Internal Controls and Financial Accountability for Not-for-Profit Boards

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New York State Attorney General Eric T. Schneiderman is pleased to offer this booklet to assist current and future boards of directors of New York not-for-profit corporations to understand and carry out their fiduciary responsibilities to the organizations they serve.

The booklet contains general information concerning internal controls for the protection and oversight of charitable assets. It is not a substitute for advice from a qualified lawyer, independent public accountant or other professional. The Attorney General publishes another booklet, *Right From the Start - Responsibilities of Directors of Not-for-Profit Corporations*, which describes basic responsibilities of boards of not-for-profit corporations. That booklet and other publications of interest to directors may be found at http://www.charitiesnys.com.

I. INTERNAL CONTROLS

A primary responsibility of directors is to ensure that the organization is accountable for its programs and finances to its 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 its annual financial report with the Internal Revenue Service and appropriate state regulatory authorities and make the report available to all members of the board and any member of the public who requests it. The development of proper internal controls helps organizations ensure accountability.

What are Internal Controls?

Internal controls are systems of policies and procedures that protect the assets of an organization, create reliable financial reporting, promote compliance with laws and regulations and achieve effective and efficient operations. These systems are not only related to accounting and reporting but also relate to the organization's communication processes, internally and externally, and include procedures for (1) handling funds received and expended by the organization, (2) preparing appropriate and timely financial reporting to board members and officers, (3) conducting the annual audit of the organization's financial statements, (4) evaluating staff and programs, (5) maintaining inventory records of real and personal property and their whereabouts, and (6) implementing personnel and conflicts of interest policies.

II. IMPLEMENTATION AND MONITORING OF INTERNAL FINANCIAL CONTROLS

A. 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 with and given to all directors and officers, trustees, employees and volunteers. It should include procedures for:

⇨ Preparing an annual income and expense budget and periodic reports - at least quarterly, preferably monthly - comparing actual receipts and expenditures to the budget with timely variance explanations.

⇨ Writing and signing checks or vouchers and receiving, recording, securing and depositing cash and other receipts. Such procedures should ensure that no single individual is responsible for receiving, recording and depositing funds or writing and signing checks, and thus to make embezzlement more difficult.

⇨ Ensuring that grants and contributions received are properly recorded, accountings required as a condition of any grant are completed, and restrictions on the use of funds, such as contributions given for a restricted purpose or prohibitions on the use of the principal of an endowment, are obeyed.

⇨ Requisitioning, authorizing, verifying, recording and monitoring all expenditures, including payment of invoices, petty cash and other expenditures. Such procedures should ensure that no single individual is permitted to request, authorize, verify and record expenditures. For example, the same person should not be responsible for cash disbursements and bank reconciliations. These functions should be assigned to different individuals.

⇨ Accessing, inputting and changing electronic data maintained by the organization. Preserving electronic records and ensuring data compatibility when systems change and creating an appropriate records retention policy are part of this process.

⇨ Providing for regular oversight by an audit committee or, if there is no audit committee, by the executive committee or by the board of directors itself.

⇨ Reporting to the audit committee or board by employees and volunteers of allegations of fraud or financial improprieties.

⇨ Ensuring that timely and appropriate financial reports are distributed to all directors and officers and reviewed by them, as well as the president, chief executive officer, treasurer and chief financial officer.

⇨ Providing procedures for approving contracts to which the organization is a party, including securing competitive bids from vendors.

⇨ Making clear the responsibilities of all individuals involved with the organization, including directors, officers, employees, volunteers and consultants, and maintaining an organizational chart and updating such information as necessary.

⇨ Preparing for the annual audit process in a timely manner.

⇨ Developing a prudent investment strategy and providing proper oversight of the investment assets.

⇨ Complying with governmental and other reporting requirements, including watchdog agencies.

⇨ Complying with obligations to members, employees and the public, including their right to a copy of the organization's annual financial report.

B. Various Roles in the Organization

There should be written job descriptions for directors, officers, employees, volunteers and consultants. The work of the organization will be more easily accomplished and problems will be avoided if all involved understand what is expected of them and the limits of their authority.

A comprehensive description of the chief executive officer's job should make clear his or her responsibilities in the day-to-day activities of the organization and set forth exactly what information is expected by the board and when it must be communicated. For example, if the board expects monthly financial reports and bi-monthly programmatic reports, making those expectations clear from the beginning will avoid ambiguity and will clarify the responsibility for accountability to the board.

Likewise, all other employees should have written job descriptions and be advised of what is expected of them. Volunteers are no exception. They should be given job descriptions that clearly describe what is expected of them. For many organizations, volunteers are the only people who conduct programs and have contact with the public. If they do not understand their responsibilities or do not act professionally, the organization could be at risk.

C. 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 "whistle blowers") should be in writing and given to all employees prior to hiring, with changes in policies communicated on a regular basis.

D. Training

Appropriate training should be arranged for all involved. New directors, officers, employees and volunteers should be trained by those who are familiar with the organization and its operations. There are many organizations that provide free or low-cost training for board members and others within the organization, and there are numerous resources that provide guidance in developing training.[1] For all involved, familiarity with the organization's internal controls is essential. Training is a wise investment!

E. Conflicts of Interest Policies and Code of Ethics

Directors, officers, trustees and others who serve a nonprofit organization should not have any personal or business interest that may conflict with their responsibilities to the organization. To avoid such conflicts, it essential that the board adopt and follow a "conflicts of interest policy" that clearly states the procedures to be followed if a board member's personal or financial interests may be advanced by an action of the board.

The conflicts of interest policy should require an individual to fully disclose any interest the individual and/or the individual's family has in any entity that does business with the organization and that any change in the information concerning potential conflicts should be provided to the organization immediately. The policy may be set forth in the organization's by-laws. The policy must require that such individual may not participate in any decision to approve doing business with the individual or any entity in which the individual has an interest, and such decision 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 fund-raising solicitations, integrity in governance and diversity.

There are many examples of written policies regarding conflicts of interest and other ethical matters available. All board members, employees, volunteers and consultants should be given copies of both policies and sign a statement acknowledging that they have read them and agreed to follow them.

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[1] Resources available to nonprofit organizations are posted on the Attorney General's Internet site at http://www.oag.state.ny.us.

F. The Audit Committee

Crucial to the governance of a not-for-profit organization is the establishment of an audit committee. Typically, an audit committee is composed of members of the board of directors who are independent of any financial interest in the organization and at least one of whom has expertise in accounting. The audit committee acts as a liaison to the organization's independent external auditor who is a certified public accountant ("CPA") or firm of CPAs. (See section G for a discussion of the role of the CPA.) The audit committee's responsibilities should include the following:

⇨ Selection and review of the independent external auditors and review of the annual fees to be paid for services rendered by them and each proposed audit plan developed by management and the external auditors.

⇨ Review with the independent external auditors the organization's annual financial statements and reports. Consider whether they are complete and consistent with information understood by the committee members.

⇨ Review and evaluate the management letter received from the independent external auditors and discuss recommendations for any changes necessary to remedy problems identified in the letter.

⇨ Maintain communication between the board and independent external auditors by meeting on a regularly scheduled basis with an opportunity for the auditors and the audit committee to meet without management present. At the completion of the audit, review the audit fieldwork process with the auditors. Obtain an understanding of their evaluation of management and whether they encountered any difficulties or had any disagreements with management during their audit. Review all journal entries proposed by the auditors.

Audits are a key factor in providing proper financial management oversight of an organization. The audit committee (or the board if there is no audit committee) should interact with management to implement and monitor the internal control structure and to take steps that insure that the possible risks of fraud or embezzlement are mitigated. In order for an audit committee to function properly, it should be comprised only of directors who are independent of any financial interest in the organization.

In addition to the audit committee's role in the preparation of the audit, its responsibilities include the following:

⇨ Ensuring that proper federal and state tax filings are completed timely, including payroll taxes, sales taxes and unrelated business income taxes.

- ⇨ Understanding the organization's internal controls and having policies in place to update them as needed.

- ⇨ Periodically reviewing the organization's insurance coverage and determining its adequacy.

- ⇨ Making recommendations necessary to improve the organization's efficiency and/or remedy problems identified by the committee or others.

- ⇨ Identifying and monitoring related party transactions and reviewing the conflict of interest, ethics and related party disclosure policies periodically and updating as needed.

- ⇨ Monitoring any legal matters that could impact the financial health and reporting of the organization.

- ⇨ Instituting and overseeing any special investigatory work as needed.

In organizations with small boards, the entire board may serve the function of the audit committee. For larger organizations, it is more appropriate to create a separate audit committee that can devote its attention to this area.

Whatever form the audit committee takes, at least one member of the committee should have a functional understanding of financial matters and should be comfortable reviewing financial reports and other financial records. No member of the audit committee should ever be involved in any conflict of interest transaction, and no member of the audit committee should be compensated in any manner by the organization other than director's fees paid generally to all directors, if any.

The audit committee should be familiar with the organization's internal controls and report to the board as appropriate the adequacy of the internal controls and any concerns raised by the staff or outside auditors.

G. Independent Certified Public Accountants

In New York, nonprofit organizations that solicit contributions from the public and are required to register with the Attorney General's Charities Bureau must file with the Charities Bureau an annual audit report certified by a CPA if they have gross receipts over $250,000 and solicit contributions from the public. Such reports may also have to be filed with other governmental agencies and other funders.

It is important that the organization have procedures in place to ensure that the CPA it engages has a good reputation in the marketplace, is qualified to perform the necessary work, commits to appropriate timeliness and offers a competitive fee. Before engaging a CPA, an organization should ask for a list of the CPA's clients and contact some of them for references. The organization should find out whether the firm offers training and provides information to its clients on issues and events of importance to not-for-profit organizations. In addition, the organization should request a copy of the CPA firm's peer review report.

The organization's CPA should be a resource for assistance with concerns about financial and other matters that arise during the year, not just during the audit fieldwork. The organization should make sure that its engagement with the CPA includes an expectation that the CPA may be called upon to provide such service.

The audit committee or the board should communicate regularly with the CPA firm, making it aware of any problems and/or concerns with regard to the management of the organization or its assets, whether there are steps that should be taken to ensure compliance with the existing internal control structure, or creation of new controls.

In addition to certifying the financial statements as part of the audit process, the CPA prepares a management letter to be sent to the board, which discusses internal controls or other issues identified during the audit that concern the financial management of the organization. Since the management letter is not a comprehensive evaluation and opinion on the internal controls (but rather just a by-product of the audit process), the board must decide whether further outside evaluation of the systems and procedures is warranted, and if so, by whom. It is also important that issues arising from prior year's management letters be revisited to make sure they have been addressed to the CPA's satisfaction.

Before releasing the opinion on the financial statements, a CPA will request a signed management representation letter (typically signed by both a board officer, such as the chair or the treasurer, and the chief executive officer or the chief financial officer). This letter describes the responsibility to provide financial information that is assumed by the organization. Before signing the letter, officers should be comfortable with the representations it contains.

In many circumstances, the CPA also prepares the tax filings for the organization based on information provided by management. The IRS Form 990 is a public document, and as much of the information disclosed is not a result of the audit process, but rather informational in nature, care must be taken to ensure that the filing truly represents the organization appropriately. These documents should be carefully reviewed before they are signed by management.

H. Review of the Organization's Governance Structure, Procedures and Programs

Periodic review of an organization's structure, procedures and programs will assist board members in determining what is working well and what practices the organization might want to change in order to be more efficient, effective or responsible.

III. MAKE USE OF AVAILABLE RESOURCES

In carrying out their responsibilities, board members should realize that there are many resources available to assist them. The Attorney General's Web site, http://www.oag.state.ny.us, has publications on a variety of subjects, as well as forms and instructions for registration and annual filing with the Charities Bureau. It also has links to other web sites that provide resources for not-for-profit boards.