Internal Control Systems

Strategic Framework for Preventing Fraud & Ensuring Compliance

Church Clergy Tax Management & Compliance

Establish Bulletproof Operational Procedures

Today's Agenda

- Why Internal Controls Fail in Churches
- The COSO Framework for Church Operations
- Five Pillars of Internal Control Systems
- Financial Transaction Controls & Procedures
- Real-World Embezzlement Prevention Case Studies
- Implementation Roadmap & Tools

Why Internal Controls Fail in Churches

- Volunteer-driven operations with limited oversight capacity
- Trust-based culture discourages formal controls as "suspicious"
- One person controlling entire financial process (treasurer handles all)
- No segregation of duties: approval, recording, custody all one person
- Infrequent reconciliation: monthly or worse, quarterly/annual only
- Weak documentation: receipts lost, informal cash handling
- Statistics: 10% of nonprofit employees commit fraud, churches highest risk

Financial Impact of Weak Controls

Average Embezzlement

$150K

In churches with no controls or weak oversight

Time to Detection

2-3 Years

Prolonged theft when controls inadequate

Recovery Rate

15-20%

Of stolen funds recovered (if any prosecution)

COSO Framework for Church Operations

The Committee of Sponsoring Organizations framework applies to churches:

- **Control Environment** - Culture, tone, commitment to integrity
- **Risk Assessment** - Identify vulnerabilities to fraud
- **Control Activities** - Specific procedures preventing errors/fraud
- **Information & Communication** - Accurate, timely financial reporting
- **Monitoring** - Ongoing evaluation of control effectiveness

Five Pillars of Internal Controls

- **Segregation of Duties** - Different people handle approval, recording, custody
- **Approval Authority** - Clear thresholds for who approves what amounts
- **Reconciliation** - Monthly bank/account verification by independent person
- **Documentation** - Every transaction has receipt, invoice, or support
- **Monitoring** - Regular review of procedures & variances

Pillar 1: Segregation of Duties Framework

❌ Wrong: One Person

Treasurer approves, records, deposits, reconciles. Easy to cover up theft.

✅ Right: Three People

1) Pastor/Board approves 2) Treasurer records 3) Authorized person reconciles

Key Principle

No one person should handle entire transaction from start to finish

Pillar 2: Approval Authority Thresholds

Clear Authorization Matrix:

- **Under $500:** Treasurer or Finance Chair approval only
- **$500-$2,500:** Finance Committee approval required
- **$2,500-$10,000:** Board approval (documented in minutes)
- **Over $10,000:** Board approval + external bid/quotes required
- **All salaries/compensation:** Board resolution with documented fair market value analysis

Pillar 3: Reconciliation - Monthly Essential

Bank Reconciliation (Monthly)

- Compare bank statement to records
- Identify outstanding checks
- Verify deposits match pledges
- Investigate discrepancies

Critical Best Practices

- Done by person WITHOUT access to accounts
- Bank statements mailed to HOME, not church
- Reviewed by Finance Chair independently
- Variance analysis documented

Pillar 4: Documentation - Every Transaction Has a Trail

- **Cash Receipts:** Pre-numbered receipt books, dual copy (one to donor, one to file)
- **Pledges & Giving:** Pledge cards or commitment forms, date-stamped
- **Expenses:** Original invoice/receipt with approval signature and date
- **Payroll:** Time records, approval forms, W-2/1099 documentation
- **Transfers:** Written request, approval, and bank confirmation
- **Retention:** Keep all supporting documents for 7 years minimum

Pillar 5: Monitoring - Regular Control Testing

Monthly Oversight

- Finance committee review of variances
- Spot-check documentation
- Verify approval thresholds followed

Quarterly & Annual

- Full reconciliation review
- Fraud risk assessment
- Controls gap analysis

Cash Handling: High-Risk Area Controls

- Two people present for ALL cash counting (collection, deposits, reconciliation)
- Cash never in single person's custody (secure lockbox until two people present)
- Bank deposits within 48 hours (same-day preferred)
- Never use cash for expense reimbursement (check/transfer required)
- Petty cash maintained at minimum balance, reimbursed from treasury
- Monthly petty cash count matches recorded balance (surprise spot-checks)
- All cash received documented immediately (receipts in real time)

Payroll Controls: Employee Management

- Salary increases approved by board in writing before implementation
- Time records (hours worked) tracked and approved by supervisor
- Payroll processed by different person than approval/record-keeping
- Housing allowance designated in December BEFORE year begins (documented)
- Independent contractor arrangements require Form W-9 and IRS safe harbor (not misclassification)
- Benefits/deductions documented and authorized in employment agreements
- Payroll tax deposits made on schedule (penalties for delays)

Case Study: The Trusted Treasurer Theft

Situation: Church treasurer for 15 years, highly trusted, handled all finances. No one reviewed bank statements.

The Fraud: Created fake expenses, wrote checks to herself, falsified reconciliations. Stole $280K over 5 years.

Discovery: Accidental when pastor requested account information for audit; treasurer immediately confessed.

✅ **Prevention:** Monthly reconciliation by independent board member would have caught this in months, not years.

Case Study: The Volunteer Cash Collection Scheme

Situation: Collection volunteers counted cash alone, deposited alone, no receipts. Minimal oversight.

The Fraud: Volunteer pocketed cash from collection plates. Submitted false collection reports ($300 actual vs. $500 reported).

Impact: $45K stolen over 3 years before suspicious variance pattern noticed.

✅ **Prevention:** Two-person rule for collections + pre-numbered receipts prevents this entirely.

Fraud Risk Assessment: Is Your Church Vulnerable?

- ☐ One person has exclusive access to financial accounts/records
- ☐ Bank statements mailed to church office (not to board member)
- ☐ No monthly reconciliation or reconciliation not reviewed independently
- ☐ No pre-numbered receipts for cash collections
- ☐ Expenses approved without supporting documentation
- ☐ No written approval thresholds/authority matrix
- ☐ Cash sometimes kept overnight at church (not deposited next business day)
- ☐ Board receives financial reports only quarterly or annually

Control Systems: 120-Day Implementation Plan

Days 1-30

- Assess current controls
- Identify vulnerabilities
- Document procedures

Days 31-60

- Draft control policies
- Reorganize duties
- Implement segregation

Days 61-120

- Staff/volunteer training
- Board adoption of policies
- Monitor & adjust

Control Systems Documentation Templates

- **Expense Approval Form** - Document request, approval authority, vendor info
- **Approval Authority Matrix** - Clear thresholds for spending authority
- **Bank Reconciliation Worksheet** - Monthly step-by-step reconciliation process
- **Cash Receipt Log** - Pre-numbered receipts with amounts, dates, purposes
- **Segregation of Duties Chart** - Who does what job, no overlaps
- **Variance Analysis Report** - Budget vs. actual with explanations for gaps

Technology Tools for Control Implementation

- **Church Accounting Software** - ChurchSoft, Arena, Breeze for transaction tracking
- **Online Banking Portals** - Real-time transaction visibility & alerts
- **Approval Workflows** - Digital approval routing for expenses
- **Giving Platform Integration** - Direct connection to accounting system
- **Reconciliation Automation** - Bank feed matching to reduce manual work
- **Audit Trail Logging** - System tracks all access & changes with timestamps

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Key Takeaways

- Weak controls enable fraud - average loss $150K, detected 2-3 years late
- No single person should control entire transaction from approval to reconciliation
- Monthly reconciliation by independent person is your #1 fraud prevention tool
- Documentation (receipts, approvals, explanations) creates accountability
- Trust is important, but controls are ESSENTIAL - controls show respect for stewardship
- Clear policies & procedures protect honest people from suspicion

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Bulletproof Your Operations Today

Do not wait for fraud to discover weaknesses - implement controls now

Next: IRS Audit Prevention Strategies

Thank You

Building Trust Through Strong Internal Controls & Operational Integrity

Questions & Discussion Welcome