

Establishing Effective Internal Procedures for a Nonprofit

This article discusses best practices in designing and developing an organization's procedures to support its overall policies and the internal control of the organization.

Remember like policies, internal controls and procedures vary from organization to organization.

Sometimes organizations get caught up in the different types of policies. There are broad sweeping policies that are entity wide and support the mission and strategic plan of the organization for which the Board is responsible and then there are other policies that are more operational oriented for which management is responsible. Understanding the different types of policies is key to developing well designed and effective procedures to manage a nonprofit organization. The management team is responsible for developing the organization's procedures to carry out the day-to-day operations of an organization. The Board of Directors' key responsibility is to provide vision and strategic thinking and planning for the organization and provide the monitoring and oversight process in order to carry out their fiduciary duty. It is important that this concept of division of responsibilities be understood by all parties.

There is not a one size fits all method for designing, establishing and implementing effective procedures to carry out the policies of the organization and provide the organization with strong internal controls.

The Difference between Internal Control and Procedures

Internal control is a process, which is affected by people. It's not merely policy, manuals, and forms, but people at every level of an organization. Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an organization's management and Board of Directors that an error or misstatement will be caught by an employee during the course of doing their job and be corrected on a timely basis. Internal control is geared to the achievement of objectives in one or more separate but overlapping categories discussed below.

The Committee of Sponsoring Organizations (COSO) defines internal control as a process, effected by an entity's Board of Directors, management and other personnel, designed to provide "reasonable assurance" regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations,
- Reliability of financial reporting, and
- Compliance with applicable laws and regulations.

It is important to remember that internal controls involve human action, which introduces the possibility of errors in processing or judgment. Additionally, we must keep in mind the human component of internal controls since in almost every major fraud since the beginning of time, collusion among employees or coercion by top management has been a factor.

The Five Components of the COSO Framework

The COSO internal control framework consists of five interrelated components derived from the way management runs an organization. According to COSO, these components provide an effective framework for describing and analyzing the internal control system implemented in an organization. The five components are the following:

Control environment: The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the tone from the top, integrity, ethical values, management's operating style, delegation of authority systems, as well as the processes for managing and developing people in the organization.

Risk assessment: Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives and thus risk assessment is the identification and analysis of relevant risks to the achievement of assigned objectives. Risk assessment is a prerequisite for determining how the risks should be managed.

Control activities: Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address the risks that may hinder the achievement of the organization's objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and most importantly segregation of duties.

Information and communication:

Information systems play a key role in internal control systems as they produce reports, including operational, financial and compliance-related information, that make it possible to run and control the activities of the organization. In a broader sense, effective communication must ensure information flows down, across and up the organization. For example, formalized procedures exist for people to report suspected fraud. Effective communication should also be ensured with external parties, such as members, customers, suppliers, regulators and other stakeholders about related policies.

Monitoring: Internal control systems need to be monitored, which is the process of assessing the quality of the system's performance over time. This is accomplished through ongoing monitoring activities or separate evaluations. Internal control deficiencies detected through these monitoring activities should be reported upstream and corrective actions should be taken to ensure continuous improvement of the system.

The policies and procedures of an organization are widely recognized as an essential component of internal control. The policies and procedures manual of an organization should include everything needed to implement accounting policies and procedures for increased internal control over your Finance, Accounting, Computer and IT, and Human Resources processes.

How to Develop Procedures to Support Internal Control

The process of developing, documenting and implementing organizational procedures to support the organization's policies and internal control should not be taken lightly. An organization's policies and procedures are the fundamental groundwork of the organization's internal control. It is important that each organization design, document and implement a sound internal control process.

Once your organization has developed and documented its policies and procedures to establish its internal control and the organization and the management team has implemented the policies and procedures that form the internal controls then it must also make the commitment to monitor the activities as well.

Failure to fully implement or implement haphazardly sends a message to employees that the controls are not important or even worse that policies and procedures only need to be followed when someone is looking over your shoulder. There needs to be only one message, which is internal control represents the policies and procedures of the organization and that they need to be followed to the letter of the law no matter what the circumstances. The tone from the top needs to be “do the right thing always.” However, there is one exception; if the policies and/or procedures are not working effectively then there needs to be a process in which a member of the organization can raise the question in a manner where their concern can be looked upon as a contribution to the organization.

What are the benefits of strong procedures?

- Reduce or eliminate misinterpretation of the organization’s critical policies and procedures.
- Feel more confident about covering legal issues like conflict of interest.
- Help an organization manage its fraud risk.
- Assert control over the organization’s assets.
- Help identify signals that raise the red flag when a policy or procedure needs to be changed.

There are several key things to consider in developing and documenting effective procedures and internal control for an organization.

Keep It Simple – Procedures should document the overall process being executed and the key internal control. It is not necessary to document every single step and detail of a transaction process. That level of detail information belongs in accounting work instructions or training materials. By including such low level minutia and details the procedures manual becomes overly long and confusing, which is a sure way to ensure that the procedures will neither be used nor followed.

Use Flow Charts and Graphics Where Possible – Graphics can illustrate the transaction process flow, inputs/outputs, and important relationships or risks that are not easily conveyed in text. We have all heard the saying that a picture is worth a thousand words; using graphics can improve simplicity and usability of an organization’s procedures manual, which can lead to better understanding of the transaction process flow and the internal control.

Be Consistent – Process transaction flows and procedures should be consistent in format and design, and especially the use of language and terms. Specific language and terms that are used in the procedures manual should be highly recognizable and familiar to the organization as a whole. If there are technical terms used, consider defining them in a glossary.

Maintain Them – Manuals need to be kept up-to-date. A change in the process means a change in the procedures manual; make sure that changes are documented in a timely manner.

Communicate – Procedures must be communicated to all affected parties through training, meetings or other types of communication or events. Then, regular internal reviews/audits are needed to ensure that personnel are aware of the accounting procedure and the process requirements.

A strong control environment set by the Board of Directors and the key members of the management team clearly sets the tone from the top for which there are several benefits, one of which is to clearly communicate the expectations and core values of the organization to all members of the staff, including volunteers.

Several questions that Board of Directors and members of the management team should be able to ask themselves are as follows:

- If someone outside the organization were to ask a member of the Board of Directors or/a member of the management team, what is the risk of fraud within the organization, would he/she be comfortable saying the risk is low? If not, why not?

- Does the Board of Directors and/or the members of the management team regularly consider whether there is anything about the organization and its operations that it would be embarrassed to read about – and know that its donors/members are reading about – on the front page of the local newspaper?
- The Board of Directors and/or members of the management team should identify risks specific to their organization. They should ask themselves the question: What could go wrong? Some of the areas that they should think about are as follows:

- Fraudulent financial reporting – Understand why/how financial information might be misstated. What motivation would someone have to misstate financial information?

- Theft of assets – Are there adequate safeguards and internal controls established and enforced to ensure that assets are not misappropriated?

It is not possible to take into account every procedure and internal control within the confines of this article, but we have included three areas that seem to come up on a regular basis.

Segregation of Duties

- There should be a policy and a process to ensure that all employees take vacation regularly, during which time their duties should be performed by others.
- There should be separate individuals involved in the initiation, review, and approval process of all key transactions and reconciliations such as the following:
 - Contributions
 - Cash receipts
 - Cash disbursements
 - Compliance with donor restrictions
- Government grants, especially: time records, procurement procedures, allowable costs, sub-recipient monitoring, and reporting
 - Purchasing (competitive bid requirements, conflict of interest consideration, etc.)
- Procedures to ensure that goods and services are provided only to those who have paid for them, i.e., admission to events (concerts, conferences, meetings, classes, dinners, etc.), sending of member publications, issuance of diplomas and transcripts, treatment in clinics, etc.
- Management should also give appropriate consideration to internal control over activities outside the financial function. Although such weaknesses are not directly related to financial transactions, they can result in severe financial consequences if not addressed (i.e. failures include control of human organ transplants to ensure proper blood type match, and misbehavior of organization staff/volunteers with respect to children).

Investment Management

- Each organization should have a formal documented investment policy that is reviewed by the investment committee on a regular basis, approved by the investment committee and the Board of Directors, and communicated to all advisors and managers.
- All investment managers and advisors should be vetted by the Investment Committee but approved by the Board of Directors.
- The Investment Committee should regularly monitor and review results of the actual investments as reported by the advisors and managers and compare the results to benchmarks established by the committee.

Information Technology

- There should be controls in place to restrict access (authorized and unauthorized) to equipment, programs, and data and define who is permitted access to what equipment and programs.
- There should be procedures in place to establish and monitor user passwords and ensure that they are changed regularly.
- Establish a disaster recovery plan to safeguard the organization's data and test the plan on a regular basis.



The design, implementation and operation of an organization's policies and procedures that make up the internal control system vary from organization to organization and there is not a one size fits all answer for what would work best in your organization. However, with careful planning and consideration of the concepts discussed in this article you will have a basis for designing an effective internal control system for your organization.

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