Section VI

INTERNAL

CONTROLS

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[From Presbytery Day Conference, February 7, 2009: *Accounting and Tax Issues for Internal Controls*, prepared and presented by John F. Heveron, Jr., CPA, Heveron & Heveron CPAs.]

The Role of Internal Controls
Internal controls include proper standards of business practice and separation of the duties of custody or assets from record-keeping responsibility for those assets. They are designed to improve accuracy, reliability and consistency, to reduce errors, and to help assure that assets are used according to your mission.

To understand the value of internal controls we must understand how things can "go wrong." Improper transactions can include any of the following:

- Incoming moneys can be intercepted and not deposited into the organization's accounts. The greatest risk here is from unexpected items such as donations that are memorials.
- Refunds can be generated and diverted by over-paying a bill or paying it twice.
- Kickbacks—a personal payment to an employee or purchasing from or contracting with a particular vendor or contractor are a common form of fraud in the construction industry. They can also affect certain not-for-profit organizations.
- Check signatures can be forged and improper payments made. Banks aren't great about verifying signatures.
- Phony invoices can be generated and submitted for payment.
- Payroll checks can be prepared for employees who no longer work for the company or for fictitious employees.
- Fund-raising events often involve cash, and while much effort goes into planning a lovely event, internal controls may not be well planned. This is inherently difficult because each event is unique. This is an area where we can help you with internal controls as part of your planning process.
- Credit cards can be used for improper charges, or credits can be improperly issued.
- Investment accounts represent high risk because they are inactive and may not be carefully reviewed. This leads to the potential risk of withdrawals of principal or of investment income.

Impact of Fraud
Fraud affects the organization and its staff and volunteers in multiple ways. There is the obvious financial affect. Resources intended to be used for a specific purpose are lost. There is also an emotional affect. A trust has been betrayed. There may also be an impact on potential donors or funders who are concerned about the problems that led to the loss of assets.

There's also a potential liability of the organization itself. As ironic as it seems, the organization may be liable for inappropriate activities that are carried on by persons who served as "agents" of the organization. In one instance a group of doctors who formed a clinic to help indigent people with health care delegated responsibility to others. The doctors were held liable when it was found that improper medical procedures were being performed and improper prescriptions were being issued.

Fraud grows! Fraud that isn't detected and dealt with properly almost always becomes bigger and more frequent. Investigation of fraud demonstrates that smaller and occasional improper activities turned into more frequent and larger ones.

Identifying the Potential Embezzler
Several things such as age, gender, race, or even education have little or not impact on fraud. The only things that do impact fraud are integrity, financial pressures and opportunity.

Integrity varies greatly from individual to individual. The bad news is that the national association of certified fraud examiners estimates that only 5% or people are honest all of the time.

Financial pressures are more a matter of perception that reality. People are affected much more by a change in their financial circumstances than the financial circumstances themselves. For example, someone who experiences a large reduction in income due to theft, poor investments, loss of a spouse, or medical costs may feel the pain of a changed lifestyle. This can increase pressure to "obtain additional resources."

Opportunity is most important because it has the largest impact and because this is the only area you can do much about. Reducing opportunity reduces the possibility of loss form 95 percent of the population.

For these reasons, internal controls need to be a priority. You must deliver the message that there will be no tolerance of any fraud. Prosecution usually has a poor return on investment although it will deter others.

Based on your organization's resources and operations, you need to assess potential risks from activities such as the items above. For example, if you have cash, medicine, food or electronic instruments you need to consider the loss of these items. If you regularly receive unexpected contributions or have special events that are paid for in cash, you need to develop appropriate procedures.

Here is a short list of key internal controls. Keep in mind that these are designed to both separate the responsibilities of custody from record keeping for assets and also to set a high standard of integrity starting with top management.

- Management needs to demonstrate an attitude of integrity and commitment to competence—proper hiring and training practices, attention to compliance requirements such as completing INS forms and withholding authorizations. Provide training to support your commitment to give people the skills to do their job well.
- Have a written code of conduct that describes proper business practices and be sure that everyone is aware of and abides by that code.
- Show no tolerance for improper practices. Even minor theft of assets should be addressed as a serious matter.
- Question unusual activities. Don't be hasty to accuse someone of wrongdoing but be sure you understand the activity.
- Develop a good budget and look at variances from that budget. Update the budget throughout the year as appropriate for changes in funding or programs. When you do this, variances are red flags that deserve your attention.
- Your church should have an audit committee that is independent from management and that has operations and financial expertise.

A proper separation of duties should exist. Generally, responsibilities for record keeping for assets and custody of those assets should be separated. Some inquires about separation of duties follow.

Receipts

_______Are offerings always controlled by at least two people?

_______Are offerings counted in a secured area?

_______Are collection reports prepared and signed by counters?

_______Do money counters verify the contents of offering envelopes?

_______Are members encouraged to use checks for offerings and use envelopes?

_______Are contribution records maintained for members? How often are contribution records sent to members?

_______Are members told to report irregularities?

_______Does someone not involved with record keeping for receipts deposit them?

How often? ______________________________

_______Are collection reports given to the finance secretary or treasurer for entry into the accounting records?

_______Are mail receipts handled by someone not involved in record keeping?

Disbursements

_______Does someone who is not involved with the preparation of checks initially receive the bank statement and review its contents for appropriateness?

_______Are invoices reviewed for no sales tax, record keeping classification and approved?

_______When checks are prepared, are they submitted to the check signor with original invoices?

_______Are invoices then cancelled by marking them paid?

_______Is there a policy that prohibits preparing checks to "cash?"

_______Are checks sent out without being returned to the check preparer after signing?

Other Procedures

_______Is a meaningful budget prepared, updated for changes in circumstances, and compared to actual results?

_______Do you have fidelity bond coverage for employee dishonesty? Consider using a carrier who isn't your general liability carrier to reduce possibility of countersuits.

_______Are there adequate physical controls over blank checks, money and other assets?

_______Is an inventory of securities, valuable and equipment taken annually?

_______Is there a proper approval process for removing contribution receivables and other receivables?

_______Is there an up-to-date accounting procedure manual?

_______Is insurance coverage reviewed periodically for coverage and cost?

Information Technology Review

_______Do you make regular backups?

How often are backups stored off-site?____________________________

_______Do you check backups to make sure that they are properly indexed?

_______Does your staff have proper computer training for the applications they use?

_______Is anti-virus software used?

How often is it updated?__________________________

_______Do servers, hubs and other key computers have surge protection and battery backups?

_______Do account records provide necessary data in a timely and efficient manner?

_______Is password protection used for accounting and other important systems?

_______Are there written procedures for the items listed above, and also for the employee Internet and computer use?