

# IV. ACCOUNTING

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Effective Date: April 21, 2008

## E. INTERNAL CONTROL SYSTEM

Management of a not-for-profit organization is responsible for establishing and maintaining a system of controls, consisting of policies, procedures, and methods, which provide reasonable assurance that the following specific objectives will be achieved: reliable operational and financial data; safeguarding of assets and records; operational efficiency; and compliance with managerial policies and applicable laws and regulations.

Set forth below are a number of control objectives which should be incorporated into the system of internal control.

- 1. Transactions, as recorded, are reasonable. Any transaction that appears to be unreasonable or out of the ordinary should be investigated.**
- 2. Recorded transactions are valid. The system of control should not permit invalid transactions to be posted to the accounting records.**
- 3. All transactions are properly authorized. The control system should identify unauthorized transactions which then should be investigated.**
- 4. Existing transactions are recorded. The control system should identify all legitimate, actual transactions and ensure that they are recorded in the financial records.**
- 5. Transactions are properly valued. Procedures must be in place to detect errors in recording and summarizing the value assigned to a transaction, including mathematical and clerical errors.**
- 6. Transactions are properly classified. Internal control procedures must ensure that each recorded transaction is properly classified so the financial statements will be properly stated.**
- 7. Transactions are recorded at the proper time. Procedures must be in place to ensure that transactions are recorded in a timely manner and in the proper reporting period in order to provide accurate financial information for the unit.**
- 8. Transactions are properly included in subsidiary records and correctly summarized. The internal control system must provide for accurate summations of transactions and ensure that subsidiary records are correctly updated.**

In order for the above referenced control objectives to be accomplished there are certain features vital to an effective control system.

### **1. Competent, trustworthy personnel with clear lines of authority and responsibility**

a) The human factor is the most important element of any system of internal control. Dishonest or incompetent employees can render almost any system of internal control useless. Backgrounds of applicants should be checked thoroughly.

b) Well defined job descriptions and a detailed organizational chart are other means of improving personnel adherence to the internal control system. Employees perform better when they know what is expected of them.

### **2. Adequate segregation of duties**

There are four elements of proper segregation of duties:

a) Segregation of the control or custody of assets, including cash, from the accounting function.

b) Segregation of authorization of transactions from custody of related assets. This element of segregation helps to prevent fraud. For example, not allowing staff members who authorize the hiring of new personnel to distribute paychecks.

c) Segregation of duties within the accounting function. One person should never be responsible for recording a transaction from its origin to its posting to the general ledger. Posting to the journals should be separate from posting to the related subsidiary ledgers.

d) Segregation of operational responsibility from recordkeeping responsibility.

### **3. Rotation of duties**

Job duties should be rotated within an organization on occasion, preferably on a surprise basis. This will reduce the likelihood of fraud since employees are aware that, at any time, another employee could be given their work assignments or tasks, and therefore may detect fraud being committed. Job duties should also be rotated when employees are on vacation. In this regard, all employees should be required to take vacations, with persons in finance or cash-handling positions required to take several consecutive days off at some point during the year.

This practice helps to detect lapping, which is the postponement of entries for the collection of receivables in order to conceal an existing cash shortage.

### **4. Bonding**

Bonding protects an organization from loss should fraud or a misappropriation of funds be committed by a bonded employee. The finance officer should be bonded for at least \$10,000 and not more than \$250,000. Any employee who has custody of more than \$100 or has access to inventories also must be bonded for an amount to be determined by the governing board.

### **5. Supervisory review of records**

A supervisory review of records serves as an internal check of records and transactions. A thorough review of records serves to detect fraudulent activity and unintentional errors. The timeliness of the review is extremely important to its effectiveness. Supervisors must be thorough and knowledgeable in the area they are reviewing.

## **6. Proper procedures for authorization**

Clear and concise lines of authority for each transaction are essential. This authorization may be general or specific. For example, a purchasing clerk may have general authorization to purchase office supplies up to a certain dollar limit. However, where the purchase of fixed assets is concerned, a specific and individual authorization should be required.

## **7. Adequate documentation**

Adequate documentation is essential to a good system of internal control. Fraudulent activity is deterred if substantial documentation is required to initiate and complete a transaction. Errors in recording transactions can more easily be detected if adequate documentation exists. Good documentation also helps ensure that all transactions have been properly authorized.

a) Well designed and properly used documents increase the effectiveness of internal control. Whenever possible, documents should be prenumbered consecutively to help account for missing documents. Transactions should be documented in a timely manner, preferably at the point of transaction.

b) Another element of documentation is the chart of accounts used to classify transactions into balance sheet and income statement accounts. The chart of accounts is important because it provides the framework for determining the information that is presented to financial statement users.

c) The use of a procedures manual is another element of good internal control. A detailed procedures manual encourages consistent application of a unit's policies, including those concerning internal controls.

## **8. Physical control of assets**

It is essential that assets be physically protected. Cash on hand should be maintained under the sole control of the person directly responsible for it.