Internal Controls for Small and Medium-sized Organizations
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Presenter

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Learning Objectives

- How to design controls, keeping in mind the COSO framework
- How to assign responsibility for oversight of controls implementation
- How to assess the effectiveness of controls
- View examples of control activities
- Answer your questions and discuss real-world application in smaller organizations
What are internal controls?

“And why do I care?”

Internal Controls - definition

A process*, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

*Embedded within this process are controls included in policies and procedures.
Why do I need internal controls?

- Reduces possibility of mismanagement, error and fraud
- Improves quality of information
- Reduces possibility of material misstatement in financial statements
- Protects your organization to reduce risk of loss
- Provides consistent practices to be followed by personnel

Cop Outs

Don’t fix what’s not broken.

Let sleeping dogs lie.

That’s above my paygrade.

WE’VE ALWAYS DONE IT THAT WAY.

This is just unnecessary red tape.

It doesn't matter; what I do is just a drop in the bucket.

Do you not trust me to do my job?
Why do I need internal controls?

• Reduces opportunities for individuals to commit fraud

Examples of control activities

Authorization
• Review by appropriate individuals
Retention of records
• Substantiation of transactions
Supervision
• Review or observation of processes

Monitoring
• Ongoing evaluation to ensure controls are operating as intended
Physical security of assets
• Protecting property, equipment and inventory
Segregation of duties
• Different individuals perform authorization, custody and record-keeping
Types of controls

Entity-level
• Includes tone setting, oversight by board and senior management, governance policies, procedures and practices that affect the entire organization (within and outside of the financial function)

Preventative
• To keep errors or fraud from happening from the onset

Detective
• To detect an error or fraud after it has occurred (before it becomes a major problem)

Automated
• Refers to triggers embedded within (or configurable) within IT system

Manual
• Requires persons to perform functions

Who’s responsible for internal controls?

Governing board
• Provides governance, guidance and oversight

Management
• Accountable to the board of directors

Staff
• Are involved in producing information/taking actions within the environment
• Responsible for communicating problems in operations

Internal Auditors (in larger organizations)
• Play a monitoring role

Virtually everyone within an organization!
Who’s **not** responsible for internal controls?

- External independent auditors
- Outsourced service providers

Controls are not “one size fits all” – they should be developed based on the risks and characteristics of the organization.
How do I design and implement controls?

Best place to start? Use the COSO Internal Control Framework

COSO Framework

“What is it and what makes it the gold standard of internal control?”
What is the COSO Framework?

- Dynamic and on-going process
- Responsibility of everyone
- Satisfies objectives
  - Operating
  - Reporting
  - Compliance

Why do we have COSO?

Committee of Sponsoring Organizations of the Treadway Commission

- 2013: Internal Control – Integrated Framework
Need for a Framework

- Changes in Technology and Risks
- Increased expectation of internal controls & auditors
- Changing interdependence of organizations
- Increased importance of compliance activities

COSO Framework

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## COSO Components & Principles

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<th>Principles</th>
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<td>2. Exercises oversight responsibility</td>
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<td>3. Establishes structure, authority and responsibility</td>
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<td>4. Demonstrates commitment to competence</td>
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<td>5. Enforces accountability</td>
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<td>Control Activities</td>
<td>10. Selects and develops control activities</td>
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<td>12. Deploys through policies and procedures</td>
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<td>15. Communicates externally</td>
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<td>Monitoring Activities</td>
<td>16. Conducts ongoing and/or separate evaluations</td>
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<td>17. Evaluates and communicates deficiencies</td>
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### Benefits of COSO

- Reliable financial reporting
- Consistent transaction processing
- Increased efficiency
- Rational basis for decision making
- Increase confidence in information reporting
Key Control Objectives for Smaller NFPs

• Controls over cash receipts to prevent skimming
• Controls over cash disbursements to prevent unauthorized disbursements
• Controls over periodic (monthly) financial reports to ensure accurate financial reporting

Controls Over Cash Disbursements
What is a smaller entity?

• Annual budget of less than $10,000,000
• Finance office consists of one, two, or three people

Controls Over Cash Disbursements
The questions!

• If anyone generated an unauthorized disbursement, would anyone other than the perpetrator know about it?
• How soon would they detect it?
Disbursements – Controls That Don’t Work

Two signatures on every check.
  • This may be a good control for other reasons, but it does not help prevent fraud.
  • Banks don’t look at signatures on checks.

Someone other than the bookkeeper performs the bank reconciliation.
  • Only if this person looks at each disbursement and determines that it was properly authorized.
  • Payees on checks could have been changed in the accounting system.

ED approves all disbursements.
  • All but the fraudulent ones!!

Controls Over Cash Disbursements
The Answers!

  • If the perp was someone other than the bookkeeper, then the bookkeeper would likely detect it when the bookkeeper performs the bank reconciliation.
    • “What is this deduction from the bank that has not been entered into the accounting system?”
Controls Over Cash Disbursements

• What if the perp is the bookkeeper? Who would catch that?
• It’s usually the bookkeeper who ends up getting away with fraud – for a while.
• Would the ED catch it if the ED reviews the bank reconciliation?
  • Depends on the quality of the review.

Controls Over Cash Disbursements (continued)

• For smaller organizations, someone other than the bookkeeper needs to review every disbursement from the bank accounts
• Someone other than the bookkeeper reviews bank statements / bank activity
• Needs to be someone who is familiar with the vendors and transactions of the organization
• Develop control procedures, regardless of the appearance of the bookkeeper’s trustworthiness
Controls Over Cash Disbursements (continued)

Example 1

ED signs all checks. ED reviews bank statement. Organization is small enough that ED will recognize every disbursement. ED inquires of bookkeeper of every disbursement that is not familiar to the ED and becomes satisfied that the disbursement was authorized.

ED initials every bank statement documenting the control procedure.

Controls Over Cash Disbursements (continued)

Example 2

ED signs all checks and authorizes all disbursements. Organization is large enough that ED will not recognize/remember every disbursement. ED initials a check register after signing checks and provides a copy of the check register to ED’s EA. EA compares every disbursement on the end of month bank statement to amounts on check register.

EA signs initials each bank statement to document performance of this control procedure.
Controls Over Cash Disbursements (continued)

• In each example, it does not matter who performs the bank reconciliation.
  • However, the bookkeeper is likely to be the most proficient.
  • Key element - review of the actual bank statement received directly from the bank, or via online access.
• Online access to bank statements enables more transparency and can reduce risks. ED and EA can have read-only access.
  • No longer need to wait for paper statement to be received and delivered unopened to the person who will review it.

Controls Over Cash Disbursements (continued)

• Whistle Blower Policies
  • Not so much about the protections.
  • More about the process:
    ・ Who do I contact if I suspect my boss?
    ・ Is there someone trustworthy who I can go to?
• The person checking on the bookkeeper needs to know the process for blowing the whistle.
• Remind all employees and board members regularly about the policy.
Controls Over Cash Receipts

- Not as easy to implement good controls
- If someone were to steal the money before it got into the bank, who would know?
- Controls depend on the type of receipt
Controls Over Cash Receipts (continued)

Rule of Thumb #1 –
- For every person who handles the money (checks and cash) before it goes into the bank, you need some sort of control process to make sure they don’t skim.

Rule of Thumb #2 –
- Limit the number of people who handle the money before it gets into the bank.

Example 1
An entity employs volunteers to manage the cash registers at its thrift store. Daily cash is delivered to the bookkeeper each day along with a cash register tape. The bookkeeper deposits the cash, records the transaction, posts the revenue entry into the accounting records and files the cash register tape along with the validated deposit ticket.

- True or False? This process should reduce the risk of fraud because of the segregation of duties.
Controls Over Cash Receipts (continued)

**Example 1**

**FALSE!**

- The segregation of duties does not reduce the risk of fraud, it merely shifts the risk to the bookkeeper.
- Consider having cashiers deposit the day’s receipts and provide a validated deposit slip which agrees to a cash register tape to the bookkeeper.
- The bookkeeper should agree the validated deposit slip to the cash register tape and review the cash register tape for any unusual entries, like significant voids.

Controls Over Cash Receipts (continued)

**Example 1**

**NOTE**

- Periodic monitoring by management is still needed. What would prevent a volunteer from not processing a sale in the cash register?
- Consider posting signs or incentives, reminding customers to ask for a receipt.
Controls over Cash Receipts – Contributions

- This can be the most difficult since, depending on the type of fundraising appeal, contributions from any one donor may not be expected.
- Typical case scenario:
  - One person receives and deposits the cash, makes copies, and distributes to others.
  - Bookkeeper records the cash receipts.
  - Development department (manager) updates donor database.

Controls over Cash Receipts – Contributions (continued)

- If just one person is available to receive the contributions (open the mail), it may be impossible to have “tight” control.
- Some sort of segregation of duties is required to provide reasonable assurance:
  - Two people opening the mail – there is a cost involved.
  - Two people receiving the cash at the event – cost involved.
  - Send donations to a lock box – cost involved.
Controls over Cash Receipts – Contributions (continued)

• Mitigating control when only one person receives the contributions:
  • Have another employee send out the donor acknowledgements only after they have evidence the money was deposited.
  • If donor acknowledgement is not delivered, donor may contact the charity to inquire.
• Not a fail-safe:
  • The employee opening the mail could send out acknowledgements instead.
  • Donors who don’t receive an acknowledgement may not inquire, or may inquire of the person who handles the money. In many smaller entities, the person checking the mail also answers the phone.

Controls Over Cash Receipts – Contributions (continued)

• Reconcile the donor database to the GL.
Controls Over Cash Receipts – Attendance

• Program services often include fees.
• Program staff should have listings of attendees.
• Such lists should be included as part of the documentation for the deposit.
• Listings should be reconciled to amounts deposited.
• Reconciliation should be performed by someone other than the person who has access to cash before it is deposited.

Controls Over Cash Receipts – Attendance (continued)

Example 2

• Small charter school operates an after school program.
• After school program is staffed by one teacher and one volunteer.
• Parents must sign a roster each day documenting that they have taken responsibility for their child (parent pick up).
• The after school teacher tracks student attendance and collects payments.

What is the best way to reduce the opportunity for theft in this situation?
Controls Over Cash Receipts – Attendance (continued)

- **Option 1.** Someone other than the after school teacher must reconcile the deposits to the attendance sheets.
- **Option 2.** Have someone other than the after school teacher collect the payments.
  - This might not be practical since most parents will want to pay the after school teacher.
  - Have payments placed in a locked box where the after school teacher does not have the key.
  - If this can be accomplished, the after school teacher is likely the best person to reconcile attendance to deposits.
  - Note that the reconciliation should compare attendance records to actual deposits, not just the amounts claimed to be deposited. Ensure that the person collecting and depositing is not skimming.

Controls Over Cash Receipts (continued)

- Unlimited number of scenarios.
- No single set of controls will work in every organization.
- Must ask the question: “If someone were to steal, who would catch it?”
- Brainstorm with your staff.
- Brainstorm at least once a year with your auditor.
What controls do you have?

- What controls are in place regarding cash received or handled by volunteers?
- How do you know the controls are working?
Controls Over Financial Reporting

- Monthly balancing procedures
  - Justify each asset and liability account every month
    - Agree to reconciliations and/or to subsidiary schedules.
  - Scan the general ledger for each account every month.
    - Are entries into revenues and expenses appropriate?
- Departmental budget to actual comparisons
  - Send to departmental managers.
- Heavy reliance on manual spreadsheets?
  - Someone other than preparer should periodically test the critical spreadsheets, including formulas and macros.
  - Who has access to the spreadsheets once prepared? Are they on a shared network/drive?

Other Controls and Control Areas to Consider

- Physical assets – could these go missing?
- Expenses – Board or ED quarterly review of top 25 vendors (name, address, and amount)
- Travel & entertainment expenses – is there abuse? Reasonable?
- Payroll – Board or ED review of payroll register or W-2s
- Special events – are ticket sales and sponsorships reconciled to revenue in the GL? Who has access to the reconciliation data?
- IT controls - Who has access to modify information in the general ledger? Who has administrative access? Does the person signing the checks have read-only access? Who has access to financial records that are not in the GL?
- External controls – could someone get into the organization and steal data or physical items?
Controls Consideration – 2 people

- Accounting function
  - Write checks
  - Mail checks
  - Reconcile bank statement
  - Record transactions in GL
  - Disburse petty cash
  - Authorize invoices for payment

- Other
  - Receive & review bank statements
  - Review bank reconciliations
  - Sign checks
  - Make deposits
  - Review petty cash ledger
  - Approve vendor invoices
  - Sign contracts

Controls Consideration – 3 people

- Accounting function
  - Write checks
  - Reconcile bank statement
  - Record items in GL
  - Reconcile petty cash
  - Distribute payroll

- Director
  - Sign checks
  - Prepare deposits
  - Sign contracts
  - Review bank reconciliations
  - Review bank account activity

- Other
  - Process vendor invoices
  - Mail checks
  - Disburse petty cash
  - Open mail log & cash receipts
Controls Consideration – 4 people

- Accounting function 1
  - Open mail & log cash receipts
  - Distribute payroll
  - Disburse petty cash
  - Mail checks
  - Review bank rec

- Accounting function 2
  - Write checks
  - Record items in GL
  - Reconcile bank statement
  - Reconcile petty cash

- Director
  - Approve payroll & rates
  - Review bank activity
  - Sign checks
  - Sign contracts
  - Review financial statements

- Other
  - Review & approve invoices
  - Prepare deposits

Additional Considerations for Larger NFPs
### Information Technology – How complex is your environment?

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<th>Medium</th>
<th>Low</th>
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<td>Custom software</td>
<td>Software with some level of complexity or customization</td>
<td>“Off the shelf” software</td>
</tr>
<tr>
<td>High volume of online transactions</td>
<td>Some sharing of data among systems</td>
<td>Small or no LAN</td>
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<tr>
<td>Integration between disparate systems</td>
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<td>Outsourcing IT support staffing</td>
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### Information Technology

- Ensure IT applications are only used with proper authorization.
- Review all third-party providers for security controls.
- Manage access to systems based on business need / job duties.
- Review system access logs.
- Review manual journal entries made on non-business days.
- Require complex passwords that are changed regularly (recommend 4-6 weeks, length & character requirements).
- Establish backup and recovery procedures.
- Physically secure laptops, tablets and other IT equipment. Lock your server room.
- Encrypt information sent outside your organization.
- Set-up firewall to keep non-authorized individuals out of your systems.
Decentralized Operations

- Training is always wise investment!
- Make clear the responsibilities of **all** individuals involved with the organization – including the board, committees of the board, senior leadership, staff and volunteers.
- Maintain an organizational chart and update such information as necessary.
- Provide organizational policies to all employees, with changes communicated on a regular basis.
- Serving as a fiscal sponsor?
- Educate employees on whistleblower policy.

Payroll and Personnel

- Establish controls over the hiring, retention and termination process.
- Ensure proper timekeeping procedures.
  - Review and approval by the employee’s supervisor - hours worked, overtime hours, and other special benefits.
- Establish process for review and approval of the payroll register prior to processing.
- Review for reasonableness of comparisons (reconciliations) of gross pay for current to prior period payrolls by person not otherwise involved in payroll processing.
Purchasing and Contracting

- Establish an approval process for new vendors and contractors.
  - Policy should give appropriate recognition to the nature and size of purchases.
  - Consider competitive bidding or a required number of price quotations before placing orders not subject to competitive bidding.
- Receive invoices from vendors in a central location.
- Track purchases from request through payment.
- Separate purchasing from invoice processing function.
- Periodically review recurring purchases for proper documentation and authorization.

Additional Controls

- Ethics program
- Reporting hotline
- Employee support programs
- Anonymous surveys to assess employee morale
- Proactive data monitoring
- Surprise audits
- Job rotation
- Mandatory vacation
How do I know if my controls are the right ones?

Assess Your Internal Controls

• Are your controls keeping pace with your business?
  • Major change – your growth, restructurings, new programs, partnerships, expanding reliance on technology
  • Review regularly
• Changes in the NFP environment
  • New and evolving expectations - stakeholders seek greater transparency and confidence in your reporting
  • Ongoing regulatory oversight
  • Scrutiny by media and ratings agencies
Assess Your Internal Controls  (continued)

How effective is your internal control?

• Does your strategic plan, initiatives, priorities or operating decisions introduce new risks that impact our internal control?
• What breakdowns have we experienced with existing controls? Why didn’t we know about these before? How could they have been prevented?

Brainstorm

• What could go wrong? Who could steal and how?
• Use checklists to stimulate creative thought.
• Encourage employees to present ideas – consider small incentive for those who bring forth new control ideas.
• Involve a third party – perhaps board members or others not involved in everyday operations.
• Engage in this process at least once a year.
• Engage in this process whenever there is a change in any of the following:
  • Key personnel
  • Organization structure
  • Systems
  • Transactions
Helpful Tools and Resources

Resources

COSO
- Internal Control – Integrated Framework
  www.coso.org/IC

ACFE
- 2018 Report to the Nations - Global Fraud Study
  www.acfe.com

AICPA
- Not-for-Profit Section’s Online Resource Library
  www.aicpa.org/nfp
About the AICPA Not-for-Profit Section

- A community for not-for-profit professionals and their business advisors
- Benefits include:
  - Online resource library
  - Complimentary webcasts
  - Subscription to eNews
  - Networking online
  - Exclusive savings
Highlighted Resources from AICPA

- An Ounce of Prevention: Combatting Fraud in Not-for-Profits
- Audit Committee Toolkit
- Controller’s Toolkit
- Increasing Risk Awareness in Not-for-Profits
- Segregation of Duties Reference Charts for Small Organizations (PDFs)
- Sample policies (download in Word!)

Questions?

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