

Internal Controls: Case Studies & Best Practices



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10+ years experience

Focusing in Not-for-Profits



Course Objectives

- ▶ Types of audit findings that can occur and how they're defined
- ▶ Common internal control findings in Not-for-Profits
- ▶ Best practices utilized in the industry
- ▶ Implementation of best practices of internal control procedures





Internal Controls and the Audit

- ▶ Reported through a separate letter or presentation in connection with the audit
- ▶ No opinion is expressed on internal controls
 - Obtain an understanding in connection with the audit procedures
- ▶ Communicate any deficiencies to those charged with governance.



Types of Internal Control Findings

Definitions and Impacts

Types of Internal Control Findings

**Material
Weakness**

**Significant
Deficiency**

**Other
Comment**



Internal Control Deficiencies

Material Weakness

- ▶ A material weakness is a deficiency, or a combination of deficiencies in internal control, such that there is a reasonable possibility that a material misstatement of the financial statements will not be prevented, or detected and corrected, on a timely basis.

Significant Deficiency

- ▶ A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.





Other Comments

- ▶ Not considered a deficiency under the definitions of material weakness and significant deficiency
- ▶ Suggested best practices
- ▶ Can be included in the letter or verbal recommendations

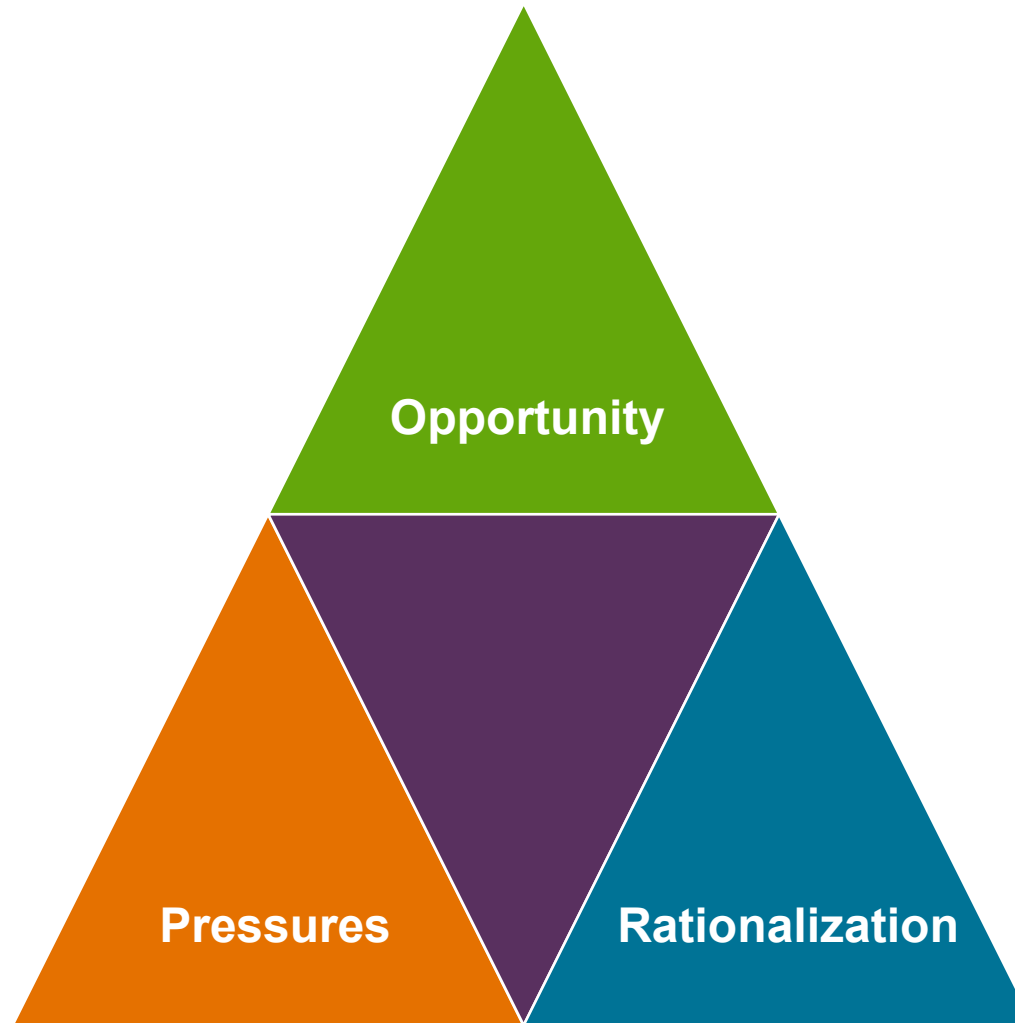
Why do internal controls matter?

A lack of internal controls can create an opportunity for fraud to occur.

The Association of Certified Fraud Examiners (ACFE) estimates that Not-For-Profit organizations sustain annual fraud-related losses of \$77 billion, with the median loss being \$150,000.



Fraud Triangle



Fraud at NFP Organizations

Executive control typically given to founder or executive directors

Volunteers may not have training or may be ignorant to the controls in place

Contributions are non-reciprocal in nature, which makes them easier to steal (versus exchange transactions)



What's the worst that can
happen?



Fraud in the News

- ▶ Accountant stole more than \$841,000 over six years from two employers
- ▶ Forged over 200 checks
- ▶ Recorded fraudulent checks or inaccurately recorded the checks with fake payees

Obtained from AP News, May 21, 2019





Fraud in the News

- ▶ Soccer Club treasurer stole \$120,000 of funds from the club's bank accounts
 - Most of which was funded through the children's parents so they could play in the club
- ▶ He was responsible for all cash transactions at the NFP
- ▶ His lawyer said that when his client lost his job working on Wall Street, he began making loans to himself from the club's account.

Obtained from the New York Times, July 7, 2016





Fraud in the News

- ▶ Rowing Association that used a volunteer to balance the books, write checks
 - Cheerfully took on the thankless and unpaid task of tallying up cash collected from parking and concessions at more than 100 regattas
- ▶ Over years, thousands of dollars had been spent on personal expenditures, and thousands more drawn out in cash.
- ▶ Should have been \$200,000 in the bank accounts, there was less than \$16,000.

Obtained from the Washington Post, Oct. 30, 2013



Common Findings

And Best Practices to Implement

Lack of Segregation of Duties

Typically the most common finding for NFPs, especially in smaller organizations

Occurs when functions are performed by one person and controls and checks by another person are not in place.



Why does it matter?

*When segregation of duties are inadequate, there is an **increased risk that fraud or errors could occur and go undetected.***



Best Practices to Implement

- ▶ Separate duties when possible
 - Especially between the functions of receiving or disbursing cash and then recording those transactions.
- ▶ Ensure controls remain in place in times when an individual involved in the control process may be absent.
 - Set a plan for when someone is out on PTO for how that control will continue.





Best Practices to Implement

- ▶ The person that receives the mail should not be the same person that records that information in the accounting system.
 - For example, the receptionist could open and create a list of any cash receipts received on a log or journal.
 - A separate person would post the activity to the general ledger and reconcile the deposit to the list of receipts from the receptionist.



Best Practices to Implement

Cash and checks should be deposited daily

Receipts from the deposits should be reconciled to the log that was created when the money was received.



Best Practices to Implement

Supporting documentation for disbursements should be reviewed and approved before a check is issued.

For recurring, normal transactions, supporting documentation should be periodically reviewed as a spot-check.

Signed checks should be mailed and not returned to the employee responsible for accounts payable.



Best Practices to Implement

Checks over a threshold should require at least two signatures.

Expenses for executives that typically approve disbursements should be approved by someone else, like a board member.



Best Practices to Implement

Bank reconciliations should be timely, and be reviewed and approved by a separate person.

Unusual and old items should be investigated.



How to Document Controls

and why it matters

Ways to Document Your Controls

Narratives

Write out your processes and the controls in place. Be clear on how things should be handled start to finish and who is responsible for preparation vs. review.

Checklist

Create a monthly close checklist – with spots for the team to sign off when tasks are completed.

Cover Sheets

Create a cover sheet for things like journal entries. Document the preparer sign off, approval, and allocation. Include the support behind the cover sheet in your files.

Expense Forms

Use an expense form to document disbursements and the approval of the expenses, or have the approver sign off on the invoice itself.



Contributions and Net Assets



Ways to Document Your Controls

General Ledger

Keep your different types of contributions and grants separated in the general ledger.

Releases

Implement a control process for releases from restrictions – showing review being completed to ensure the restriction was met.

Cover Sheets

Document restrictions noted on your control sheet and document how it was recorded in the accounting system.

Agreement

Use the agreement itself and highlight the various restrictions or conditions.



Information Technology

Most common finding relates to the access of the Organization's accounts and systems.



Best Practices to Implement

Implement Password Requirements

- Require for access
- Have an expiration period
- Require length and complexity
- Account lockout
- No shared accounts



Best Practices to Implement

Other Best Practices

- Perform periodic assessments of the IT environment
- Consider using a third party to look for security gaps
- Maintain segregation of duties related to IT system and administrative rights



Financial Reporting

Most small organizations rely on their auditors to draft the financial statements and disclosures.



Best Practices to Implement

Oversight of Financial Reporting

- ▶ Involve management and the board in the in drafting the financial statements and execution of the audit.

Stay Educated

- ▶ Attend classes, especially on new and updated standards, to gain an understanding of what is required to be reported.



Improved Control Environments

Example



Background Information

Small NFP with staff of 10 people

Most functions over cash and reporting were performed by the Executive Director

Had a recurring significant deficiency for the lack of segregation of duties



Changes Implemented

Cash Receipts

When checks are received they are added to a cash receipts log by the receptionist who opens the mail.

Reconciliation

Deposit slips are reconciled by the finance accountant to the cash receipt log the receptionist created.

Recording

Amounts are recorded when approved by the executive director.

Statements

Unopened bank statements go to the executive director.



Changes Implemented

Expenses

Payments require support and approval using an expense reimbursement form.

Check Signing

Reimbursements to the executive director require approval by a board member.

Large Checks

Checks over \$2,500 require a second signature by a board member.



Financial Reporting

- ▶ Monthly packages sent to the board
- ▶ Review of package is documented
 - Executive Director
 - Board
- ▶ Checklists implemented as part of the monthly close process

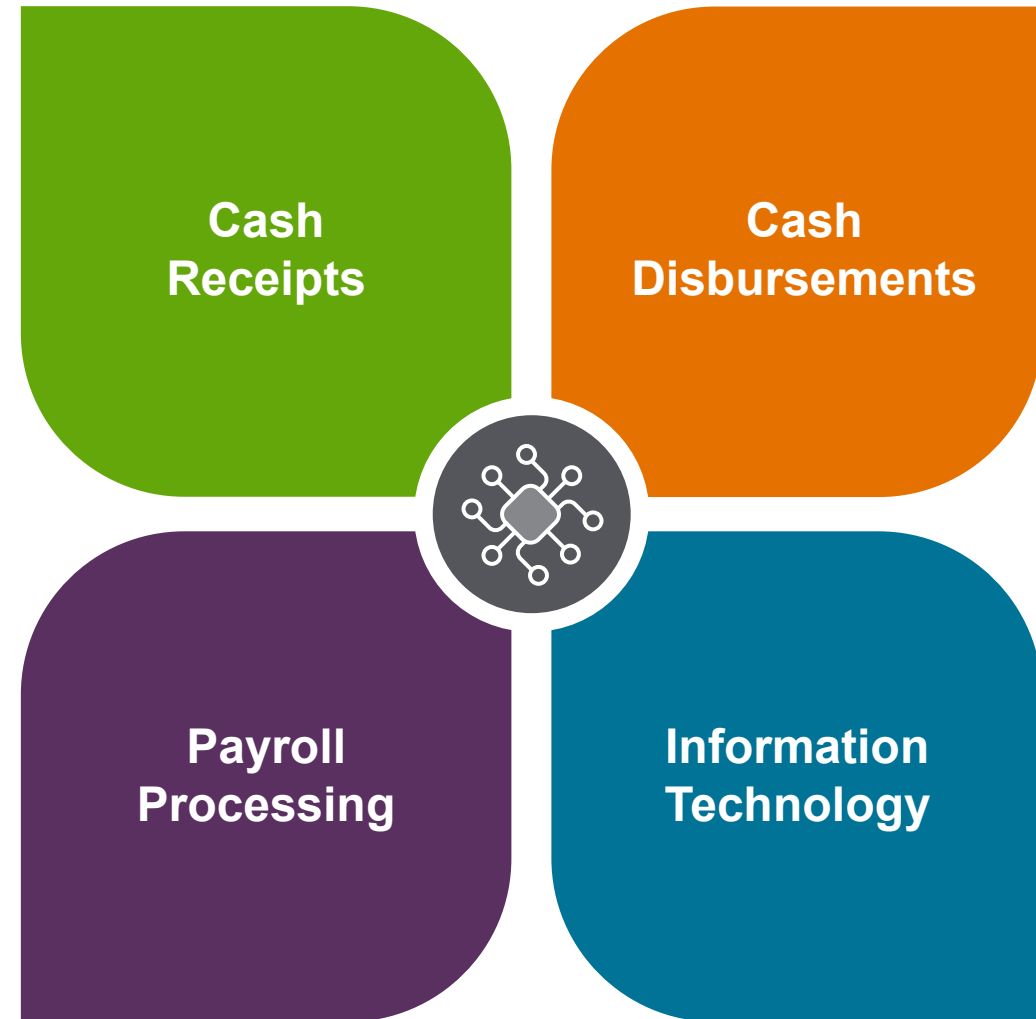


Next Steps



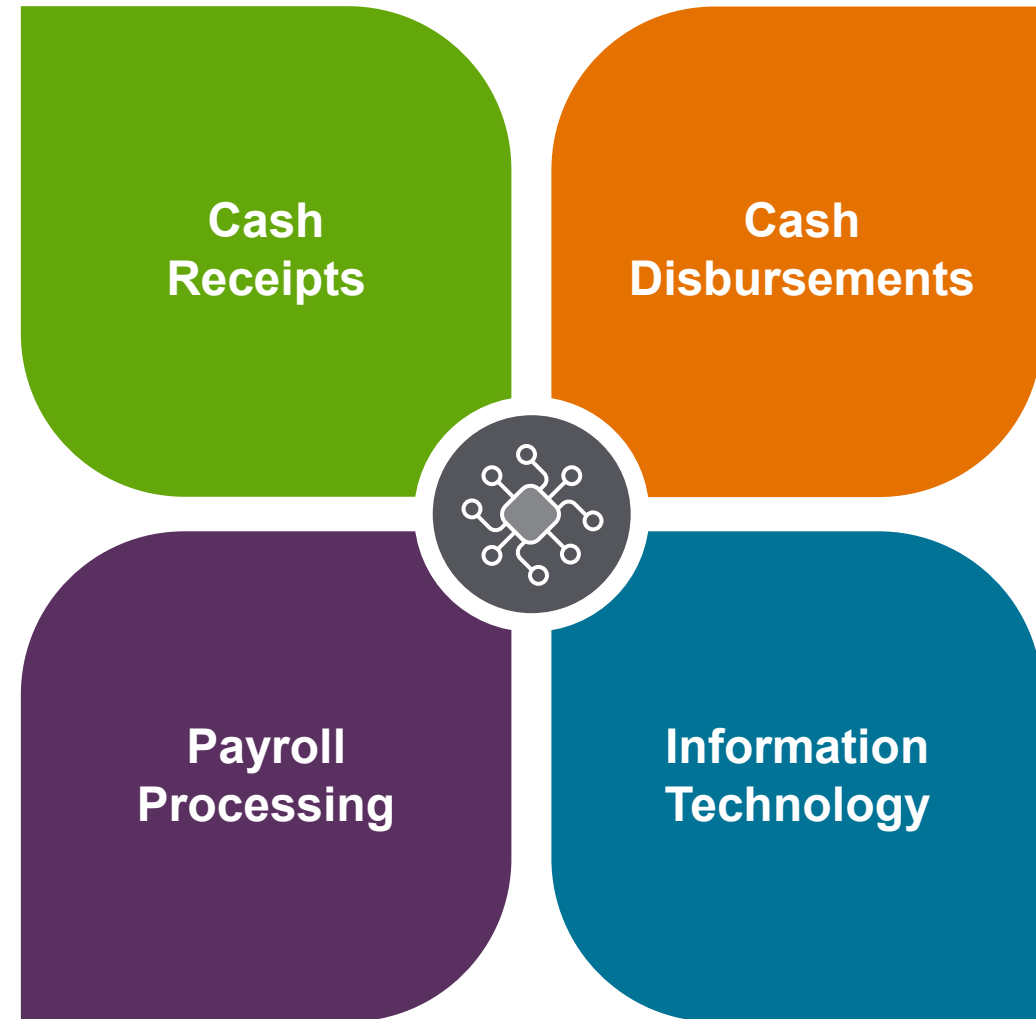
Where to Begin

- ▶ Summarize the procedures currently in place.
- ▶ How are checks and disbursements processed?
- ▶ Who receives cash? How and when is it deposited?
- ▶ Who records activity in the accounting system? Does anyone review the entries before or after they are posted?
- ▶ Who has access to systems?



Checks and Balances

- ▶ Use the best practices as guides for separating duties and creating controls
- ▶ Create a formal process to follow – and document it!
- ▶ Use a checklist to document the processes completed



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Questions

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