Internal Control Toolkit for Small Non-Governmental Organizations

HKCSS 社聯

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Building a better
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Contents

Foreword

Non-governmental organizations (NGOs) play a critical role in developing society, improving communities, and promoting citizens' participation in different fields – including the environment, health, poverty-alleviation, social services, art, sports, education etc.

Each NGO therefore, serves the community in various ways and scales according to their respective mission(s). However, a common and equally critical goal is the obligation to uphold the NGOs' accountability and transparency to the public, while responding to the needs of the community.

For NGOs to maintain and gain a high level of trust with their stakeholders, especially funding bodies and donors, they must demonstrate that their resources have been put to good use for achieving their missions. One important way is through fostering a culture of good governance/ check and balance and putting in place relevant internal controls to improve the overall operations and delivery of services.

This toolkit can serve as a foundational basis to help an NGO take the initial step towards this obligation.

As at March 2019, there were

9,096

charitable institutions which are exempted from tax under S.88 of the Inland Revenue Ordinance, reflecting an increase of over

1,100 or 13%

new organizations as compared to March 2014.

Source: HKSAR Inland Revenue Department Annual Report for 2013/14 & 2018/19

Target of this
Internal Control Toolkit

This toolkit is primarily intended for use by small NGOs that may wish to:

1 **Understand more about the principles of risks and internal controls in the context of governance over non-profit organizations.**

2 **Evaluate the risks faced by the organization within key processes which we have identified from the perspective of the resources and funding flow.**

3 **Self check the sufficiency of relevant internal controls and determine the initial effort that may be needed to enhance by an NGO to enhance their coverage and effectiveness.**

Principles of
Internal Controls

The toolkit aims to highlight

Risks and Controls

within key processes of small NGOs.

What is the relationship between Risks and Controls?

Risk is the threat from an event, action, or circumstances that may negatively affect the achieving of an organization's missions.

Internal controls are mechanisms or procedures carried out by an organization or rules to mitigate or reduce the risks to an acceptable level.

Example of Risks and Controls

1. **Situation at hand** - One staff is responsible for maintaining staff master list and the preparation and processing of payroll payment.

2. **Risk** - Fictitious employees created in the staff master list could not be identified and are processed for payroll, leading to loss of funds.

3. **Control** - Segregate the conflicting duties to ensure the accuracy and completeness of payroll information.

As many small NGOs are charitable institutions with tax-exemption status, they are held accountable for public resources that are entrusted to them.

In the year of assessment 2017-18, the approved tax-deductible donations made by corporate and individual to charitable institutions amounted to

HK$12.8b

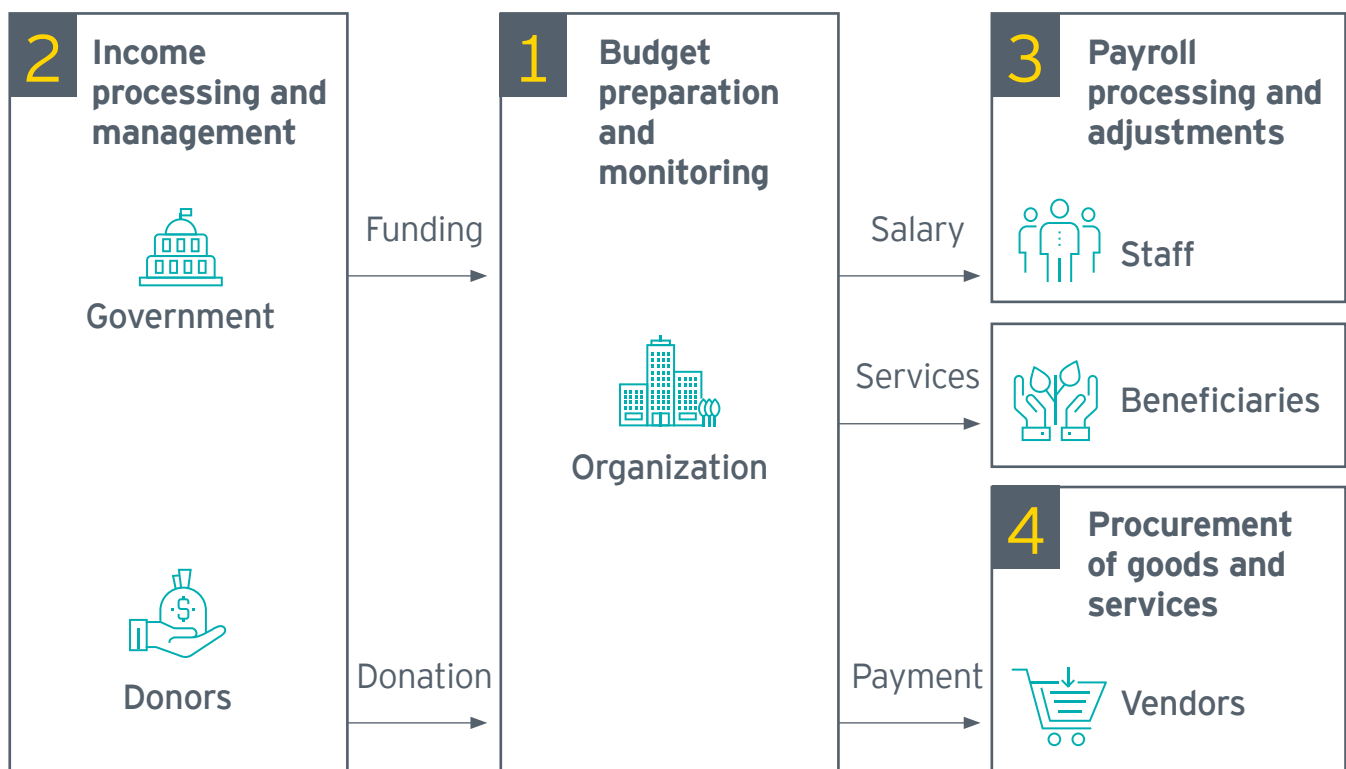*Source: HKSAR Inland Revenue Department Annual Report for 2013/14 & 2018/19*

Why do small NGOs need to establish good Internal Controls?

Regardless of their size of operations and funding, all NGOs are faced with risks in various areas of their operation just like commercial companies. Furthermore, NGOs generally utilize public funds from government, charitable funding bodies or public donations to serve their beneficiaries. While small NGOs may not have their own internal audit units, they are still required to be accountable to various stakeholders by sustaining a sound internal control system to manage their risks properly.

In particular, the establishment of internal controls in key processes can facilitate small NGOs to:

▸ Reduce the opportunities for fraudulent activities from occurring

▸ Use resources in a transparent and effective manner

▸ Comply with relevant laws and regulations

▸ Build good reputation and public trust

In this toolkit, we aim to provide insights on common risks faced by small NGOs within four selected processes aligned with the flow of resources and funding as depicted below:

2 Income processing and management		1 Budget preparation and monitoring		3 Payroll processing and adjustments
Government	Funding →	Organization	Salary →	Staff
			Services →	Beneficiaries
				4 Procurement of goods and services
Donors	Donation →		Payment →	Vendors

Self-Assessment

How mature are your Internal Controls?

The self-assessment checklist in next page aims to help small NGOs assess the maturity of existing key controls in four specific processes. These processes include:

1. Budget preparation and monitoring

2. Income processing and management

3. Payroll processing and adjustments

4. Procurement of goods and services

Assess a score from 0 to 4, representing the maturity levels of control establishment, by comparing your existing controls against the description of good control practices* in each of the processes. In particular, you should consider if the control exists, whether it is performed timely by an appropriate personnel and whether adequate documentation is being retained.

| Scores attained in each process	Actions to consider
5 or below	The internal controls established for this key process should be reviewed immediately. You can use this toolkit as a foundational reference when establishing key internal controls for your organization.
6 to 11	The internal controls established for this key process have areas for improvement. You can improve the current procedures and internal controls by improving the controls discussed in the toolkit.
12+	The internal controls for this key process appear to be well established. However, in view to changes in operations or arising of new risks, you should regularly assess the sufficiency of existing controls and make relevant adjustment as needed.

*The good control practices of the selected processes included in this questionnaire are examples of **key controls that need to be in place**. When evaluating your internal controls, always exercise judgement to assess whether the controls, functions, processes or programs in place are sufficient to mitigate the unique risks faced by each organization in the above processes.

	Statement of good control practices	Not established			Well established		Score
1 Budget preparation and monitoring	Agency budget is formulated annually based on budgets for individual programs, services and central administration.	0	1	2	3	4	
	Budget checks are performed before spending or hiring to prevent over-budget.	0	1	2	3	4	
	Annual budget is compared against the actual financial position at least quarterly to identify significant variance and understand their root cause.	0	1	2	3	4	
	Important changes to operations (e.g. addition, cancellation of key activities) are updated and reflected in the annual budget.	0	1	2	3	4	
2 Income processing and management	Custody of received income and keeping of corresponding accounting records are performed by different persons.	0	1	2	3	4	
	Cash or cheque received are locked securely where bank-in are arranged as soon as practicable or upon reaching a defined threshold.	0	1	2	3	4	
	Surprise cash counts are performed by an independent party who is not involved in the custody of cash/ cheques.	0	1	2	3	4	
	Transactions in bank statements are reconciled at least monthly against accounting records of income received.	0	1	2	3	4	
3 Payroll processing and adjustments	Payroll amount and details (e.g. bank account/ payee name) are independently checked by a separate person before they are processed.	0	1	2	3	4	
	Salaries are paid to staff within 7 days from the end of the wage period, and MPF contribution is paid for monthly-paid staff on or before the 10th of each month.	0	1	2	3	4	
	Part-time staff's payroll amounts are compared to the relevant supporting documents (e.g. attendance sheet/ number of class) for identification of discrepancies.	0	1	2	3	4	
	Performance of staff is assessed at least annually and reflected in payroll adjustment.	0	1	2	3	4	
4 Procurement of goods and services	Approval from required authority based on expected purchase value is obtained before an order is placed to a vendor.	0	1	2	3	4	
	Quotations are obtained for comparison of price and before a vendor is selected.	0	1	2	3	4	
	Quotations obtained, rationale for selection and approval from management are documented and retained.	0	1	2	3	4	
	Invoices are checked against goods/ services received and order placed to the vendor before payments are settled.	0	1	2	3	4	

Risks and Controls
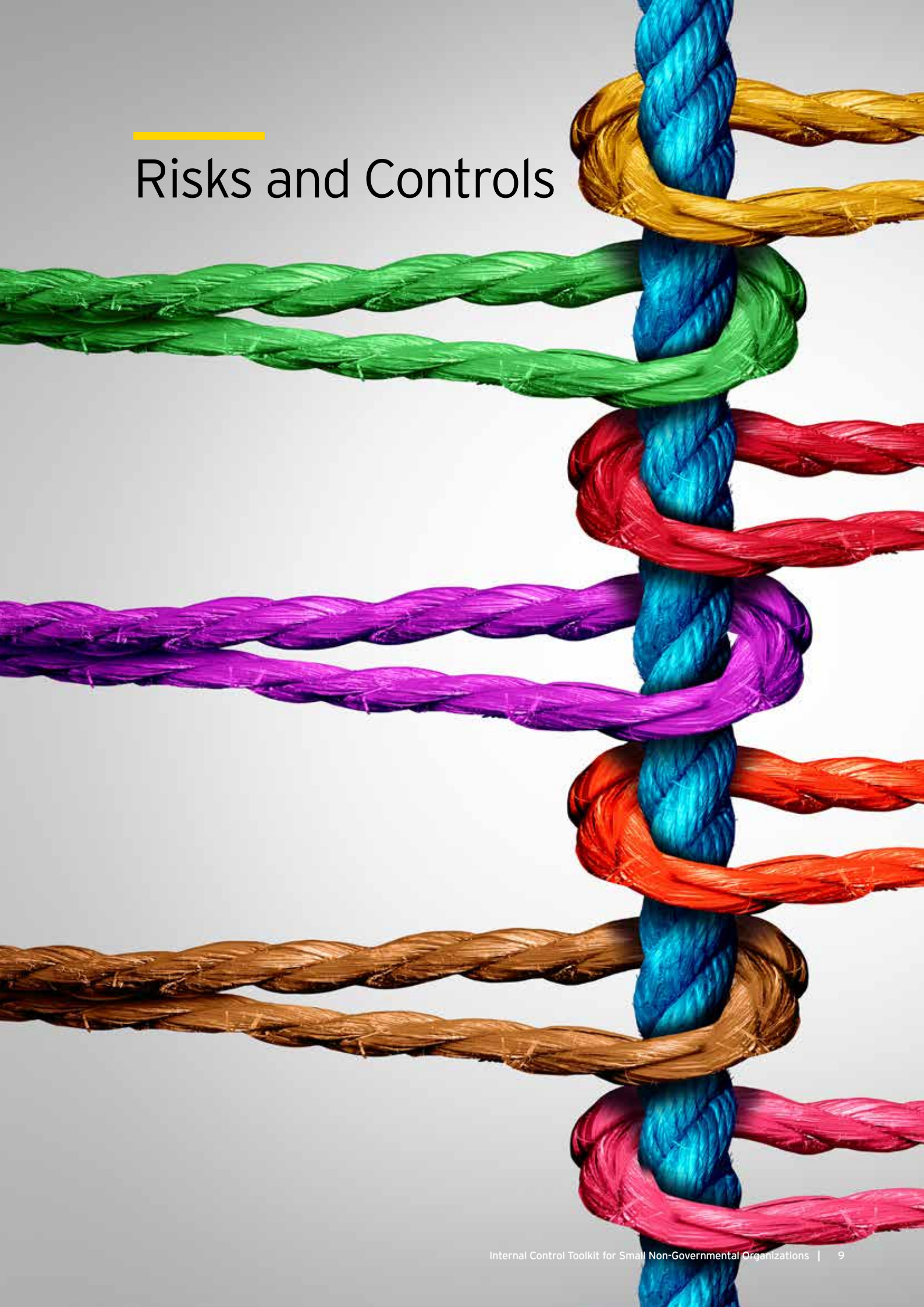
What should be considered when designing Internal Controls?

	Principles of Internal Control	Example of Internal Controls
Authorization	Appropriate personnel should review or approve the transactions before execution	‣ Set the required level of authority within organization (e.g. executive committee/ board) required ‣ Clear matters to be authorized ‣ Timely authorization
Documentation	Sufficient information is recorded or retained to support and illustrate transactions occurred	‣ Establish policies and procedures for key areas ‣ Set standard forms for key processes ‣ Maintain records of communication/ meetings
Safeguarding of Assets	Physical items (e.g. cash and fixed assets) are secured and are not accessible by unauthorized personnel	‣ Restrict unauthorized access to fixed assets and cash with security measures, e.g. store the cash in a double-locked safe ‣ Review the list of personnel with access to the safe and storage of assets
Segregation of Duties	No single individual should have taken over conflicting duties and responsibilities	‣ Separate duties where possible to maintain check and balance ‣ Document assigned responsibilities ‣ Regular review of conflict in duties

In the following pages, we will highlight typical examples of "what could go wrong" (i.e., risks) in each of the four key processes and apply the above consideration to suggest relevant internal controls practices that can be established by small NGOs.

Key Risks and Controls in selected processes

1. Budget preparation and monitoring

Budget preparation

What could go wrong

Information in the annual budget is not accurate enough to reflect the activities planned for the coming year.

What can be done

For the budget of individual activities, budget holders should list out the income, expenses to be incurred and the expected net subsidy/ proceeds based on the components of the activities.

For the preparation of an annual budget, considerations should be given to :
- ‣ Organization's overall income sources (e.g. subvention, donations)
- ‣ Incomes and expenses from the budgets of individual activities
- ‣ Organization's overall operating expenses (e.g. payroll, rental, utilities, etc.)
- ‣ Key changes in organization structure/ missions
- ‣ Prior year's financial statements

Seek approval from appropriate level of authority on the annual budget prior to the commencement of the financial year.

Budget monitoring

What could go wrong

Key deviations from the approved annual and activity budget are not identified and analyzed for their root cause.

Key changes to annual operations are not timely updated and reflected in the latest annual budget.

What can be done

Upon completion of individual activities, a summary of income and expenses should be prepared within a designated period. Relevant supporting documents should be attached and justifications should be provided for significant variances.

Regular comparison of actual year-to-date performance should be performed against the approved annual budget. Updates should be made to the annual budget as needed with justifications for significant variances.

Results of comparison and revision to budgets should be reported to relevant approval authority for endorsement.

| ■ Authorization | ■ Documentation | ■ Safeguarding of Assets | ■ Segregation of Duties |

2. Income processing and management

Income collection

What could go wrong

Income (e.g. donations and activity fees) are not deposited into the organization's bank account and/ or not reflected in relevant records.

What can be done

All income shall be transferred or deposited only to the organization's bank. Personal bank account shall never be used for processing the organization's transactions.

Issue pre-numbered receipt slips as soon as incomes are received. The receipt should at least have 2-ply and include details such as names of the payor, staff processing the receipt, purpose, amount, time and date.

Receipt slips should only be issued by relevant approval authority to ensure their validity.

Income safekeeping

What could go wrong

Cash and cheque are not properly safeguarded and lead to loss of income or misappropriation of cash.

What can be done

Authority to collect income and access to the cash box/ safe should be granted to designated personnel only.

An independent staff without access to the cash box/ safe should be assigned to keep records of the movement of cash/ cheque kept in custody.

Arrange bank-in for all received cash/ cheque as soon as practically possible or upon reaching a pre-determined threshold as defined by management. If overnight custody is required, make sure the cash box/ safe is properly locked.

Perform ad-hoc cash/ surprise cash count by a separate staff to ascertain the accuracy of records maintained and completeness of cash under custody.

■ Authorization   ■ Documentation   ■ Safeguarding of Assets   ■ Segregation of Duties

Reconciliation

What could go wrong

Errors and irregularities throughout the income processing and management could not be detected and resolved timely.
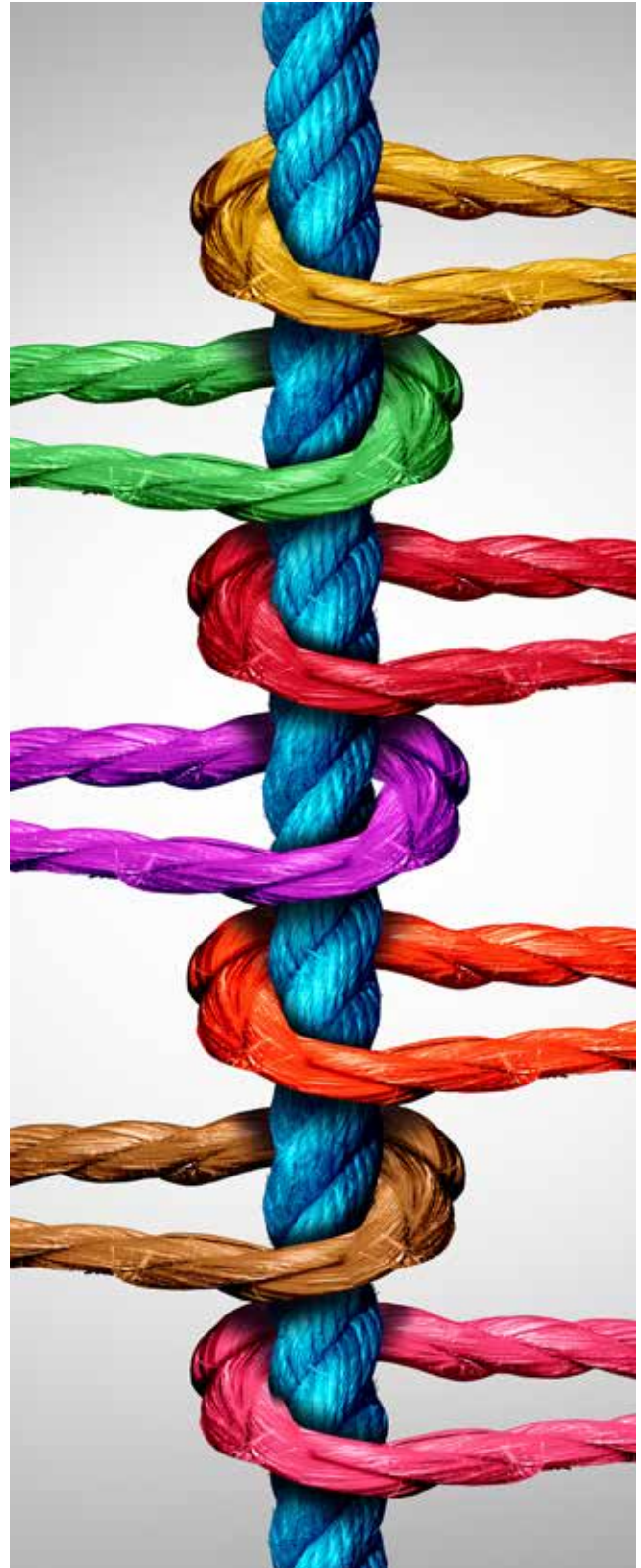
What can be done

Reconcile all supporting documents for income received (e.g. bank-in slips, cheque copy) to the issued receipts on a daily basis to ensure the completeness and accuracy of issued receipts/ income collected.

Perform bank reconciliation at least monthly to reconcile the differences between bank statements and accounting book. Follow up the unreconciling items timely (e.g. within a month) to ensure the errors and irregularities, if any, could be identified.

Maintain segregation of duties over conflicting functions for reconciliation, such as arranging different staff to:
‣ Perform reconciliation
‣ Record accounting transactions

Please refer to "Management of Charities and Fund-Raising Activities" published by the Independent Commission Against Corruption (ICAC) for more information relating to donation handling.

| Authorization | Documentation | Safeguarding of Assets | Segregation of Duties |

3. Payroll processing and adjustments

Payroll calculation

What could go wrong

Errors in payroll calculations are not detected.

What can be done

Establish standard payroll review procedures for each payroll run to ensure accuracy which includes, but not limited to:
- calculation arithmetic check
- reconciliation between payroll movement and its supporting document (e.g. annual leave data, attendance record, staff contract for new staff)
- comparison of the current month payroll against the one of previous month to identify unusual discrepancies

Document each checking performed on the payroll calculation and retain review evidence. The review should be done by parties not involved in payroll calculation.

Payroll processing

What could go wrong

Unauthorized or inaccurate payroll payment is processed.

What can be done

Staff responsible for payroll should only prepare the bank autopay instruction/ cheques after the payroll amounts have been reviewed and approved by the required level of authority. Payroll should be completed within 7 days after the end of payroll period where MPF contribution should be paid on or before the 10th of each month.

Implement access control (e.g. read-only file)/ independent checking to ensure the final payroll amount is the same as the approved amount. Checking can be performed on the total amount, the number of line items and individual staff payroll information on the bank instruction/ cheques prior to disbursement.

Obtain a copy of bank card/ bank book from staff during the onboarding process to verify the name and bank account details before inputting the information into staff master list.

Divide the conflicting duties for payroll processing, for example payroll calculation and maintenance of staff's payroll information (e.g. bank account number) should be performed by different staff.

■ Authorization   ■ Documentation   ■ Safeguarding of Assets   ■ Segregation of Duties

Performance appraisal

What could go wrong

Staff's performance is not timely or systematically assessed to provide feedback for improvement.

What can be done

Establish policies and procedures for performance appraisal and annual salary adjustment on:
- Appraisal criteria
- Appraisal procedures
- Performance expectation
- Annual salary adjustment procedures
- Approval authority for performance appraisal and annual salary adjustment
- Roles and responsibilities
- The policies and procedures should be communicated to all staff through staff handbook, regular reminder, periodic training session, etc.

Performance appraisal should be conducted at least annually based on agreed appraisal criteria and performance expectation. Quantifiable standards for performance measurement could be set for reference where possible.

Annual salary adjustment

What could go wrong

Payroll is adjusted inaccurately and/ or without proper approval.

What can be done

Seek written approval from the defined authority for the proposed salary adjustment based on results of performance appraisal.

Divide each conflicting duties in the annual salary adjustment process so that no one has control over all parts of the process, including:
- Setting of appraisal criteria and performance of appraisal
- Approving salary adjustment and performance of appraisal
- Updating salary amount in staff master file, and review the modification for staff master file

Notify the staff in writing about their salary adjustment result as a confirmation. The notification should be issued by the appropriate level of authority and department.

■ Authorization   ■ Documentation   ■ Safeguarding of Assets   ■ Segregation of Duties

4. Procurement of goods and services

Purchase initiation

What could go wrong

Unauthorized or unnecessary purchases are made.

What can be done

Orders should be placed to vendors in writing with information, such as goods/ services description, quantity, shipping address and expected delivery date, etc.

Define the approval authority for purchase order based on purchase amount and nature.

Budget holder should check the budget prior to approval, especially for procurement with recurrent nature. If the items to be purchased are not covered in the approved budget, additional consent must be obtained before placing the orders.

Vendor selection

What could go wrong

Vendor selected are unable to provide satisfactory goods and services at the most competitive price.

Staff involved in the selection process may be subject to undue influence due to conflict of interest.

What can be done

Define vendor selection and approval procedures, such as:
- Number of quotations from vendors required based on purchase value or nature
- Criteria in assessing the quotations (e.g. price and/ or technical elements)
- Roles and responsibilities of the staff involved
- Justification for specific brand or sole-sourcing

Require staff involved in the selection process to make a declaration on whether he/ she is free from any conflict of interest, whether perceived or actual.

Please refer to "Tips for NGOs- Management of Conflict of Interest" published by the ICAC for more information relating to declaration for conflict of interest.

■ Authorization	■ Documentation	■ Safeguarding of Assets	■ Segregation of Duties

Single-sourced or small purchases

What could go wrong

Repetitive single-sourced or small purchases are made without price comparison or competitive bidding, leading to reduced effectiveness in use of resources.

What can be done

List out items or services that obtaining of quotations are not required (e.g. routine consumables, or services of specific nature which is difficult to find in the market)

Establish a pre-approved list of goods / services and the corresponding vendors where direct purchases can be made by:
- Obtaining quotations from other comparable vendors to ensure the competitiveness of price at the beginning of the year
- Submitting the list to the appropriate level of authority for approval

Enter into term contract with vendor where repetitive high-value purchases of the same nature are expected if a lowered overall price can be achieved.

Receiving and payment

What could go wrong

Unauthorized payments are made to:
- goods/ services not received
- unsatisfactory purchases
- vendor with incorrect details

What can be done

Accept goods by an independent person who is not the user and not involved in the procurement process, and check the details (model, quantity, etc.) of goods received against the approved Purchase Order ("PO"). When checking is done and no discrepancies/ damaged goods are noted, the receiver should sign on the delivery note as an acknowledgement of receipt and pass it to Accounting Team for checking.

Verify the invoice by relevant approval authority defined within the user department to ensure the goods/ services are accepted by the user, and the invoice is approved for payment.

Make the payment only when the details (e.g. items, quantity, amount) in the approved invoices, approved PO and signed delivery note are matched by Accounting Team. Payment details (e.g. payee, bank account number) should be verified by the Accounting Team by checking against the approved invoices.

Maintain a record of higher-value items (e.g. computer, projector), label them for easy identification and perform stocktaking periodically.

■ Authorization	■ Documentation	■ Safeguarding of Assets	■ Segregation of Duties

ACT Now

▸ Revisit your organizational and governance structure, roles and responsibilities of each process owner, as well as policies and procedures established within key processes.

▸ Collaborate between the board and staff to strengthen the control environment and communicate the importance of internal controls.

▸ Be proactive about addressing emerging risks within your organization.

▸ Refresh and enhance the internal controls based on the dynamic change and needs of the society.

If you have any questions about this toolkit, please contact:

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Notes

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