Internal Control Checkup for Nonprofits

Presented by:
Bruce J. Toews, CPA, MBA
Assoc. Professor of Accounting/Finance
Walla Walla University

June 12 and 13, 2012

Brought to you by:
A Learning Center for Nonprofits
Sponsored by:
The Sherwood Trust & Walla Walla Community College
House-keeping

- **Schedule:**
  - Start 11:30am
  - 1:30pm -- out of here

- **CPE for CPAs (sign-in & out)**

- **Kudos to:**
  - A Learning Center for Nonprofits
    - co-sponsored by:
      - *The Sherwood Trust*
      - *Walla Walla Community College*
1. Why internal controls?
2. Internal controls defined
3. Five components of internal controls
4. Internal controls for small nonprofits
5. Limitations of internal controls
6. Illegal/improper acts by nonprofits
7. Audit and other CPA services
8. ACFE Fraud Report
Why internal controls?

Three Cups of Tea

One Man's Mission to Promote Peace...One School at a Time

Greg Mortenson and David Oliver Relin

Greg Mortenson
Why internal controls?

- Maintain the trust/confidence of constituency/donors
  - Contributions can drop precipitously if a breach in trust occurs

- Avoid direct losses from fraud
  - One in three fraud cases involve nonprofits/gov’t, with a median loss of about $100,000 per incident

- Promote efficient and effective operations
  - Things run a lot smoother with when there are clear management structure, policies, and channels of authority and communication

- Respond to increasing government regulation
  - Many states now require audits and reviews of large nonprofits, and two provisions of the federal Sarbanes-Oxley Act (SOX) applies directly to nonprofits (whistleblower protection and document retention)

“Just as Congress has acted in the public interest to protect shareholders and workers from corporate mismanagement, so too must Congress demand transparency, accountability and good governance from the nonprofit sector...Tightening rules and regulations governing the nonprofit sector will help repair the breach of trust that threatens to tarnish even the most reputable charities in America.” Senator Chuck Grassley.
Internal controls defined

According to COSO*, internal controls are a process, effected by the board and management, designed to provide reasonable assurance of achieving the following objectives:

- Safeguard assets from misappropriation and misuse
- Facilitate timely and accurate financial reporting
- Foster effective and efficient operations
- Ensure compliance with laws and regulations

* COSO is the acronym for the Committee of Sponsoring Organizations, which includes American Accounting Association, American Institute of Certified Public Accountants, Financial Executives International, Institute of Management Accountants, and Institute of Internal Auditors.
Components of internal control

1. Control environment
2. Risk Assessment
3. The Accounting Information System
4. Control Activities
5. Monitoring
1. Control Environment

- **Integrity and ethical values**
  - Establish behavior and ethical standards in a written code
  - Management models highest integrity

- **Commitment to competence**
  - Employees possess the needed skills/knowledge; outside specialists used if expertise not available in house

- **Management philosophy and operating style**
  - Different controls needed if aggressive/conservative, loose/formal
1. Control Environment (cont.)

- **Board of Directors**
  - Consists of at least 5 knowledgeable, committed directors who are independent from CEO (Question on Form 990 about this)
  - Meets regularly (sometimes without CEO present)
  - Records minutes (Question on Form 990)
  - Signs conflict of interest statements annually
  - Reviews CEO performance/compensation
  - Reviews Form 990 (Question on Form 990)
  - Establishes governance and internal control policies
Audit Committee

- Required of public companies by SOX.
- Optional for nonprofits under SOX but required of large nonprofits in some states (not WA, yet)
- Consists of 3-5 members who are independent (not employees or relatives of CEO, etc.)
- Chair should be a director
- At least one member should have significant financial expertise
- Functions include hiring auditors, receives audit reports, review fraud tips and employee complaints, etc.
1. Control Environment (cont.)

- **Organizational Structure**
  - Segregation of Duties: separate functions of Authorization, Recordkeeping, and Custody (ARC) among different departments and people
  - E.g. Finance usually has functions of authorization and custody, while Accounting does recordkeeping.
  - Clear job descriptions, lines of authority, responsibility, and reporting.
  - Hard to do in small nonprofits, but in no case should bookkeeper sign checks.
Internal Controls Modified or Implemented in Response to Fraud

- Increased Segregation of Duties: 61.2%
- Management Review: 50.6%
- Surprise Audits: 22.5%
- Fraud Training for Employees: 16.4%
- Fraud Training for Managers/Executives: 14.8%
- Job Rotation/Mandatory Vacation: 13.5%
- Internal Audit/FE Department: 12.3%
- Anti-Fraud Policy: 11.7%
- Code of Conduct: 8.7%
- External Audit of F/S: 8.7%
- Hotline: 7.9%
- External Audit of ICOFR: 7.8%
- Independent Audit Committee: 6.0%
- Management Certification of F/S: 5.9%
- Rewards for Whistleblowers: 4.0%
- Employee Support Programs: 1.8%

Source: 2010 ACFE Fraud Study
1. Control Environment (cont.)

- **Human Resource Policies and Procedures**
  - Background/reference checks
  - Regular performance reviews
  - Fidelity bond insurance for cash-sensitive positions
  - Mandatory vacations (e.g. two consecutive weeks)
  - Cross-training and rotation of duties
  - Establish job/shift accountability
  - Whistle-blower policy
    - Required by SOX
    - Firm cannot retaliate in any way
    - Question on Form 990
Primary Internal Control Weakness Observed by CFEs

- Poor Tone at the Top: 8.4%
- Lack of Competent Personnel in Oversight Roles: 6.9%
- Lack of Independent Checks/Audits: 5.6%
- Lack of Employee Fraud Education: 1.9%
- Lack of Clear Lines of Authority: 1.8%
- Lack of Management Review: 17.9%
- Override of Existing Internal Controls: 19.2%
- Lack of Internal Controls: 37.8%

Source: 2010 ACFE Fraud Study
Importance of Control in Detecting or Limiting Fraud

<table>
<thead>
<tr>
<th>Control</th>
<th>Very Important</th>
<th>Somewhat Important</th>
<th>Not at all Important</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal Audit/FE Department</td>
<td>60.8%</td>
<td>17.9%</td>
<td>19.2%</td>
</tr>
<tr>
<td>Management Review</td>
<td>50.3%</td>
<td>50.3%</td>
<td>21.4%</td>
</tr>
<tr>
<td>Surprise Audits</td>
<td>49.0%</td>
<td>25.7%</td>
<td>23.6%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>42.0%</td>
<td>25.3%</td>
<td>31.2%</td>
</tr>
<tr>
<td>Hotline</td>
<td>41.3%</td>
<td>19.3%</td>
<td>38.3%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>36.0%</td>
<td>32.4%</td>
<td>30.6%</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>34.7%</td>
<td>24.5%</td>
<td>41.5%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>45.4%</td>
<td>23.0%</td>
<td>31.9%</td>
</tr>
</tbody>
</table>

Source: 2010 ACFE Fraud Study
Components of internal control

1. Control environment
2. Risk Assessment
3. The Accounting Information System
4. Control Activities
5. Monitoring
2. Risk Assessment

- Management’s process for identifying and responding to events that might weaken controls, such as
  - Changes in key personnel
  - New computer system
  - New line of business
  - Rapid growth
  - Changes in regulations
- Regularly review risk management and insurance policies
Components of internal control

1. Control environment
2. Risk Assessment
3. The Accounting Information System
4. Control Activities
5. Monitoring
3. Accounting Information System

- A disorganized and sloppy AIS is a major weakness in internal controls. A good AIS should have:
  - Chart of accounts
  - Accounting manual
  - Capitalization cutoff policy
  - Records retention policy
  - Required by SOX
  - Covers retention and destruction of hardcopy and electronic files (including email/voicemail)
  - Question on Form 990 about this
  - See sample in Appendix
Components of internal control

1. Control environment
2. Risk Assessment
3. The Accounting Information System
4. Control Activities
5. Monitoring
Control Activities

Control activities are physical or information systems checks and balances:

- Safeguarding records and assets (fireproof vault, locked storage of cash, checks, supplies, inventory)
- Pre-numbered documents
- Periodic physical counts of assets matched to books
- Bank accounts reconciled regularly, and either reviewed independently or duplicate copy of stmt mailed to board or audit committee chair
- Dual-signatures for large checks
- Strong and periodically changed passwords, including when creating new vendors
- Offsite backup, password-protected or encrypted laptops and USB drives
Components of internal control

1. Control environment
2. Risk Assessment
3. The Accounting Information System
4. Control Activities
5. Monitoring
5. Monitoring

- Independent assessment of controls over time:
  - Internal audits
  - External audits
  - Regular board and management reviews (budget variances, other reports)
  - Anonymous hotline for complaints and tips from employees & others
Fraud Detection Methods

Source: 2010 ACFE Fraud Study
Source: 2010 ACFE Fraud Study
COMPONENTS OF INTERNAL CONTROL

1. Control environment
2. Risk Assessment
3. The Accounting Information System
4. Control Activities
5. Monitoring
Why are controls especially important for small nonprofits?

- Limited number of personnel makes segregation of duties difficult and causes overreliance on one individual
- Executive leadership is often dominant
- Fewer resources to support the accounting function
- Focus on mission, not on fiscal function
- Atmosphere of trust
- Lack of financial expertise in personnel and volunteers

- Effective control in small nonprofits will have some parts of all 5 components in place; any shortcomings can be offset by effective monitoring and board/management review
Size of Victim Organization — Frequency

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>2010</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100</td>
<td>30.8%</td>
<td>38.2%</td>
</tr>
<tr>
<td>100 — 999</td>
<td>22.8%</td>
<td>20.0%</td>
</tr>
<tr>
<td>1,000 — 9,999</td>
<td>25.9%</td>
<td>23.0%</td>
</tr>
<tr>
<td>10,000+</td>
<td>20.6%</td>
<td>18.9%</td>
</tr>
</tbody>
</table>

Source: 2010 ACFE Fraud Study
Source: 2010 ACFE Fraud Study
The COSO acknowledges that the controls in smaller companies will be of different types than larger ones & at times the categories may not be distinguishable.
1. Mistakes from fatigue, carelessness, indifference
2. Management override
3. Collusion among employees
4. Cost/benefit tradeoff
Illegal or improper acts committed by nonprofits

- Charging fundraising and management support expenses to programs to improve ratios
- Misrepresenting extent of charitable contribution deduction (e.g. car donation programs)
- Failing to comply with donor restrictions
- Misreporting compensation of officer and high-salary employees and independent contractors on Form 990
- Misclassifying employees as independent contractors
- Selling donor data
- Resisting making available last three Forms 990
- Promoting political candidates and lobbying
- Direct competition with for-profits
Auditors & Information Risk

Ernie, your prospectus doesn’t mention that your factory was flooded recently.
Right up front it says, “assets are all liquid”!

ETUS INC.

or the long list of outside accountants who resigned over the questionable accounting practices.

“Auditors in complete agreement”!

And most of your employees are desperately seeking jobs elsewhere.

“Highly motivated work force”!

But what about the fact that you’re down to your last 25 cents?

“High hopes for the quarter”!

© 2002 Thaves
The Attest Function

Management-Assertor

Auditor-Attestor

A raised eyebrow indicates professional skepticism

Information

Stakeholders
# Types of CPA Services

<table>
<thead>
<tr>
<th>Type of Service</th>
<th>Level of assurance</th>
<th>Procedures</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ATTEST SERVICES:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Audit of financial statements</td>
<td>Highest or reasonable level of assurance, resulting in an opinion on fairness of fin. stmts.</td>
<td>Test every material item on financial statements; look at internal controls as related to fin. stmts.</td>
</tr>
<tr>
<td>Review of financial statements</td>
<td>Limited (negative) assurance (nothing came to auditors’ attention that would indicate otherwise . . .)</td>
<td>Limited to inquiry (ask lots of questions) and analytical review (ratio analysis, etc.). Internal controls ignored.</td>
</tr>
<tr>
<td><strong>NON-ATTEST SERVICES:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Compilation of financial statements</td>
<td>None whatsoever; only responsible for glaring misstatements</td>
<td>Put financial statements together in proper format; no testing done</td>
</tr>
</tbody>
</table>
Note: when CPAs audit your fin. stmts., they are NOT auditing your internal controls.
1. **Federal**
   a) If a nonprofit expends $500,000 or more of federal funds annually, or participates in a Combined Federal Campaign > $100,000

2. **Washington State (effective 1/1/10)**

<table>
<thead>
<tr>
<th>Avg revenue over last 3 years</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greater than $1 million up to $3 million</td>
<td>Form 990 prepared /reviewed by CPA, OR audited fin. stmt.</td>
</tr>
<tr>
<td>Greater than $3 million *</td>
<td>Audited fin. stmt. by CPA*</td>
</tr>
</tbody>
</table>

* Not required if receive < $500K cash contributions or hit $3M in one-time event
ACFE 2010 Fraud Report
Based on 1939 fraud cases reported by CFEs

Studies have consistently shown the above three factors to be present in a fraud case. **Opportunity** is afforded by a weakness in internal control (a perpetrator sees an opportunity to take advantage of a hole in internal controls). **Financial pressure** usually occurs because of a bad financial situation at home. **Rationalizations** for fraud include when the perpetrator feels underpaid and underappreciated at work, or feels that everyone else is doing it, or that he might lose his job if he didn’t do, etc.
Behavioral Red Flags of Perpetrators

- Living beyond means: 2010 - 38.5%, 2008 - 43.0%
- Financial difficulties: 2010 - 36.4%, 2008 - 34.1%
- Control issues, unwillingness to share duties: 2010 - 22.6%, 2008 - 18.7%
- Unusually close association with vendor/customer: 2010 - 22.1%, 2008 - 15.2%
- Wheeler-dealer attitude: 2010 - 19.2%, 2008 - 20.3%
- Divorce/family problems: 2010 - 17.6%, 2008 - 17.1%
- Irritability, suspiciousness or defensiveness: 2010 - 14.1%, 2008 - 13.6%
- Addiction problems: 2010 - 13.9%, 2008 - 13.3%
- Refusal to take vacations: 2010 - 10.2%, 2008 - 6.8%
- Past employment-related problems: 2010 - 9.3%, 2008 - 9.0%
- Complained about inadequate pay: 2010 - 7.9%, 2008 - 7.3%
- Excessive pressure from within organization: 2010 - 7.5%, 2008 - 6.5%
- Past legal problems: 2010 - 6.3%, 2008 - 8.7%
- Instability in life circumstances: 2010 - 5.6%, 2008 - 4.3%
- Excessive family/peer pressure for success: 2010 - 5.1%, 2008 - 4.2%
- Complained about lack of authority: 2010 - 3.6%
Questions?

Don’t hesitate to contact me:

Bruce Toews
Tel 509-527-2376
bruce.toews@wallawalla.edu