Control Environment and Internal Controls

Whatever their mission or size, all organizations should establish policies and procedures to assure that 1) boards and officers understand their fiduciary responsibilities, 2) assets are managed properly, and 3) the mission or purpose of the organization or entity is carried out. Failure to meet these three obligations is a breach of fiduciary duty, and can result in financial and other liability for the board of directors and the officers.

Directors and officers are responsible for ensuring that the organization is accountable to 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 an annual financial report with the IRS and state regulatory authorities.
- Make the report available to all board members and members of the public who request it.

Directors and officers meet the above requirements by implementing and establishing an effective control environment through internal controls.

What are internal controls?

Internal controls are the financial processes and procedures that enable an organization to safeguard its assets. As defined in accounting and auditing, is a process for assuring achievement of an organization's objectives in operational effectiveness and efficiency, reliable financial reporting, and compliance with laws, regulations and policies. A broad concept, internal control involves everything that controls risks to an organization.

It is a means by which an organization's resources are directed, monitored, and measured. It plays an important role in detecting and preventing fraud and protecting the organization's resources.

At the organizational level, internal control objectives relate to the reliability of financial reporting, timely feedback on the achievement of operational or strategic goals, and compliance with laws and regulations. At the specific transaction level, internal control refers to the actions taken to achieve a specific objective (e.g., how to ensure the organization's payments to third parties are for valid services rendered.) Internal control procedures reduce process variation, leading to more predictable outcomes.

How are effective internal control procedures accomplished?

The most effective procedures are those that have the greatest segregation of duties. The more people involved in the process, the less likely it is that an error or defalcation will occur.

For example, the person who writes the checks should not be the person signing the checks. The person who orders the service or product should approve the invoice. The person with budget responsibility should also approve the expenditure and should code the invoice.

Who establishes the procedures?

Generally management establishes the system of controls. It is helpful to have an accounting manual detailing the procedures to be followed. In volunteer only organizations, this is accomplished by the governing body.

Board of Directors

The Board of Directors or governing body of the organization set policy and provide guidance and oversight to the officers or management of an organization. Effective board members are objective, capable and inquisitive. They also have knowledge of the organization's activities and environment, and commit the time necessary to fulfill their board responsibilities. Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling a dishonest management which intentionally misrepresents results to cover its tracks. A strong, active board, particularly when coupled with effective upward communications channels and capable financial, legal and internal audit functions, is often best able to identify and correct such a problem.

Management

The Executive Director of an organization has overall responsibility for designing and implementing effective internal control. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. In a large company, the chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way they're controlling the organization. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for the specific functions. In a smaller organization, the influence of the tone at the top flows directly from the governing body to employees and is more direct. In any event, in a cascading responsibility, a manager is effectively a chief executive of his or her sphere of responsibility. Of particular significance are financial officers and their staffs, whose control activities cut across, as well as up and down, the operating and other units of an enterprise.

Operating staff

All staff members should be responsible for reporting problems of operations, monitoring and improving their performance, and monitoring non-compliance with the organization’s policies and various professional codes, or violations of policies, standards, practices and procedures. Their particular responsibilities should be documented in their individual personnel files. In performance management activities they take part in all compliance and performance data collection and processing activities as they are part of various organizational units and may also be responsible for various compliance and operational-related activities of the organization.