STANDARD 6 FINANCIAL OVERSIGHT

D. Written Internal Controls

1. Establish written internal controls and accounting procedures, including segregation of duties, in a form appropriate for the scale of the land trust, to prevent the misuse or loss of funds.

Accreditation indicator elements located at www.landtrustaccreditation.org

WHAT ARE INTERNAL CONTROLS?

Internal controls are a system of checks and balances designed to safeguard the assets of the organization and to help ensure that resources are directed to appropriate and authorized purposes. A key element of sound internal controls is segregation of duties, which mandates that no one person has complete control over a financial transaction. Proper internal controls are crucial, not only to help protect the land trust against theft, fraud and loss due to unethical or illegal behavior, but also to inspire confidence in donors, regulators and other board members. Examples of internal control policies and procedures may include requiring multiple signatures for large checks, having one person log in checks received and another responsible for making bank deposits and requiring competitive bids for certain contracts.

The core concept that underlies effective internal controls is the recognition that bad things do happen to good organizations. And while it is not possible (or at least not cost effective) to prevent every bad outcome from occurring, it is extremely important to understand the risks your land trust might confront and design comprehensive internal controls to prevent errors and malfeasance and, if they do occur, to ensure that they are detected and corrected quickly.
Many land trusts have only really thought about internal controls when confronted with a checklist of policies and procedures that experts advise them to put in place. While policies and procedures are a critical part of effective internal controls, they are only part of the comprehensive system that your land trust will need to establish and monitor to be certain that the controls are working as intended.

**FRAMEWORK FOR ESTABLISHING AND EVALUATING INTERNAL CONTROLS**

In the United States, the most common framework for establishing and evaluating internal controls is the *COSO Framework*, which is a comprehensive framework for thinking through the controls that both nonprofits and business entities need to put in place to manage significant risks. You can download a free Executive Summary of the latest version of the COSO Framework and find a variety of helpful resources at the main COSO website.

**Five Key Elements of Effective Internal Control**

The COSO Framework emphasizes five key elements for internal controls, with the understanding that all five elements must be addressed to establish and maintain effective controls. The elements are:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

**Control Environment**

The starting point for effective controls lies with establishing clear expectations for integrity and accountability at the top. In a nonprofit organization, the board must express and demonstrate absolute commitment to integrity and compliance with controls. The control environment includes the board’s commitment to disclosing and addressing their own potential conflicts of interest and moves beyond those basic policies and procedures to include embodying the highest standards of integrity and ensuring that the executive director, all staff and volunteers meet those standards.
The most significant aspect of the control environment is actually how people experience the behaviors and expectations of those in authority. It extends well beyond the adoption of specific policies and compliance with specific procedures to focus on the perceptions of all who are exposed to the organization – staff, donors, volunteers, partners and others. In a strong control environment, all those who come in contact with the organization’s leaders perceive their commitment to integrity and accountability and understand that each leader meets those standards and holds their fellow leaders fully accountable for meeting them as well.

For accreditation, the “control environment” aspect of internal controls is addressed, in part, with requirements for adopting Land Trust Standards and Practices (which are the ethical and technical guidelines for the responsible operation of a land trust) and carefully managing conflicts of interest (see Practices 4A1 and 4A2).

Risk Assessment

Every land trust faces a variety of risks from external and internal sources. The concept of risk includes the possibility that an event will occur and adversely (or positively) affect the achievement of objectives. As noted in the COSO Internal Control – Integrated Framework:

Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks to the achievement of these objectives from across the entity are considered relative to established risk tolerances. Thus, risk assessment forms the basis for determining how risks will be managed.

To conduct a meaningful risk assessment of management practices, the board and management must identify their objectives for operations, reporting and compliance “with sufficient clarity to be able to identify and analyze risks to those objectives. . . . Risk assessment also requires management to consider the impact of possible changes in the external environment and within its own business model that may render internal control ineffective.” Your land trust’s assessment of its risks should focus on both the significance of each risk (what damage would be done if controls failed and errors or irregularities occurred) and the likelihood that such a control failure will occur. Based on that assessment, you will be able to develop control activities, appropriate communication around risk controls, as well as a targeted plan for monitoring. For more on assessing your risks and developing a plan to mitigate those risks, see the Alliance’s online risk management course (now located on the Terrafirma website) and Practice 6E.
For accreditation, the “risk assessment” aspect of internal controls is addressed with a short risk-assessment questionnaire completed by someone familiar with the land trust’s financial and accounting practices. (A land trust may have responded to a similar questionnaire for its auditor; the auditor uses the information to determine whether the financial statements fairly represent the land trust’s financial position, not to evaluate internal controls. The answers given to the auditor, however, can be useful in answering the accreditation questionnaire.)

Control Activities

As the COSO Framework notes: “Control activities are the actions established through policies and procedures that help ensure that management’s directives to mitigate risks to the achievement of objectives are carried out.” Control activities include the development and implementation of written policies and procedures that are designed to prevent error or irregularity from occurring and ensure rapid detection and correction for any errors or irregularities that do occur, despite the land trust’s best effort to prevent them from occurring.

Control activities include both manual and automated systems, policies and procedures, such as authorizations and approvals, verifications, reconciliations, reporting and meaningful employee performance reviews. Segregation of duties mandates that no one individual performs the roles of authorizing, executing, recording, supervising and reporting any financial transaction or activity. For example, the person who gets the mail is not the same person to record the checks. Where segregation of duties is not possible due to limited staffing, management, possibly at the board level will need to become more involved. This may also require development of alternative control activities, such as random review of transactions, dual signature requirements or review of exception reports. It is also important to remember the critical role the budget plays in internal controls. The budget forms the road map by which those individuals charged with executing, overseeing and reporting transactions are guided.

Small land trusts often struggle with the design of control activities that will be effective when full segregation of duties is not possible. As is true for organizations of all sizes, the key issue in the design of control activities is clarity about the risks that the control is intended to mitigate and consideration of alternative approaches to address those risks. You may also find it helpful to talk with the CPA who provides you with audit or review services. While they may not have conducted a study of your internal controls, as part of their work they will have learned a great deal about both the risks that your land trust confronts and the control activities you have already put in place. They may also have worked with other nonprofits of similar size and have some practical suggestions for control activities.
Once you have completed your risk assessment and designed the controls you believe will be most effective in addressing your most significant risks, you will need to develop written fiscal policies and procedures to document your controls. Be sure to avoid the temptation to simply copy the policies and procedures developed by another organization without conducting a risk assessment that is specific to your land trust and determining how you can best mitigate those risks. Adopting another organization’s policies and procedures without thinking through their appropriateness or feasibility in your situation can increase your actual risk. This unintended consequence arises from the reality that effective fiscal policies and procedures provide a basis for evaluating whether staff and volunteers are following the requirements described in them. If you have adopted sample policies that cannot be fully implemented within the limitations of your organization, and consequently tolerate non-compliance, you have eliminated an important accountability tool.

For accreditation, the “control activities” aspect of internal controls is addressed with requirements for written internal controls or accounting procedures that address the risks of misuse, loss or misstatement of funds – such as those risks identified in the risk-assessment questionnaire. (Many land trusts already have policies and procedures that address these risks, and organizations can provide these existing documents with the accreditation application; some organizations may need to formalize written internal controls that address these risks.)

Information and Communication

Your staff, volunteers and others who are expected to perform control activities and comply with fiscal policies and procedures must have good information in order to carry out internal control responsibilities. Beyond providing basic information about your control expectations, risk assessment and control activities, the board and management team must ensure that a continual iterative process is in place to provide, share and obtain necessary information. Equally important is implementing systems and processes to ensure clear communication of information flowing up, down and across the entity. Personnel must receive a clear message from the board and management team that control responsibilities and fiscal policies and procedures must be taken seriously.
Clear communication with external parties is also a key part of effective internal controls. External communication is twofold: it enables inbound communication of relevant external information and it provides information to external parties in response to requirements and expectations. For example, your control activities must include systems that will ensure that the appropriate staff are aware of key compliance requirements in funding agreements. Your land trust’s communication with external parties can also provide an important control resource. For example, if you are required to submit requests for reimbursement of covered expenses to some of your funders, the submission of reports provides an excellent opportunity for feedback from the funder that will help you identify potential misunderstanding regarding the funder’s requirements and expectations.

For accreditation, the “information and communication” aspect of internal controls is addressed, in part, with the requirements for board oversight of the land trust’s finances (see Practice 3A2a-d), the board’s governance practices and the land trust’s response to any significant concerns identified through the annual financial audit, review or compilation.

Monitoring

Your land trust will need to develop effective approaches to monitoring its entire system of internal controls in order to understand whether they are working as intended. Your monitoring system may include periodic confidential surveys or interviews designed to reveal whether staff, volunteers and partners perceive the board’s and management team’s commitment to integrity and accountability as serious and effective. You may also want to establish a regular procedure to review and evaluate your risk assessment to determine whether new risks have emerged or your perception of the significance of various risks has changed.

If your land trust has an audit, the auditor will conduct a limited evaluation of your control activities to learn whether they appear to address your most significant risks and whether they have been implemented consistently. But, as your audit engagement letter will emphasize, the auditor’s evaluation of internal control is limited, conducted as part of their effort to determine whether the financial statements fairly present your financial condition and not intended to function as a separate evaluation of internal controls. So while your auditor will have useful observations and should communicate those observations directly to your board (or a committee designated for that purpose), you cannot rely on the auditor’s work as your only strategy for monitoring the implementation of your internal controls. This means that as part of your system of controls you will need to identify ways that your board and management team can learn whether your comprehensive system of controls is working.
For accreditation, the “monitoring” aspect of internal controls is addressed with an internal controls certification, completed by a board officer or executive director, attesting that the land trust periodically verifies the organization’s financial controls to ensure they are effective.

**ESSENTIAL POLICIES AND PROCEDURES**

One way to begin thinking about the policies and procedures that will be important for your land trust is to review the sample Land Trust Financial Controls Checklist. The checklist is organized to reflect the cycle of financial management that guides your efforts throughout the year, beginning with the board’s adoption of the budget and moving through your efforts to minimize risks as you execute your financial plan, ensure proper recording of all activities, generate reports needed for effective oversight and monitor your financial results. The checklist suggests policies, procedures and practices that can address risks that arise in each phase of the financial management cycle.

Once you have conducted your risk assessment and identified your most significant risks, you will be ready to develop specific policies and procedures to minimize opportunities for damage from those risks. The Sample Fiscal Procedures will give you an outline of the topics that are frequently included in land trust controls. You may identify other risks and other control strategies that you want to include in your written fiscal policies and procedures document. Alternatively, you may determine that you do not need to establish policies or procedures in some of the areas listed on the sample outline.

Many organizations experience challenges drafting fiscal policies and procedures. In fact, creating them is one of the most frequently put off tasks among land trusts. You may be able to clear away one barrier to getting the policies and procedures done by thinking clearly about the difference between a policy and a procedure.

A policy is a high-level description of what the land trust intends to do, approved by the land trust board. For example, you will almost certainly have a policy that requires you to distinguish whether a donor has or has not restricted the use of a contribution. You will also have a policy to use gifts with donor restrictions only for the purposes for which the donor has restricted them. In order to implement these two policies, you will need to establish a number of procedures, including obtaining written guidelines from the donor about the restriction, recording the receipt of the gift as a restricted contribution and identifying specific expenditures that meet the donor’s restriction. Over time, you will probably maintain the same policies with regard to distinguishing and following donor restrictions, but your specific procedures may change as you restructure your staff, implement new accounting and donor-tracking software and so forth.
Your auditor or reviewer may have already helped you describe some of your most important policies by helping you draft the Notes to the Financial Statements that appear in your audit or review report after the financial statements themselves. Typically, those notes will include your policy with regard to following or not following Generally Accepted Accounting Principles (GAAP), your policy regarding the recording of easements, your policy regarding recording investments at their fair market value and many other policies. The level of detail provided in these descriptions of some of your policies may provide a good example for drafting your policies and procedures.

Drafting procedures can be particularly challenging. The most common temptation is to be overly detailed – for example describing what to do on each screen that appears in your accounting software when you are processing a check or a deposit. Trying to include this level of detail presents two problems: (1) It makes the drafting of the procedures too time-consuming and overwhelming; and (2) software changes regularly, and overly detailed procedures will become out of date quickly.

Instead, you want your written procedures to focus on the critical control features, especially requirements for authorization and review of transactions, reconciliation of accounts and retaining key documents. For example, you may have established a policy that a board member must review and approve travel expense reimbursements for the executive director. Your procedures would describe when the board member conducts that review, what documents would be provided for review and that the board review and approval must be documented. You would not need to describe the exact forms that would be used to request and document approval.

Another significant barrier to writing fiscal policies and procedures is the reality that it is often the person doing the bookkeeping and fiscal processing who knows the most about the specific procedures used to accomplish various functions. Therefore, it is very tempting to ask this individual to write the policies and procedures. However, this individual is often too close to the subject to understand what a person coming to the system cold would need to know to be able to step in and follow the policies and procedures.

An alternative approach is to ask a volunteer with background in financial management to review your risk assessment and any current policies and interview the people involved in operating your financial systems. This outside party may actually find it easier to write clear policies and procedures than the people doing the work. Another approach is to contact a nearby college with an accounting program and see if a graduate student or an advanced undergraduate could draft your policies and procedures as a class project.
Whatever approach you end up using, the most important thing is to get a first draft of your policies and procedures completed and then get feedback on them. While your auditor will remind you that they cannot make management decisions for your land trust and cannot decide what your policies should be, they may be very willing to review your draft to point out missing pieces or areas in which either the policies or procedures are unclear.

**ONCE IS NOT ENOUGH**

One of the wonderful truths about land trusts is that they are constantly growing and changing. This means that effective internal controls will require regular reassessment of the control environment, updates to the risk assessment and review of the control activities, including fiscal policies and procedures, to be sure they still meet the land trust’s needs and address its most significant risks.

**ADDITIONAL RESOURCES**

- COSO Executive Summary
- Sample Financial Controls Checklist
- Sample Land Trust Fiscal Procedures
- Sample Land Trust Accounting and Financial Management Policies