

Best Practices for Nonprofit Internal Controls: Enhancing Your Internal Control Environment

BY THE STAFF OF CLIFTONLARSONALLEN

Whatever their mission or size, all nonprofit organizations should establish policies and procedures to assure that 1) boards and officers understand their fiduciary responsibilities, 2) assets are managed properly, and 3) the charitable purposes of the organization are carried out. Failure to meet these three obligations is a breach of fiduciary duty, and can result in financial and other liability for the board of directors and the officers.

External audits closely examine an organization's internal control practices in the annual audit plan and management report. Effective internal controls help protect and manage an organization's assets and address concerns raised by an external audit.

Directors and officers are responsible for ensuring that the organization is accountable to contributors, members, the public and government regulators. Accountability requires that the organization:

- Comply with all applicable laws and ethical standards.
- Adhere to the organization's mission.
- Create and adhere to conflict of interest, ethics, personnel, and accounting policies.
- Protect the rights of members.
- Prepare and file an annual financial report with the IRS and state regulatory authorities.
- Make the report available to all board members and members of the public who request it.

Development and maintenance of internal controls helps ensure accountability.

THE TOP FIVE NONPROFIT INTERNAL CONTROL RISKS

1. Accounting policy manual

2. Sarbanes-Oxley Act

- Whistleblower channel and compliance monitoring
- Document destruction and retention policies

3. General organization-level controls

- Conflict of interest and ethical code of conduct
- Segregation of duties
- Delegation of authority

4. Information technology controls

- User access
- System, application, and data security
- System and application change management
- Use of spreadsheets

5. Key internal controls

- Cash management
- Payroll
- Accounting

What are internal controls?

Internal controls are policies and procedures that protect the assets of an organization, create reliable financial reporting, promote compliance with laws and regulations, and facilitate effective and efficient operations. They relate to accounting, to reporting, and to the organization's communication processes.

Internal controls typically include procedures for

- Handling funds received and expended by the organization,
- Preparing appropriate and timely financial reporting,
- Conducting the annual audit of the organization's financial statements,
- Evaluating staff and programs,
- Maintaining inventory records of real and personal property, and
- Implementing personnel and conflicts of interest policies.

The following actions will help you institute effective internal controls.

Establish procedures for monitoring assets

Every organization should have procedures to monitor and record assets received, held, and expended. These financial controls should be described in an accounting policies and procedures manual. The manual should be reviewed by and distributed to all directors and officers, trustees, employees, and volunteers. Representative procedures addressed by the accounting manual typically include the controls described below. (These limited examples do not constitute a complete internal control environment; they illustrate a few example controls.)

- **General organization-level controls.** Organizations should prepare an annual income and expense budget as well as quarterly (preferably monthly) reports that compare actual receipts and expenditures to the budget. Reports should include timely variance explanations.
- **Information technology general controls.** IT controls should specify protocol for accessing, inputting, and changing electronic data maintained by the organization; for preserving electronic records, ensuring data compatibility, and creating a records retention policy; and securing competitive bids from vendors and approving contracts.
- **Segregation of duties.** Effective checks and balances hinder embezzlement by segregating duties. No single individual should be responsible for writing and signing checks or vouchers and receiving, recording, securing, and depositing cash and other receipts. These functions should be assigned to different individuals.
- **Sarbanes-Oxley Act.** All nonprofit organizations should establish a confidential and anonymous mechanism to encourage employees to report inappropriate financial management. At the same

time, organizations should develop procedures for handling employee complaints so that no retaliation—including firing, demotion, suspension, harassment, failure to consider for promotion, or any other discrimination—is permitted.

- **Revenue.** The organization should properly record grants and contributions, complete all accounting required as a condition of grants, and comply with restrictions or prohibitions on the use of grant funds and the principal of an endowment.
- **Purchasing and accounts payable.** No single individual should be permitted to request, authorize, verify, and record expenditures, including payment of invoices, petty cash, and other expenditures.

Define roles in the organization

Create written job descriptions for directors, officers and trustees, and consultants. Clear expectations and limits of authority facilitate work and problem solving. Likewise, all other employees should have written job descriptions and be advised of what is expected of them. Volunteers, as well, should be given job descriptions that describe expectation. Failure to understand responsibilities or to act professionally puts the organization at risk.

Record the organization's personnel policies

Personnel policies, including vacation and sick leave, health insurance and other benefits, evaluations, ordinary and overtime compensation, conflicts of interest and code of ethics, and grievance procedures (including protections for whistleblowers), should be in writing and provided to all employees prior to hiring. Changes in policies should be communicated on a regular basis.

Adopt a conflict of interest policy and code of ethics

Directors, officers, trustees, and others who serve a nonprofit organization should not have any personal or business interests that may conflict with their responsibilities to the organization. The organization should have a conflict of interest policy that clearly states the procedures to be followed if a board member's interests may be advanced by a board action.

The conflict of interest policy should require full disclosure of individual or family interest in any entity that does business with the organization. The policy may be set forth in the organization's by-laws. It must require that such individuals may not participate in any decision to approve doing business with the individual or any entity in which the individual has an interest. Such decisions must be made by a disinterested majority of the board of directors or trustees.

The organization should also have a code of ethics addressing issues such as transparency, disclosure in fundraising solicitations, integrity in governance, and diversity. All board members, employees, volunteers, and consultants should be given copies of both policies and be required to sign a statement acknowledging that they have read them.

Summary

Instituting and applying an effective internal control environment is a sign of proper governance and proactive management. Moreover, a strong internal control environment assists nonprofit organizations in fulfilling their fiduciary duties.

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