

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. IMPLEMENTATI

- 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 is 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.

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 review

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.

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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.