETS

- × Protect assets from misappropriation
- × Protect assets from misuse

# FIVE COMPONENTS OF INTERNAL CONTROL

1. Control environment – sets the tone of an organization influencing the control consciousness of its people. It is the foundation for all other elements of internal control.
2. Risk assessment – the entity's identification & analysis of risks to achievement of its objectives

# FIVE COMPONENTS OF INTERNAL CONTROL

3. Control activities – the policies & procedures that help ensure that management's directives are carried out

- + Top-level reviews
- + Information processing controls
- + Physical controls
- + Segregation of duties

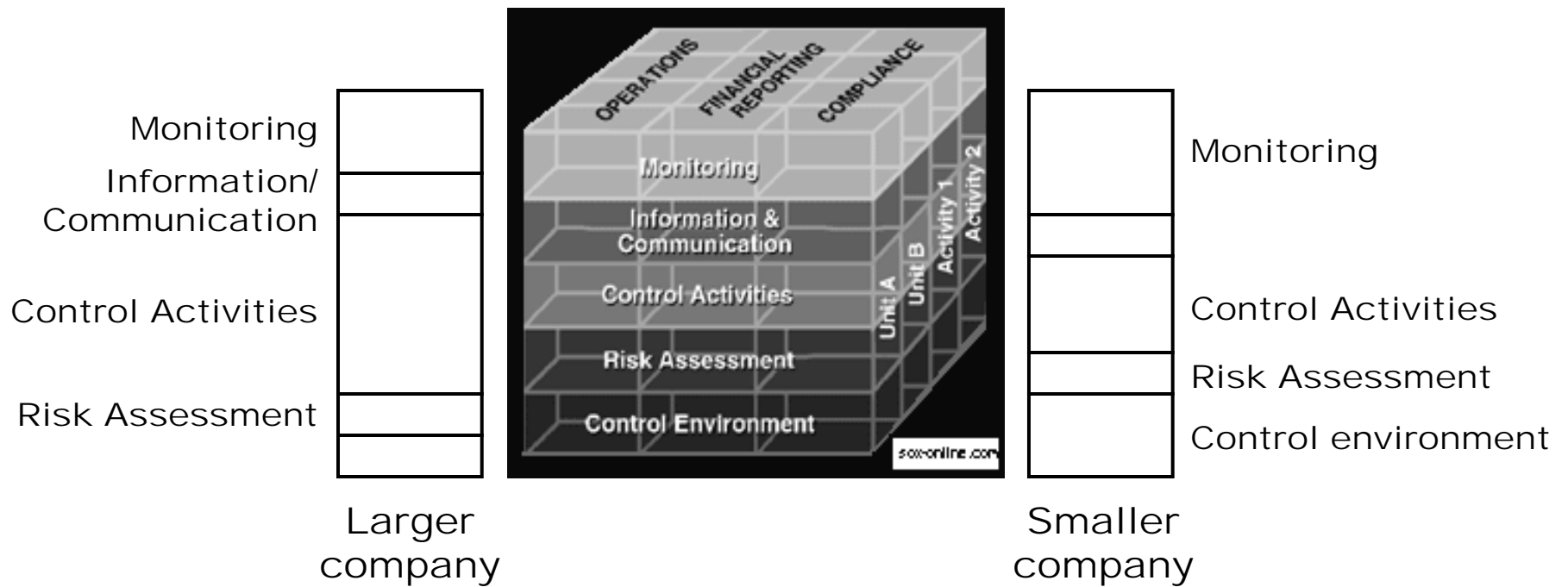
# FIVE COMPONENTS OF INTERNAL CONTROL

4. Information & communication – the identification, capture & exchange of information that enable people to carry out their responsibilities
5. Monitoring – a process that assesses the quality of internal control performance
  - + Management & supervisory activities
  - + Comparisons of budget to actual
  - + Reconciliations of account detail to the G/L



## **FIVE COMPONENTS OF INTERNAL CONTROL**

- ✘ For effective internal control, all five components must be in place & operating
- ✘ However, highly effective monitoring activities can offset certain shortcomings in other components



The COSO acknowledges that the controls in smaller companies will be of different types than larger ones & at times the categories may not be distinguishable.

# ATTAINING COST-EFFECTIVE INTERNAL CONTROL IN SMALL NONPROFITS

- ✘ Obtaining sufficient resources to achieve adequate segregation of duties
- ✘ Recruiting & retaining personnel with sufficient experience & skill in accounting & financial reporting
- ✘ Promoting management's attention & sufficient focus on accounting & financial reporting
- ✘ Recruiting individuals with requisite financial reporting & other expertise to serve on the board or audit committee

# ATTAINING COST-EFFECTIVE INTERNAL CONTROL IN SMALL NONPROFITS

- ✘ The cost of attaining effective internal control can be proportionally higher for nonprofits (especially smaller organizations)
- ✘ Nonprofits can usually meet this challenge & succeed in attaining effective internal control in a reasonably cost-effective manner

# ATTAINING COST-EFFECTIVE INTERNAL CONTROL IN SMALL NONPROFITS

- ✘ This can be accomplished through
  - + Control environment
    - ✘ Effective board of directors
    - ✘ Effective committee structure
    - ✘ Effective management
  - + Compensating for limited segregation of duties
  - + Monitoring activities

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- × Control environment includes:
  - + Integrity & ethical values
  - + Attention & direction provided by board of directors
  - + Management's philosophy & operating style
  - + Human resources policies & procedures
  - + Commitment to competence
  - + Organizational structure including assignment of authority & responsibility & communicating that assignment to those involved

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

## ✘ Integrity & ethical values

- + Organization's actions & decisions are ethical & reflect integrity
- + Performance appraisals focus on & reward ethical behavior
- + Above-board dealings with contractors & suppliers (both staff & board)

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- × Integrity & ethical values (cont.)
  - + Distribute ethics policies
    - × New hires receive information that illustrates organization's view of ethics
    - × Train employees on current & new ethics policies
    - × Have employees periodically confirm their understanding of ethics policies in writing



# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- × Integrity & ethical values (cont.)
  - + Ethical violations not tolerated
    - × Inform employees how to report potential violations
    - × Investigate, document & follow-up on potential violations

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- ✘ Attention & direction provided by board
  - + Board has a clear charge
  - + Board meets regularly
  - + Board does not include relatives & friends of CEO
  - + Background & independence of potential board members are checked
  - + Minutes are taken at board meetings
  - + Board regularly discusses the effectiveness of internal controls

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- ✘ Attention & direction provided by board (cont.)
  - + Board reviews financial statements
  - + Board monitors information from anonymous tips
  - + Members certify compliance with code of ethics & conflict of interest policy
  - + Board discusses issues without management
  - + Board establishes audit committee

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- ✘ Attention & direction provided by board (cont.)
  - + Audit committee has three independent members & chair has financial expertise
  - + Audit committee evaluates judgments & estimates & discusses them with management
  - + Audit committee considers management override of controls
  - + Audit committee meets with external auditors in executive session

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- ✘ Management's philosophy & operating style
  - + Management emphasizes minimizing risks, especially relating to accurate & reliable financial reporting
  - + Material journal entries & accounting estimates are properly authorized, documented & reviewed by the CFO
  - + Management emphasizes to employees the importance of exercising skepticism

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

- ✘ Human resources policies & procedures
  - + Background & reference checks (for those who handle finances)
  - + Job descriptions that reflect the organization's values
  - + Ethics training programs
  - + Annual review & appraisal process
  - + Exit interviews
  - + Compensation plan for management includes nonfinancial goals as well as financial, & is not tied only to short-term results

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

## × Commitment to competence

- + Establish criteria for hiring financial positions
- + Effective oversight of employees
- + Use of outside consultants with specialized skills
- + Training for employees involved in financial reporting
- + Management reviews & evaluates employees
- + Board evaluates competencies of CEO & CFO

# THE CONTROL ENVIRONMENT IN SMALL NONPROFIT ORGANIZATIONS

## × Organizational structure

- + Job descriptions & organization charts
- + Flowcharts or narratives to document the flow of transactions, controls & reporting responsibilities
- + Management is aware of whether there is adequate segregation of duties
- + Board reviews organizational structure including authority, responsibilities & reporting relationships



# MONITORING INTERNAL CONTROL

- ✘ Have board committees & officers with clear charges & articulated authority (ideally in bylaws)
- ✘ Review & document segregation of duties
- ✘ Review financial reports regularly, including budget vs. actual & programmatic activity
- ✘ Where staffing is minimal, insert processes that ensure a separate review
- ✘ Interact with the external auditor & regularly review the status of management letter comments

# ROLE OF THE EXTERNAL AUDITOR

- ✘ The external auditor cannot be part of an audit or attest client's internal control
- ✘ The auditor cannot be a compensating control for an audit or attest client
  - + Control deficiency issues (SAS No. 112)
  - + Independence issues (Ethics Interpretation 101-3)

# HIGH RISK AREAS

- × Cash/checks
  - + Receipts
    - × Contributions
    - × Other receipts
  - + Disbursements
    - × Payroll
    - × Vendors & others

# HIGH RISK AREAS

- ✘ Items that can be converted into cash
  - + Inventory
  - + In-kind contributions
  - + Equipment
- ✘ Financial statements

# RECEIPTS

- × Separate
  - + Billing
  - + Collection/physical receipt
  - + Recording of receipts
  - + Bank deposits
  - + Acknowledgements sent to payers
  - + Follow-up on donor/payer complaints

# RECEIPTS

- ✘ Restrictive endorsements
- ✘ Lock boxes
- ✘ Pre-numbered receipts
- ✘ Make all deposits intact daily
- ✘ Timely reconciliation between accounting & development/program departments
- ✘ Timely reconciliation between general ledger & receivables ledger with supervisory review
- ✘ For collections of currency, have two people count cash

# DISBURSEMENTS - PAYROLL

- × Separate
  - + Time sheet & salary approval
  - + Check preparation
  - + Check distribution
  - + Recording
  - + Reconciliation

# DISBURSEMENTS - PAYROLL

- ✘ Separate payroll & personnel functions
- ✘ Written approvals for new hires & terminations
- ✘ Written approval for all salary changes
- ✘ Periodic management review



# DISBURSEMENTS - VENDORS

- × Separate
  - + Purchasing
    - × Who sets up vendors?
  - + Preparation of checks
  - + Approval for payment
  - + Recording
  - + Signatures
  - + Vendor inquiries

# DISBURSEMENTS - VENDORS

- × Control over checks
  - + Numerical integrity
  - + Physical security
- × Dual signatures on checks
- × No checks payable to “cash”
- × Review cancelled checks
- × Tighten controls over petty cash
  - + Timely reconciliation-complete back-up

# DISBURSEMENTS - VENDORS

- ✘ Purchase orders/receiving reports
- ✘ Compare vendor addresses to employee addresses
- ✘ Board Chair or Treasurer reviews CEO's expense reimbursements

# CASH/RECONCILIATIONS

- ✘ Minimal cash accounts
- ✘ Bank statement should be opened by someone outside of the receipts/disbursements functions who should examine the contents
- ✘ Cash reconciliations should be reviewed by someone outside of the receipts/disbursements functions

# FINANCIAL STATEMENTS

- ✘ Separate preparation & review
- ✘ Make them understandable
- ✘ Make them timely
- ✘ Provide comparisons
  - + Prior year
  - + Budget
- ✘ Involve the board – encourage questions

# OTHER CONTROL POLICIES

- × Code of conduct
- × Conflict of interest policy
- × Employee/vendor hotline
- × Whistle-blower policy
- × Enforce mandatory vacations
- × Bond employees who handle cash
- × Fiscal procedures manual

# FISCAL PROCEDURES MANUAL

- ✘ Contains the specific tasks, methods or steps that are conducted, within the policy guidelines, usually by staff, to carry out the fiscal operations of the organization
- ✘ Assumption should be that any qualified person could enter a fiscal position in the organization &, based on the documented procedures in the manual, be able to readily assume the duties

# FISCAL PROCEDURES MANUAL

- × Accounting entity flowchart
  - + Subsidiaries
- × Office locations
  - + Satellite offices
- × Organizational chart
- × Board developed fiscal policies
- × Fiscal job descriptions & employee listing
- × Procedural flowchart



# FISCAL PROCEDURES MANUAL

- × Daily general ledger duties
- × Bank reconciliations
- × Payroll, including paid leave time tracking
- × Fixed assets
- × Line of credit
- × Petty cash
- × Filing system
- × Supply order procedures

# FISCAL PROCEDURES MANUAL

- × Accounting software
  - + Password protections
  - + Chart of accounts
  - + Record retention policy
  - + Computer security
- × Budget
  - + Process
  - + Cost allocations
  - + Funding sources
  - + Program listings

# FISCAL PROCEDURES MANUAL

- × Intercompany transactions
- × Monthly reporting
- × Audit procedures & preparation schedule
- × Tax filings
- × Bank accounts & insurance carriers
- × Equipment maintenance & safeguarding
- × Government grant information (grant years, subcontractors, voucher preparation, reporting requirements)

# WHEN FRAUD OCCURS

- ✘ Have a plan & make sure that occurrence is known by:
  - + Board
  - + Management
  - + Staff
- ✘ Investigate quickly & fairly
- ✘ Document everything
- ✘ Consult with legal counsel
- ✘ Determine where the internal control system broke down & fix it

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*Presents*

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