Establishing Effective Internal Controls for Smaller Nonprofits with Limited Resources
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Smaller nonprofit organizations frequently experience difficulty in developing effective internal controls because they are limited in terms of both their financial and human capital. The purpose of this white paper is to identify cost effective controls that can be implemented by tax-exempt organizations in order to segregate accounting functions as much as possible in an effort to mitigate fraud risk and promote quality financial reporting.

Tax-exempt organizations are charged with an important, yet highly challenging, responsibility - to raise sufficient levels of funding for worthy philanthropic causes under tight operating budgets. This task is often out of the nonprofit's control since fundraising success is frequently dictated by the ever-changing socioeconomic climate, which can have a major impact on charitable giving. In order to meet this challenge, management of nonprofits commonly expects nonprofit personnel to wear multiple hats; that is to say, nonprofit staff are asked to take on numerous responsibilities in order to run a charity's programs within a limited budget.

While most accountants are familiar with the concept of "segregation of duties," most nonprofit accountants embrace the "do-gooder" mentality and do whatever is asked of them in order to help the organization carry out its mission as efficiently and as cost effectively as possible. What some nonprofits do not realize is that by implementing a few relatively simple internal controls, they can establish an adequate level of segregation of duties to effectively mitigate fraud risk and promote accurate financial reporting. These basic internal controls can be implemented in the areas of cash receipts, cash disbursements, and account reconciliations to effectuate transparent financial reporting. In each of the main accounting cycles, it is imperative that no individual has custody, recordkeeping, and authorization privileges, as fraud is more likely to be perpetrated when an individual is assigned more than one of those job responsibilities.

With regard to cash receipts, organizations can establish safeguards against fraud by involving multiple staff throughout the process of receiving, depositing, and recording cash receipts. This key control can be implemented by separating duties so that no one individual is in a position to receive cash (custody responsibility) and record cash receipts (recordkeeping responsibility) without the involvement of other personnel. Failure to effectively establish proper segregation of duties in the cash receipts cycle enables an unscrupulous staff member to skim cash without ever recording it in the accounting system. To illustrate this concept, assume that a fictitious charitable organization called 'Funding for a Better Tomorrow' receives a check in the mail. The individual who initially opens the mail, the receptionist, is not authorized to deposit the check at the bank; the receptionist stamps the back of the check 'for deposit only' and then gives the check to the office manager (or other non-accounting personnel) who copies the check and distributes two copies– one for the accounting department and the other for the development department - before depositing the check at the bank. When the office manager is unable to deposit the check immediately upon receipt, the check is locked in a filing receptacle until it is ready to be deposited at the bank. The bank deposit slip is provided to the accounting department to enable the bookkeeper to record the deposit in the accounting system. In addition, the executive director, who is not involved in the deposit or recordkeeping functions, signs a donor acknowledgment letter[1] for

[1] Issuing donor acknowledgment letters for all donations received is a good internal control to implement for two reasons: for compliance purposes, it provides a written contemporaneous acknowledgment to donors for their tax-deductible gifts (which donors need to substantiate gifts of $250 or more under IRS regulations); and, for fraud prevention purposes, it serves as a check and balance that all donations received have been deposited and recorded in the books since donors typically follow up with a charity if they have not been issued the letter.

the donation received. As this example demonstrates, at no time during the cash receipts process should any individual have the authority to receive cash and record cash receipts while acting alone.

With respect to cash disbursements, organizations can implement fraud deterrent controls by establishing a similar level of segregation of duties as the level articulated in the cash receipts example above. While the key control relative to cash receipts is separating the custody of cash from the recording of cash, the key control with cash disbursements is to segregate the authorization of cash disbursements from the recording of cash disbursements. Using the same organization from the preceding example, assume that 'Funding for a Better Tomorrow' needs to pay a vendor for an amount that is above the organization's dual signature threshold[2]. The first individual involved in this example would be the receptionist (or other administrative staff) who opens the mail and receives the vendor invoice. The receptionist makes a copy of the invoice and gives the invoice copy to the bookkeeper, who does not have authorization privileges. The bookkeeper enters the bill into the accounting system and generates a check for signature (recordkeeping responsibility).   The bookkeeper then brings the invoice copy and the check to the two authorized check signers, who each review the invoice and sign the check (authorization responsibility). If the check is below the dual signature threshold, only one authorized check signer's review/signature is necessary. The signed check and payment voucher are then given to the receptionist (custody responsibility) to prepare for mailing and delivery to the vendor. It is important that only the bookkeeper has access to the organization's check stock, which should be locked up in a filing receptacle when not in use. As this example illustrates, at no time during the cash disbursements process should any individual have the authority to record a bill, write a check, and approve payment.

The last internal control that can be implemented to segregate duties is monthly account reconciliations. All accounts (particularly cash) should be reconciled on a monthly basis by an accounting staff member who does not have cash custody or authorization responsibilities, only recordkeeping responsibilities. The bank reconciliations should be reviewed by the top financial officer to help mitigate fraud risk and promote accurate financial reporting. For organizations with only one accountant on staff, a board member can review monthly bank reconciliations prepared by the accounting staff person as a cost effective mitigating control.

<u>Executive Summary:</u>

Nonprofit organizations face an ongoing challenge of accomplishing more with less. These conflicting interests can often lead nonprofits to assign accounting staff multiple roles as part of the job duties they are expected to complete. This balancing act almost invariably leads to a segregation of duties issue whereby key accounting functions are carried out by the same staff without mitigating controls in place. Nonprofits must realize that by implementing a few basic and cost effective internal controls, they can effectively segregate duties and promote transparent financial reporting while staying within budgetary parameters.

[2] As a best practice, nonprofits should consider implementing a dual signature policy that requires two signatures on checks at or over an agreed upon threshold in order to mitigate the risk of checks being paid to fictitious vendors.