

**United Way  
of Central New Mexico**

**Center for  
Nonprofit  
Excellence**



## **Internal Controls**

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Toolkits are designed to provide you with easy to access information on key subject areas that can strengthen your organization.

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## Internal Controls

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#### Internal Controls:

- Internal Controls are policies and procedures used as internal checks and balances over an organization's assets and financial statements.
- Internal Controls:
  - Reduce the misuse of assets.
  - Reduce the risk of misstatement of the financial statements.
  - Help to deter fraud and errors.
  - Ensure compliance with regulations and donor requirements.
  - Help to provide effective and efficient operations.
  - Help the organization maintain a good reputation.

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#### The Five Components of Internal Controls are:

- *Control environment* – An effective control environment establishes an ethical tone from the top, which includes integrity, ethical values and commitment to competence. An organization's control environment is determined by:
  - The amount of attention and direction provided by the governing board.
  - The effectiveness of the organization structure.
  - Management's philosophy and operating style.
  - The methods used by management in assigning authority and responsibility.
  - Whether employees are held accountable for their actions.

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- *Information and communication* – Information and communication is necessary to disseminate the organization’s internal controls.
  - Management must communicate a clear message that control responsibilities are to be taken seriously.
  - All employees and volunteers must understand their own role in the internal control system. These roles include:
    - Board of Directors must provide governance, guidance and oversight. Effective board members are objective and inquisitive. They are knowledgeable of the entity’s activities and environment. They are committed to fulfilling the board’s responsibilities, including establishing internal control policies. Those policies include:
      - Conflict of interest policy.
      - Whistleblower protection policy.
      - Code of conduct policy.
      - Excess benefits policy.
      - Record retention and destruction policy.
      - Audit committee’s responsibilities.
    - Chief executive officer or executive director is ultimately responsible for all control activities and sets a positive control environment. They provide leadership, direction and oversight to senior managers.
    - Senior managers are generally responsible for establishing more specific internal control policies and procedures.
    - All employees and volunteers are responsible, to some degree, for the organization’s internal controls. Some aspect of the internal controls should be part of everyone’s job description. Also, all employees and volunteers should be responsible for communicating problems and weaknesses in the control system to management.

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- *Risk assessment* – Risk assessment is a process of identifying, analyzing and managing risks that prevent the organization from reaching their objectives. The most common risks related to protecting an organization’s assets and preventing misstatement of the organization’s financial statements are:
  - Changes in the organization’s operating environment.
  - Restructuring within the organization.
  - New personnel, especially those in leadership roles.
  - Rapid growth within the organization.
  - New business models, products or activities.
  - New or revised information systems.

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- *Control activities* – Control activities are the policies and procedures in place to ensure that management directives are carried out. They determine the actions needed to address the risks identified and include:
- Safeguarding assets from loss or unauthorized use by minimizing opportunities for employees or volunteers to misuse the assets.
  - Information processing controls that ensure the accuracy, completeness, and authorization of transactions. They include:
    - Identifying and recording all valid transactions.
    - Providing, on a timely basis, enough detail about the transaction to allow proper classification for financial reporting.
    - Allowing transactions to be recorded at their correct dollar value.
    - Indicating when transactions have occurred so they are recorded in the proper accounting period.
    - Properly presenting the transactions and related disclosures in the financial statements.
  - Financial reporting controls ensure accurate and timely financial reporting of the organization's activities.
  - Segregation of duties involves allocating tasks among personnel, to the extent possible, so that one individual does not have the opportunity to make errors or commit fraud and cover it up. The following are methods of segregating duties:
    - One individual should not control all phases of a transaction process.
    - With limited personnel, it may not be possible to perfectly separate all incompatible duties. Some control procedures to offset this risk are:
      - Reconciling the bank account in a timely manner.
      - Reconciling a donor database to cash receipts.
      - Performing analytical procedures for unusual or unexpected variances, balances or relationships.
      - Reviewing detailed transaction reports.
      - Oversight of the physical inventory and comparing the inventory to the accounting records.

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- *Monitoring* – Monitoring internal controls is a process that assess the quality of the organization's internal controls over time. Deficiencies are reported and addressed.

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**Policies and procedures should have basic procedural controls over receipts, expenditures and assets. Some of these controls are:**

➤ Receipts

- Perform background checks on all employees and volunteers.
- Mail opening should not be done by a person who processes transactions or has access to the accounting software.
- Checks should be endorsed as soon as they are received.
- A list of cash receipts should be prepared for all cash receipts.
- Bank Deposits
  - The list of cash receipts should be compared to the bank deposit.
  - Make deposits as soon as possible.
  - Keep receipts not deposited in secured locked location.
  - If applicable, compare activity report to deposit.
- Recording cash transactions
  - Use a separate person to record transactions into the accounting system than those who physically handle the cash receipts.
- Revenue Recording
  - Require documentation of noncash contributions.
  - Require documentation of promises to give.
  - Require approval and documentation for adjustments, write-offs, fee reductions and other items reducing revenue or accounts receivable.
- Other
  - Make vacations mandatory.
  - Cross train employees.
  - Rotate job assignments periodically.
  - Train volunteers who assist in the cash receipts function.

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➤ Expenditures

- Purchase Orders
  - Use only approved vendors. Management should approve all changes to the vendor list.
  - Purchase orders should be compared to the approved budget before processing.
  - Vendor invoices should be compared to authorized purchase orders before processed.
  - Prenumbered purchase order forms should be used.
  - Competitive bidding should be used for large disbursements.

- Vendor invoices
  - Attach a packing slip that confirms the goods were received (if purchase is for physical items).
  - Check mathematical accuracy of vendor invoices.
  - Mark invoices paid once processed.
  - Set up accounting software to recognize duplicate invoices.
- Checks
  - Make all disbursements by check or electronic transfer.
  - Never write checks to “cash” or “bearer”.
  - Never sign blank checks.
  - Severely restrict the use of manual checks.
  - Use prenumbered checks and periodically check their sequence is accounted for.
  - Keep unused stocks of documents (checks, purchase orders, and receiving reports) locked up.
  - Use software controls (passwords) and limit access within the software so that only those who process transactions can access only the function they are charged with.
  - Accountant and others that process transactions in the accounting software should not be signers of checks.
  - Use dual signatures for large disbursements.
  - Review documentation (invoices, etc.) before signing checks. Make sure checks issued to vendors are on the approved vendor list.
  - Once checks are signed they should not be returned to the accounting staff.
- Bank reconciliations
  - Bank statements should be given unopened to someone who does not prepare deposits or checks.
  - Checks should be reviewed for unusual items, including unfamiliar vendors, unauthorized signatures and alterations to checks.
  - Bank statement reconciliations should be reviewed by someone who does not prepare the reconciliation and who does not have access to accounting software. Examine unusual and old outstanding items.
- Payroll
  - The payroll master file should be maintained by someone who does not process payroll.
  - Requests for new personnel should be properly approved.
  - Termination notices should be properly approved.
  - Access to HR and payroll records should be limited (passwords, locked file cabinets, etc.).

- Timecards or other attendance records should be signed by employees and supervisors.
- Changes to timecards or attendance records should be approved by the employee and their supervisor.
- Detailed payroll reports should be reviewed before payroll checks are signed.
- Direct deposit transmission access should be limited.
- Direct deposit transmission report should be reviewed by person who does not process payroll.
- Paychecks should be distributed by someone who does not process payroll.
- W-2's should be reconciled to general ledger.
- Someone in authority should ensure all payroll tax payments and tax reports are being timely made.

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➤ **Assets**

- Contributed assets are recorded at fair market value and added to the organization's asset listing.
- Only assets that have been authorized in the capital budget should be purchased. Exceptions should be approved by the board of directors.
- Assets that are disposed of should be approved by someone in authority. Documentation of the approval should be maintained.
- Assets should be kept in a secure location.
- Assets should only be used for authorized purposes.
- A physical inventory should be taken at least annually of all tangible assets (equipment, vehicles, etc.). The physical inventory should be compared to the asset listing and discrepancies investigated.

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**Limitations of Internal Controls**

- Judgment – The effectiveness of controls will be limited when decisions are made under pressure.
- Breakdowns – Personnel misunderstand the instructions or commit errors due to carelessness, distraction or fatigue. Also, breakdowns occur when system changes are implemented before personnel have been adequately trained.
- Management override – The internal control system is only as effective as the people who are responsible for it. Management override means overruling prescribed policies or procedures for illegitimate purposes with the intent of personal gain or to enhance the presentation of the financial condition of the organization. This is not to be confused with management intervention which is when management's actions depart from prescribed policies and procedures for legitimate purposes (nonstandard activities).

- Collusion – When two or more individuals act collectively to perpetrate and conceal an action from detection.
- Cost versus benefit – The challenge is to find the right balance between excessive control and too little control. Excess control is costly and counterproductive and too little control presents undue risk.

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### **Auditor Communications about Internal Control Related Matters**

- Effective for audits that have fiscal years ending on or after December 15, 2006, auditors are required to communicate in writing to the organization's management and governing body any significant deficiencies and material weaknesses in internal control that come to their attention during the course of the audit that are related to financial reporting.

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### **Resources**

AICPA Audit Committee Not-for-Profit Toolkit:

<http://www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/Resources/NotForProfitResourceCenter/Pages/AICPANot-for-ProfitAuditCommitteeToolkit.aspx>

Church, Nancy CPA, Beyond the Checkbook: Accounting Systems in Growing Organizations, Guidestar, 2007, <http://www.guidestar.org/DisplayArticle.do?articleId=1130>

Committee of Sponsoring Organizations of the Treadway Commission (COSO), <http://www.coso.org>

Committee of Sponsoring Organizations of the Treadway Commission (COSO), Internal Control – Integrated Framework, May 1994.

Hartfield, Cheryl A. and Paschall, Winford L., PPC's Nonprofit Financial and Accounting Manual, Practitioners Publishing Company, Fort Worth, Texas, October 2006.

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### **About the Author:**

Janice Moen has over 25 years of accounting experience, twelve years of which were as Chief Financial Officer or Chief Executive Officer of nonprofit agencies. Janice is currently the CFO of ARCA, a nonprofit providing service to individuals with developmental disabilities. Janice also has five years experience as an external auditor of governmental and nonprofit agencies. Janice received her BBA and Master in Accounting from the Anderson School of Management at the University of New Mexico. Janice was awarded the 2007 Outstanding Member in Corporate Practice Award by the New Mexico Society of CPA's in 2007. She was also recognized as one of the Business Weekly's Top CFO's in 2007. Janice is a member of the American Institute of CPA's

and currently serves on the New Mexico Society of CPA's Course Selection Committee and the Anderson School of Management's Accounting Department Advisory Committee.



ARCA, working together to open doors for people with developmental disabilities to be valued members of the community. [www.arc-a.org](http://www.arc-a.org)

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