



Effective Internal Controls for Not-For Profit Entities

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ABSTRACT

The importance of internal control is clear. Effective internal control makes sure non-profit organizations to carried out their mission and objectives, such as proper use of funds and provide professional services to the public without any risk of fraud and mismanagement or breach of ethics. Through continuous monitoring of non-profit's performance and activities, internal controls dispose of the behaviors of non-profit organizations with their objectives.

Internal controls also engaged in good management and make sure to provide appropriate financial reporting by providing accurate and complete reports to the management in a timely manner and make sure the sources are correctly allocated. Internal control is also the tool to safeguard assets that make sure the organizations physical and intangible assets are protected from fraud, misused, and error. Internal control is not only able to deter and detect fraud and error but also is able to reduce the chance to risks.

Introduction

Internal controls play a major role in regulating the non-profit organization, and people do not want non-profit organizations misusing the public monies and governmental funds. In order to prevent the negative impacts of internal controls, we should have a clear understanding of governances and boards in a non-profit organization. Nowadays, people might have the confusion of roles of board and managers within the non-profit organization. Board members might have different functions in terms of profit and non-profit sectors. For non-profit sectors like charitable organizations, boards always have to match their best interest within their local communities. Many non-profits accept donations from the public or apply for grants from foundations and the government in order to operate service and programs. Thus, strong internal controls are needed for non-profit organizations especially when they are using public monies. These controls help to eliminate fraud and misuse of funds, and they play a major role in the accuracy of financial reports. Good internal controls also help non-profits reach an acceptable ratio between allocations for program support and expenditures for program activities.

Bottiglieri et al.(2011) propose since most NPOs fail to regulate themselves efficiently, the government and the Financial Accounting Standard Board must establish compulsory procedures and policies for nonprofits. COSO's updated internal control framework in 2013 shows that the board of directors should provide oversight for internal controls and the transparency reinforces accountability of the board.¹

For transparency, the most important thing is that financial statements should be available properly and timely. In the internal control system, the main purpose of the financial statement audit is making the organization cooperate with external auditors, providing an opinion about whether the entity's financial statements are presented fairly in all material and applicable to the financial reporting framework. In COSO's framework, the annual audit should also include the report of internal control about financial reporting and compliance with provisions of laws, regulations, and contracts.

¹ Jill M. D'Aquila and Robert Houmes, "COSO's Updated Internal Control and Enterprise Risk Management Frameworks", The CPA Journal, May 2014



For NPOs, compliance is especially important. Laws and regulations can often determine their mission and structure. NPOs are also subject to unique compliance and reporting requirements. For example, NPO must comply with relevant tax provisions to qualify for tax-exempt status. As clearly stated in the internal control framework, internal controls must first know about the rules, regulations, laws, and reporting requirements in order to ease the effects of risks associated with compliance and regulatory.

NPOs boards have the responsibility to protect stakeholder interests, communicate with the public, and establish trust-based relationships to generate additional resources. NPOs board can have a significant influence on the organization's performance and have a direct influence on the behaviors of managers and employees at the same time. Therefore, it is important to have an audit committee to evaluate the board. As a management tool, internal controls provide reasonably assume whether the management's objectives are achieved. So, internal controls have the responsibility of management. The relation between the audit committee and the NPO board extends the internal control's responsibility range, making it a significant role in internal management reports.

Control Environment

The control environment consists of four other components of internal control and it sets the tone for the internal control system. The control environment is made up of the management and governance of the entity and its integrity and ethical values" (32 Lynford) if the audit committee or management are not following the internal control procedures or are doing something they should not be doing, it sends a message to the rest of the employees and volunteers. A component within the control environment is management's ability to be on the lookout for red flags from lower levels and also to assign responsibilities to different people on different levels. Policies need to be put in place and enforced so that people can see that there are consequences for committing fraud or an "ethical breach" (34 Graham). If there are no policies or disciplines put in place then what is there to stop someone from doing something unethical? As discussed earlier in the management structure section, not all of the board members will have a financial background and this is part of the control environment. In order to prevent this from inhibiting the organization or allowing for fraud to slip through the cracks because the committee does not understand everything requirements should be put in place to prevent unqualified people from obtaining a seat on the committee. Accounting competence "places a cap on the effectiveness of financial information and communication" (38 Graham) such that if the management only knows so much accounting then they cannot create a clear and concise picture of the financials of that organization. Fraud happens when employees do not think they are being treated fairly or appreciated for the work that they do. This is where management and human resources come into play. If an employee is doing a great job and sees that another employee, with a worse work ethic than him, is being rewarded he might start to feel resentment and leave. Then human resources would have to find someone new to hire who maybe does not work as hard or do as good as a job as the previous employee.

Risk Assessment

Risk assessment is the organization's "identification and analysis of risks in the achievement of its objectives" (28 Graham). If a risk is identified then management can start from there and figure out what the best way is to manage this risk. Once again, management has to have an understanding of the organization's business processes to be able to identify where the risks are coming from. Information Technology (IT) is extremely important to risk assessment. IT security issues need to be accounted for in the risk assessment. The nonprofit needs to be aware of risks of exposure and have a consistent and reliable method to assess the risk(s) that are present (42 Graham). Some of IT controls are security and access, change controls, system development, and operations. These are all important to making sure that the IT data is safe. With all of this technology, it is easy to gain access to the books and records of the not-for-profit, so it is important to take these precautions to help assure that that does not happen. A part of risk assessment is outside threats. Not-for-profits need to be mindful of the situations that are happening outside of their walls that might have a negative impact on their organization down the line.

Control Activities

"Control activities are the processes, policies, and procedures that help ensure that management directives are carried out" (28 Graham). Management has to understand "how transactions are initiated, processed, and recorded" (47 Graham) to



understand the overall process and what is relevant to the business processes. Sometimes simple is better when it comes to internal controls. Having complex procedures can slow things down and can be more costly. Some procedures that should be implemented are the preparation of estimates and allowances, currency translation, and recording depreciation (51 Graham). An important piece of control activities is the “how”. How do the organization’s processes and procedures help ensure that their controls are working properly? To assure that their controls are working properly, they could use assertions. Assertions are used in this component to “consider the risks in accounts, transactions, and disclosures that are required in financial reporting” (55 Graham). Some examples of assertions are occurrence, completeness, accuracy, existence, and valuation and allocation. Control activities are put in place to make sure that their accounts are accurate.

Monitoring

“Monitoring is a process that oversees internal control performance” (28 Graham). Monitoring should be conducted throughout the finance period. It could be continuous or periodic (64 Graham). Monitoring in a small not-for-profit could be proven difficult because the different layers of people are blurry. This component of the framework should be applied to all of the other components to make sure everything is running smoothly and working how they should be.

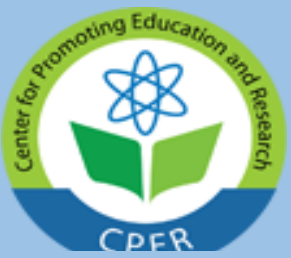
Accounts Example: To be more specific, the audit for cash accounts is similar to that of for-profit organizations. However, nonprofits have many more cash accounts. Often accounts are set up for several different programs, some of which are temporary. In addition, the funding sources usually require a separate bank account. Thus, accounts are closed more frequently than with for-profits. Also, many nonprofit organizations will allow banks to keep canceled checks. Therefore, modification of audit procedures is required to ensure the fair presentation of cash.

Receivables are another type of account that needs special attention from auditors of nonprofits. Nonprofits have two kinds of receivables: contributions and receivables such as membership fees. Contributions refer to nonreciprocal transfers of assets or settlement of liabilities. The assets transferred can be in the form of pledges, assets, securities, property, etc. For this reason, the nonprofit has a separate development office. Thus, there is a need to reconcile the records in the development and accounting offices. The main objective is that all cash contributions that have been received are properly accounted for. For that reason, contributions by check present a lesser problem.

As in audits of business organizations, confirmations are used to verify cash and check contributions. As far as pledges are concerned, special estimation techniques have to be employed by the company and verified by auditors. Moreover, a discount rate has to be applied to determine the present value of future contributions. Finally, auditors have to agree with the estimate of uncollectible accounts that is projected by management. As for the receivables in the form of membership fees, tuition, etc. they are considered reciprocal transactions and, thus, are accounted for in the same way as in the for-profit sector. The confirmations from third parties are still applicable, however, since they have a high degree of reliance. The only problem with confirmations in the nonprofit sector is that the response rate is very low. Individuals who owe money to the nonprofit are unfamiliar with the role of the auditor and the necessity to cooperate. Thus, alternative procedures might be applied.

A third special account is investments. The main guidance here is the pronouncement SFAS No. 124, Accounting for Certain Investments Held by Nonprofit. According to this provision, nonprofits should report equity and debt securities at fair value in the statement of financial position and all realized and unrealized gains and losses in the statements of activities. Moreover, investments should be reported as increases in net assets, along with the gains as increases and losses as decreases in net assets. If no restrictions apply, they should be included in unrestricted net assets. Otherwise, they should be considered as increases or decreases in permanently or temporarily restricted net assets.

Profit and nonprofit entities both have the same auditing of equipment and property. Before 1990, nonprofits fixed assets did not have to be depreciated. Now that the regulations have changed, establishing the cost of fixed assets may present a challenge to auditors. The accounting and auditing for expenses and other liabilities is also similar to that of for-profit organizations. Nonprofit organizations have two main types of expenses: program service expenses and supporting service expenses. Program service expenses are related to the direct and indirect costs incurred to provide the program and services that the nonprofit aims to provide. These would pertain to salaries, employee benefits, contractual services, etc.



Payroll and fringe expenses represent the biggest portion of expenses. Nonprofits, especially private schools, have to accrue liabilities for payroll for the summer months as well. Auditors should pay special attention to contracts with teachers, who usually render their services from September to June, but get paid for the whole 12 months. And as the school's fiscal year ends on June 30, all the salary expenses for July and August must be accrued as of June 30 in order to adhere to the matching principle of accounting. The same situation can be observed with nurseries, daycare facilities, etc. Audit procedures depend mostly on whether the workforce is stable or changes each year. When the personnel are relatively permanent, the auditor can use analytical procedures. It is important to verify whether there are proper accruals for expenses and fringe benefits if any apply. However, if the personnel are temporary, some more detailed work is necessary. Supporting service expenses would refer to management, fund-raising, and general expenses. The best approach here is to combine analytical procedures, using comparisons to prior years, and detailed vouching.

Another account that is audited differently from for-profit companies is revenues. The most significant part of revenues for NPOs is contributions and grants. Some NPOs have income from sales of materials or membership fees. Auditing of revenues can be accomplished by analytical procedures, as detailed in SAS No.56. Analytical procedures are used to determine how results are consistent with the expectations. Even simple calculations, rather than the use of complicated ratios, can assist in obtaining evidence. For example, if there are 1000 students at school, and the tuition fee is \$500 per person, then the tuition revenues have to be around \$500,000.

Lastly, matching costs present two challenges for an auditor: ensuring that the donated services or materials actually qualify under the terms of the grant and were actually used by the nonprofit, and determining the value of the donated materials and services. Usually, the funding source provides instructions for the valuation of the donations. For example, a nonprofit might be instructed to value donated clothes at thrift-shop value.

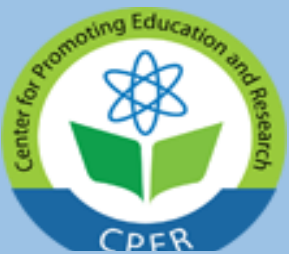
Thus, auditors need to understand the differences in conducting an audit for nonprofit organizations and that audit deficiency is not limited to profit-making organizations. As a matter of fact, there are three case examples that demonstrate what auditors have actually uncovered in external audits of nonprofit organizations. The three cases involve large, mostly government-funded organizations that have been established for several years, providing important services and support to society. Their role as non-profit organizations was in no way diminished by audit findings. However, it was crucial for all three companies to clear up their accounting records and maintain healthy reputations because in non-profit business, like in any other business, reputation is what brings support and funding.

1. Big Brothers Big Sisters

Big Brothers Big Sisters is a non-profit organization whose mission is to help children facing adversity. It has a measurable impact on youth. Big Brothers Big Sisters is one of the largest youth mentoring organizations in the United States and has served over 200,000 at-risk children from ages 6 to 18 since its founding in 1904. The organization is headquartered in Philadelphia but operates in all 50 states and in 12 different countries around the world. Since 2004, the Justice Department has provided \$68.4 million federal tax dollars to support Big Brothers Big Sisters. However, the Department of Justice reduced millions of dollars in federal grants due to failed tracked taxpayer funds it passed on to affiliates.

Although the Inspector General's report found no criminal wrongdoing and did not identify specific waste on a large scale, it was determined that most of the reporting problems were systemic accounting issues. One of these issues was that of mixing together grant funds that were intended for specific projects with general funds. This was a direct material non-compliance with the essential grant requirements. Additionally, the charity's books were such a mess that it was impossible to tell how nearly \$20 million earmarked for helping tribal, military and other at-risk adolescents was spent. Most of the money was so co-mingled with the group's general fund that there was no way to track whether or not it was used for unrelated salaries and expenses. The organization also did not monitor how affiliates handled taxpayer money passed down to them. As such, Big Brothers Big Sisters of America lost track of nearly \$12.6 million affiliates spent.

Furthermore, the report found that one unidentified information management consultant was hired outside the competitive bidding process and paid \$100 an hour, nearly double the allowable rate. Also, Big Brothers Big Sisters paid \$30,000 to Native American Mentoring consultants without any proper documentation of activities and expenses. The officials



for the charity pointed out that the audit did not find any instances of “intentional misuse or misdirection” of federal funds. T. Charles Pierson, who has been the CEO of Big Brothers Big Sisters since June 2012, claimed that there was no issue of missing money or fraud, just accounting procedures that needed to be fixed.

In the end, even though the audit findings did not necessarily point to intentional misuse of funds, the non-profit organization still needs to sort its accounting policies out in order to maintain public and government support. For organizations like Big Brother Big Sister, the reputation and public trust is the key factor to obtain funds and remain sustainable. The presidential and celebrity support that the organization has enjoyed throughout the years will quickly disappear if future audits do not show any improvement in accounting and bookkeeping procedures.

2. *May Institute*

Although independent audits serve an important purpose they rarely detect fraud. There is no guarantee from fraud when an independent audit or review of its financial statements is conducted. Independent audits only provide some certainty that an organization’s financial statements are free of misrepresentations. It is difficult for an independent auditor to detect fraud due to relying on the nonprofit’s representations about their financial position.

However, sometimes the facts are so overwhelming that it is impossible to ignore them as was the case with May Institute. This case is an example of power abuse and using an organization’s funds for personal reasons. Two years ago, the Massachusetts State Auditor Suzanne M. Bump had found that the longtime head of a Randolph-based nonprofit, Walter P. Christian, collected a six-figure salary.

The non-profit, known by the name of its founders as May Institute, provides services to people with autism and other disabilities. It was the “first school for children with autism founded on Cape Cod in 1955 by Dr. Jacques May and his wife, Marie Anne. Two of the school’s first students were May’s twin boys. Little was known about autism at the time, and children with autism were typically institutionalized for life.

Unfortunately, a school with such a noble mission was not immune to gross violations of funding. Bump’s audit had found that the May Institute used state funds to reimburse its former president and chief executive, Christian, for nearly \$140,000 in personal expenses. More than \$150,000 of Mr. Christian’s salary and benefits failed to be reported as taxable income to the state Department of Revenue and the Internal Revenue Service.

According to the audit, the May Institute reported annual revenues of more than \$100 million and described itself as one of the largest providers of services to people suffering from autism in Massachusetts and the United States. It provided services to 8,500 individuals and families through programs in 14 states and employed 2,000 people. Overall, during 2009-2011, the organization billed the state nearly \$350,000 for benefits and salaries that the organization was not entitled to receive.

In 2010, Massachusetts had capped annual salaries for managers of social service providers at \$144,000 and in 2011 at \$149,000. According to the audit report, The May Institute found its way around this rule by reporting that some executives were clinicians and padding their salaries accordingly. It was unclear how long the organization might have been overcharging the state since the audit only looks at the first two years of the May Institute’s operations.

One critic of the state’s decades-long effort to privatize services to the mentally disabled, Thomas J. Frain, said that the state’s ability to allow for the millions it is spending on private service providers raises many questions.

“Is this really what people in the Commonwealth intended when they privatized these services?” said Frain, president of the Coalition of Families and Advocates. “We have the head of a very large organization being paid all this money by the Commonwealth and living very far from the Commonwealth. What was he doing to justify his salary?”

After an extensive audit inquiry, Christian along with the May Institute’s treasurer and the chief financial officer was replaced. The non-profit, however, had insisted that it was just a coincidence and was not related to auditor’s findings. The outcome of Bump’s audit was that the May Institute promised to review the audit findings and if it was determined that it needed to repay the state the organization, it would consider doing so. Going forward, the auditor was also promised that the organization would be made unspecified “significant changes” to prevent problems with executive compensation, “including



the implementation of tighter controls and reporting standards.”

3. Maricopa Community College District

It is almost a fact that the non-profit sector is often more susceptible to fraud and abuse than many for-profit enterprises. One of the reasons for this unfortunate reality is their environment of trust, which is unlike that found in for-profit enterprises. In order to prevent fraud, it is important to understand the fraud committed against the not-for-profit and the fraud committed by the not-for-profit. Typical examples of fraud committed against non-profit organizations include, among others, the payroll schemes or as defined by Eisner Amper “continued payment of terminated employees, overstatement of hours, or fictitious expenditure reimbursement.”

Sometimes it is more difficult to correct fraudulent or improper practices than it is to uncover them. This may be because of the consequences that it might have on the third parties evolved. The perfect example of such an assertion is the Maricopa Community Colleges District audit finding and its outcome on the employees involved.

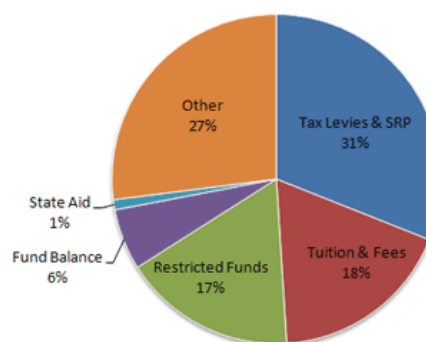
In 2009, a state audit found at least 22 employees to be misrepresented as district employees and was allowed to enroll in the state retirement system. The district had placed employees of education non-profits on its payroll. The district accepted reimbursement from the employees' non-profits. The arrangements carried benefits for both the nonprofits and its employees: retirement plans were provided to small non-profits and the college district gained workers. The issue was uncovered after receiving a tip. However, Maricopa district officials denied any wrongdoing and said the practice was above-board, legal, served the public and benefited all parties involved. Although the arrangements were undone since the findings of the Auditor General's Office jeopardized the employees' retirement benefits and triggered lawsuits.

Maricopa Community Colleges District consists of 10 colleges, 2 skill centers, and numerous education centers. Each college is individually accredited, yet part of a larger system - the Maricopa County Community Colleges District, which is one of the largest providers of higher education in the United States. According to its website, the annual tuition is approximately \$2430 or \$81 per credit. The school's major revenue sources are as follows:

Funding

Revenue Sources - All Funds (*FY2012-13)

Tax Levies & SRP	\$481,711,831
Tuition & Fees	\$287,898,318
Restricted Funds	\$274,216,443
Fund Balance	\$90,076,539
State Aid	\$8,315,700
Other	\$427,792,949
Total	\$1,569,711,780



Source: *Funding, About*, Maricopa Community Colleges, retrieved on July 28, 2013, <http://www.maricopa.edu/about/?funding>

As seen above, the state aid is the least source of income for the District, yet the most problematic one when it comes to the employee retirement plan. Non-governmental employees are not allowed to participate in the retirement system. Nonprofits must get permission from the retirement system although the state allows for exceptions. The auditors had discovered that the district never sought such permission. It was also determined that the practice was a loan of public money to corporations and a violation of the Arizona state constitution.

The Maricopa district's chancellor, Rufus Glasper, disputed the audit's findings, saying that the employees were "externally funded" district workers and that the nonprofits provided the district significant benefits. He called the findings "one-sided" and asked for a review by outside auditors "without an agenda." George Graham, manager of the auditor general's



investigative unit, said it was hard to say whether similar arrangements with non-profits were widespread because it was not something that would jump out at state auditors in routine audits.

In the end, the District had ended its arrangement with two of the three nonprofits when "it became very clear the auditors felt it was an improper loan of money." Those employees whose retirement plans were subject to audit scrutiny, however, threatened with lawsuits against the Maricopa District and the Arizona State Retirement System.

As the above example proves, audit findings are not always a celebration of justice. Correcting one actuarial, accounting or bookkeeping issue might cause someone's retirement or health benefits to be lost. Essentially this might trigger more complications for non-profits. One way out from such a scenario is to have a thorough research of local and state laws as well as a good understanding of specifics of non-profit accounting as well as proper oversight of the financial reporting process.

Internal controls are procedures and policies used to allow the reliability of accounting systems. The way to implement and manage the internal controls also involved with monitoring the internal financial controls. First of all, every non-profit organization should clearly state the procedures and instructions for monitoring assets. This means that on-profit organization should record every transaction that records any receive of asset and any expenditures of the asset. In other words, these financial reports should be described in an accounting policies and procedures mechanic. The mechanic should be reviewed with and distributed to all internal and external people including directors and officers, trustees, employees and volunteers.

There are several examples of policies and procedures of internal controls. First, general entry-level controls by providing an annual income and expense budget and periodic reports (quarterly or monthly) in order to compare the actual receipt of the asset and actual uses of the assets to the budget. Second, information technology general controls are a faster way to effective controls. It first gets access, input and change electronic data sustain by the organization; then save the electronic records when systems change and creating a record in order to provide procedures for approving securing competitive bids from vendors.

In order to control the financial procedures of the non-profit organization, the organization should establish specific permissions or requirements for authorizing all expenditures. There are many non-profit organizations that required at least two signatures when organizations were making a purchase. It is a "must-have" step to prevent fraud. And it provides limited control with the previously authorized amount of money spend for any vendors.

Third, here comes the most important component of internal controls: segregation of duties. Required action by more than one person or department is essential when the organization was conducting any receiving and expanding financial transactions. In other words, this segregation of duties produces checks and balances prevent fraud and error. Especially for organizational functions such as payroll, it is important to provide separate records and documentation from the authorization of the cash receipt and expenditures. With this strict and effective control, the authority to issue paychecks or process payroll data cannot be done by the person or department that authorizes employment. Thus, the authority is not centralized and prevents fraud.

Fourth, non-profit organizations should be familiar with Sarbanes-Oxley Act since it protects the general public from fraudulent practices and accounting errors. In addition, the non-profit organization should create procedures for handling employee complaints ensures that no punishment and fines for reporting problems. Examples are including firing, sexual harassment, and discrimination.

Fifth, revenue should accurately record. In other words, any grants and contributions received should be correctly recorded. Accountings for non-profit organizations required to report whether any contribution received are completed and restrictions on the use of such funds, including building, scholarships. And any temporal restrictions contribution the organization should clearly distinguish from permanent restrictions.

Sixth, purchasing, and accounts payable are also important in internal controls. According to the article, "the activities including requisitioning, authorizing, verifying, recording and monitoring all expenditures, including payment of invoices, petty cash, and other expenditures". This means any of these activities should not be done by a single person that request, authorize, verify and record expenditures at the same time. It will also prevent the conduct of fraud and error.



When we speaking about internal control of non-profit organizations, we also mean the internal control of the board of directors, employees, and volunteers. In other words, the internal control should be involved with any person that is in that specific non-profit organization.

Regardless of their perfect or imperfect composition, audit committees are very important for the success of nonprofit organizations. “Success for not-for-profit organizations, regardless of their type or size, is built on a firm foundation of fiscal accountability and governance” (AICPA). The audit committee should help oversee the financial reporting process, be aware of accounting principles that are used, review annual financial statements, and oversee internal controls in the accounting process. Thus, by carrying out all of its responsibilities, the audit committee helps the nonprofit create the image of fiscal accountability that is so necessary to its success.

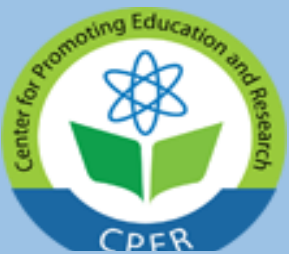
One of the major responsibilities of an audit committee is to oversee internal controls set in place by the board of directors. This function of audit committees is particularly important because nonprofit organizations are known to have weaker internal controls than for-profit companies. Two examples of control weaknesses that nonprofits suffer from are improper separation of duties and inefficient oversight of financial reporting. Many smaller nonprofits suffer from a lack of funding and thus cannot afford to staff as many employees as needed, requiring one employee to take on many aspects of a single transaction cycle. This results in the employee having much more authority in that particular area than would normally be the case, leading to improper separation of duties. This can also occur in larger nonprofits if one employee takes an extended leave of absence, requiring another to take on multiple roles in the same transaction cycle. The lack of segregation of duties may allow a material misstatement to go unnoticed or allow misappropriate assets to occur.

Audit committees play a critical role in overseeing the organization’s compliance with laws and regulations that govern billing, spending, and investing practices. Most non-for-profit organizations must follow the regulations that dictate how they execute their procedures and what information must be conveyed to regulators. In general, non-for-profit audit committees should focus its efforts and responsibilities in the following areas:

- *Integrity – is vital to the organization’s financial statements.*
- *External Auditor Evaluation – qualifications, independence, and performance of the external audit firm should be evaluated by the audit committee.*
- *Compliance – this is the oversight of the organization’s compliance with various legal and regulatory requirements.*
- *Review of IRS Form 990 – members of audit committee review Form 990 and share responsibility with management.*
- *Confirming that the organization complies with laws and regulations and its policies and procedures.*
- *Determining that a record retention policy is adopted and implemented Ensuring that conflict of interest and code of ethics policies are adopted and implemented.*
- *Verifying that the whistle blowing procedures are in place.*

In order to make the audit committee fair and efficient, all of the audit committee members should be independent of the organization’s management. The members should not be employed by the organization nor offer services in exchange for compensation from the non-for-profit organization. Also, the board treasurer is not allowed to join the audit committee since the treasurers, which are in charge of the organization’s financial situation, have conflicts with the role of the audit committee member, which is responsible for overseeing the organization’s financial situation. Similarly, the role of the audit committee member also may have conflicts with the finance committees and investment committees. When the overlaps cannot be forbidden, the board should guarantee that the overlap only happens on the minority of audit committee members.

At least one of the committee members should be a financial expert so that the committee can deal with the kinds of financial issues professionally and accurately. Generally, the financial expert in normal corporations should be knowledgeable and experienced in both financial reporting and internal control. For not-for-profit organizations, since non-for-profit organization accounting has many differences with the for-profit corporation on both accounting principles and procedures, the financial expert in the audit committee should also be familiar with the specific requirements and procedures for the non-for-profit organization. On the contrary, the organization cannot only be composed of financial experts. The organization should try to make the audit committee composed of people with different backgrounds. Even though a financial expert is significant,



people who are familiar with the industry and people who have rich working experience can bring different perspectives, which may be ignored by the financial expert and significant for the organization's development.

There are also requirements for audit committee members' skills. Not-for-profit organization's audit committee can be considered to be effective and efficient with the following characteristics:

- *I have knowledge and experience in business and finance.*
- *Be familiar with internal controls.*
- *Have the ability to read and understand financial statements.*
- *Know what risks are involved.*
- *Understand unique requirements and issues to the organization.*
- *Keep a healthy skeptic.*

Accounting software is extremely helpful and crucial to proper accounting controls for a non-for-profit organization. The data being entered is the most important part otherwise none of the reports being generated will be accurate. Therefore, the checks and balances approach will not work. Many not-for-profit organizations have enterprise risk management (ERM) software which has both accounting and administrative functions. The board of directors whose role is to manage the commercial and ethical operations of the company can access the ERM where they can view the company's operations and books.

Compliance with the Sarbanes-Oxley Act of 2002, P.L. 107-204, is the first thing that needs to be in place in a not-for-profit organization, even if there are only some provisions that actually apply to the not-for-profit sector. The main two provisions that apply to not-for-profit organizations are the following: (1) it is a crime to retaliate against an individual for providing law enforcement with information on a federal offense; and (2) it is a crime to destroy or forge documents and/or records in order to obstruct an investigation by federal agencies (Murphy, 2015, p.79). In addition, the Independent Sector's Panel on the Nonprofit Sector has recommended the following on fraud prevention: (1) a requirement of independent directors; however this only applies in three U.S. states; (2) no personal loans allowed to executives or board members; and (3) individuals barred by the SEC cannot serve on the board of a not-for-profit (Greenlee et al., 2007, p. 689). Aside from this, there are also other controls that can be utilized to prevent and detect fraud. You can use accounting controls to prevent the abuse of authority by people on the board or by executives, and segregation of duties can be implemented in order to make sure no one has full control of an entire transaction. This can be done through the independent review of reports and other financial documents by a supervisor or outside accountant, or by having a centralized recordkeeping, where fiscal records are kept in a safe place and a few employees are given controlled access to sensitive information and company records (Murphy, 2015, p. 82). Nonetheless, people can still bypass the accounting controls in place, or the organizations are so small that it becomes hard to apply all segregation of duties, so they can still be able to carry out fraudulent activities. For this reason, just implementing the right policies and regulations in a not-for-profit organization is not enough. Some other suggestions that could help an organization lower their risk of fraud are through background checks for all employees, as well as researching fraudulent charities and possible individuals who have been involved in fraudulent activities before (Greenlee et al., 2007, p. 691).

Another way in which not-for-profit organizations can protect themselves against fraud is through insurance. They can invest in surety bonds or insurance in the event that fraud does occur and they need to cover their losses. However, in order for organizations to acquire insurance, the insurance companies require that the not-for-profits have someone else, aside from the treasurer, review the financial statements, and perform an annual audit, which further helps as another control to lower their fraud risk (Greenlee et al., 2007, p. 689).

Back in 2010, a financial officer of a Kid House of Seminole was arrested and charged with stealing over \$14,000 of the firm (Taylor). He had altered a bank statement by inserting copies of other checks. Meanwhile, he had created eleven checks under his name. According to the Investigator, one of the responsibilities of Oliver was to receive the monthly statement and review the revenue and expenses for auditing (Taylor). From the moment that Oliver had access to write checks and reviewing the expenses and revenue, the charity unknowingly allowed him to have the authority of manipulating the



records. By having access to the physical custody of the checks and statements, he can easily justify the expenses in favor of his interest. This could have been avoided by implementing the principle of segregations of duties. If another employee had reviewed the bank statements, they could have detected earlier the misuse of funds.

A different principle is the independent internal verification which is defined as, "... the review, comparison, and reconciliation of data prepared by employees (CSUN). It helps to reconcile the accounting records with the actual assets. Sometimes it is done through an employee that is not related to a determined process. For example, a shift supervisor makes sure that the register has the same amount recorded. Another way of verification is through internal auditors. These auditors are employees that review and evaluate regularly that the internal controls are being applied. This is also recommended by Andrew Cuomo, who states, "[That what is] crucial to the governance of a not-for-profit organization is the establishment of an audit committee" (8). The document specifies that the committee must be made of a member of the boards who have not financial interest in the organization and have knowledge of accounting. The author McMilliam claimed that the audit committee of a not-for-profit organization, "...[provides] your board with another level of assurance that the organization's financial affairs are being managed effectively" (63).

Even though the committee elects the external auditors, they should also know about finances. When the committee does not demand or reviews financial reports, it makes it easier for employees to take advantage of the resources. This occurred at HiCaliber Horse Rescue where members of the board claimed they never saw accounts statements or checkbooks to know how the funds were used (Rubin). Currently, the founder, Michelle Knuttila, is being charged with donor fraud and animal cruelty which has wrecked the company's reputation. What is most surprising is that the board has failed to review or question what is going on in the organization.

The next principle is documentation procedures. It shows documents that can confirm the transactions or occurrences taken place. In an article, it declares that "Documents should be prenumbered and all documents should be accounted for" (CSUN). By prenumbering the documents, it avoids duplicate entries. Also, documentation, when possible, should require a signature to identify the responsible for the transaction. Later, all documentation should be sent to the accounting department to record the transaction accurately and reliably (CSUN).

An additional principle is physical controls. These are used to keep safeguard assets. In an essay, physical controls are described as, "... electronic or mechanical controls (such as safe, fireproof files, and locks) or computer-related controls dealing with access privileges or established backup and recovery procedures" (Basic Principles of Internal Control). It is essential that a not-for-profit organization periodically count their inventory to match their records. As well, they must make sure that their physical controls such as alarms are working correctly and are up to date.

Conclusion

Internal controls are an essential thing for a healthy non-profit organization to survive and succeed. Any person that is working in a non-profit organization will be preventing fraud and error since the non-profit organization provides a not centralized system when conducting the transactions. Segregation of duties and policies and procedures that each individual workers needs to follow also eliminate the misuse of funds and prevent the fraud. As we know, governance plays an important role in a non-profit organization. The effectiveness of governance determines the success of operating a non-profit organization. Governances in non-profit involve different strategies and policies in which employees have to follow them. Furthermore, boards of directors owe their fiduciary duties to the non-profit organization. In other words, the board of directors should not put their self-interest ahead of the organization's interest. Also, they should not self-deal any transactions that would harm the organization. Some elements of fiduciary duties for the board of directors can be indicated as the duty of care, obedience, and loyalty. These fiduciaries' duties allow the board of directors to pursue the best goals for the company and help chief executives to operate and manage in the corporation. Within the board of directors, audit committees are important for running non-profit organizations. It provides an independent audit for the board of directors to make further financial decisions and directions in the corporation. Internal control procedures start with the administrative team that works for the organization and how they are monitored and assisted. This team needs to be very detail-oriented in the daily work procedures in order to provide the organization with the accurate and up to date information needed to stay compliant with the laws and regulations.



Accounting software has an important role as well, as mentioned above. This software has to remain up to date and monitored by management as well as outside tech companies to ensure there is no breach internally or externally.

The results from the paper have demonstrated that internal controls make a significant contribution to NPO, not only in financial performance but also the financial management processes. But organizations are different and will have varying requirements, so, the best internal control is matched each different organization with the objectives and resources. The suitable internal controls will help to make the organization safe and efficient, thus make the good to the people as a whole.

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