

101 Internal Controls

Canon 1276 §1 Ordinaries must carefully supervise the administration of all the goods which belong to public juridic persons subject to them, without prejudice to lawful titles which may give the Ordinary greater rights.

§2 Taking into account rights, lawful customs and the circumstances, Ordinaries are to regulate the whole matter of the administration of ecclesiastical goods by issuing special instructions, within the limits of universal and particular law.

(Appendix 1 contains all the Canon Law applicable to the administration of a parish including its temporal goods and the acquisition of goods).

101.1 Why are internal controls needed in the diocese?

The Church is not immune to financial malfeasance, a fact that has become increasingly clear as financial scandals have been reported from all over the country. In fact, some in the media and elsewhere have coined Church finances as the next big scandal for the Catholic Church. In today's environment of the Enrons, Worldcoms, et al, the Church must remain vigilant. It must continuously seek measures and procedures which better ensure the monies and resources entrusted to it are prudently safeguarded and are being expended in accordance with the intention of donors and benefactors. A sampling of actual instances of recent fraud against the Church follows:

- In New Jersey, a priest was sentenced in June 2006 to five years in prison after the misappropriation of \$2 million.
- In Ohio, the CFO was charged in August 2006 with participating in a kickback scheme totaling nearly \$785,000. The CFO had left one diocese and was working as the Director of Finance for another diocese when the 23 count federal indictment related to the first diocese was handed down.
- In Florida, two priests were charged in September 2006 with skimming more than \$8.6 million from a parish. In another Florida parish in October 2007, a bookkeeper was arrested for what investigators say will amount to an embezzlement charge of over \$900,000.
- In Illinois, a priest was indicted in October 2006 on charges of stealing more than \$190,000 from a parish.
- In New York, four church procurement officials allegedly conspired to extort \$2 million from vendors who provided food to church schools and parishes.
- In December 2006, a survey by researchers at Villanova University found that 85% of dioceses that responded had discovered embezzlement of church money in the last five years, with 11% reporting that more than \$500,000 had been stolen. While this report is somewhat misleading in that it seems to imply that 85% of the institutions (i.e., over 19,000 parishes, 8,000 schools, etc.) within the dioceses are experiencing fraud, the report has received national media attention.
- In Connecticut, a priest was removed in January 2007 over the disappearance of approximately \$500,000. This followed a report late last year in which another priest in Connecticut had embezzled approximately \$1.4 million.
- In Virginia, a priest was accused In January 2007 of stealing over \$600,000.
- In the Diocese of Pensacola-Tallahassee, we have experienced cases of embezzlement, fraud and malfeasance since the fall of 2007 that have totaled over \$375,000.

Further examples of past problems could be listed. However, the real issue is not what has happened in the past, but what needs to be done now and in the future to prevent, to the maximum extent possible, any recurrence of fraud within the diocese. All responsible persons within the diocese are to safeguard the resources provided to all of us collectively by God. Well written and faithfully executed internal controls will help us all to meet that expectation.

101.2 Internal Control: A Definition

Internal control is a process, accomplished by an entity's management, finance council, employees and volunteers, designed to provide a reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Fundamentally, internal controls deal with the safeguarding of assets, including physical items of value; funds, whether cash or checks, and personnel, whether employees or volunteers.

The four basic concepts underlying the definition are as follows:

- (1) Internal control is a *process*. It is a means to an end, not an end itself.
- (2) Internal control is accomplished by *people*. It is not merely policy manuals and forms, but people at every level of an organization.
- (3) Internal control can be expected to provide only *reasonable assurance*, not absolute assurance, to an entity's management and board.
- (4) Internal control is geared to the achievement of *objectives* in separate but overlapping categories.

The internal control process is divided into five elements as follows:

101.2.1 Control Environment. The core of any business is its people—their individual attributes, including integrity, ethical values, and competence—and the environment in which they operate. Some examples include:

- Clear lines of authority and accountability that emphasize the importance of internal controls
- A documented code of conduct/ethical standards
- A formal budget process and prompt variance analysis
- A plan to attract and retain competent personnel
- An effective and proactive finance council and internal review process

101.2.2 Risk Assessment The entity must be aware of—and deal with—the risks it faces. It must set objectives, integrated with all activities so that the organization is operating *in concert*. It also must establish mechanisms to identify, analyze, and manage the related risks. Some examples include:

- Clear objectives regarding operating, financial reporting, and law compliance functions
- An entity-wide review to assess and evaluate risk throughout each of its components.

101.2.3 Control Activities Control policies and procedures must be established to ensure that management's responses to risks are effectively carried out. Some examples include:

- Clear Delineation of Responsibilities/Segregation of duties: collection of cash; remittance of payments
- Independent counting and/or confirmation of assets: contributions counted by two or more people
- Controlled access to check stock and electronic data processing operations and adequate backup (disaster recovery) is in place

101.2.4 Information and Communication Information and communication systems surround all of these activities. They enable people to capture and share the information needed to conduct, manage, and control operations. Some examples include:

- Management support for developing, communicating and maintaining effective financial management information systems and training for employees/volunteers
- The sharing of information on emerging risk issues with other dioceses and within our own
- Channels of communication for employees and church workers to report suspected irregularities or illegal acts

101.2.5 Monitoring The entire process must be monitored, and modifications must be made as necessary. In this way, the system can react dynamically, changing as conditions warrant. Some examples include:

- Regular reviews of internal controls (from external/internal auditors, etc.) and prompt action to enact recommended changes
- Prompt follow-up on unusual variances from budget
- Periodic comparison of physical inventories of salable items (textbooks, cemetery lots, etc.) and permanent assets (sacred vessels, historical treasures, office equipment) to accounting records and the reconciliation of differences

101.3 Realistic Expectations from Internal Control: Some Limitations

To ensure expectations are realistic, it is necessary to focus on what internal control is NOT. Inherent limitations of any internal control system include the following:

- Mistakes and human errors in applying the established policies and procedures
- Circumvention of controls by collusion of two or more people (e.g., an employee and a vendor)
- Intentional disregard of controls (e.g., management override, falsifying documents, forgery, theft, etc.)

These limitations should serve as a sobering "reality check."

Even the best system can be defeated—innocently or intentionally. However, one can expect that a good system of controls will provide the site and its leadership with “reasonable assurance” that its control objectives are attained. It is important to be able to demonstrate that an entity is making reasonable and prudent efforts to achieve its internal control objectives, rather than complacently “assume” or “trust” that the objectives will be achieved by “good people.”

A final limitation of internal control that must be considered is *cost*. Common sense dictates that controls should not cost *more* than their potential benefit. Balancing this cost-benefit equation frequently involves considerable judgment, especially in placing a value on such benefits as the avoidance of scandalous publicity or the efficient handling of contributions and donor relations. Nonetheless, stewardship over assets and the spiritual mission of the diocese should recognize that the value of any control benefit exceeds the costs of related control implementation efforts.

While it must be acknowledged that some entities operate with few employees and/or volunteers which may make the carrying out of these principles more difficult, good internal controls are still imperative and achievable.

101.4 Relationships and Responsibilities

To be effective, internal control policies and procedures must be properly followed by **all** personnel, regardless of responsibility level. People, not policies, determine whether a system will function properly. People at different levels have different backgrounds, technical skills, needs, and priorities. Therefore, it is important that they be properly trained in their responsibilities and limits of authority.

Everyone within the organizations in our Diocese has some responsibility for internal control; and absolutely everyone also has an expressed or implied responsibility to report a breakdown in internal control. Personnel must always believe they can report a problem to a responsible member of management, where the ultimate responsibility for the internal control system lies.

Bishop

The bishop, as the head of the organization, assumes ownership of the system of internal control. He is responsible for ensuring integrity, ethics, competence, and other factors of a positive control environment. The bishop fulfills his responsibilities by providing leadership to his management team and the College of Consultors and Presbyteral Council representing the sites, who shape and enact the values, principles, and operating policies that are the basis for a strong internal control system.

Chief Financial Officer

The Chief Financial Officer and staff are important in the development and monitoring process. Their activities cross all of the operating and other activities of the diocese. They are involved in developing diocese-wide budgets, fiscal quality improvement plans, employee benefit packages and reports used to analyze, monitor and review performance from operational, compliance, and financial perspectives. The Chief Financial Officer's staff provides support, guidance, training and risk assessment to all entities in the diocese to assist them in maintaining strong financial controls and reducing risk.

The Pastor/Principal/Administrator

Each administrator has the responsibility to his/her constituency, the Bishop and the Church to be good stewards of the assets entrusted to them. Consequently, he/she is the key accountable person for ensuring a strong internal control program is established and maintained at the site. The success of the program demands he/she lead by example to demonstrate that required processes will be followed and that he/she (or designated persons) will be involved in monitoring procedures for compliance with policy and sound business practices.

Internal Review (Audit)

The primary objective of an internal review is to provide an evaluation and test of our controls/procedures. The internal review process used within the diocese follows these steps to appraise the internal control system at all organizations:

- Reviews the reliability and integrity of financial and operating information.
- Reviews compliance with diocesan policies, plans, and procedures and compliance with laws and regulations.
- Reviews the means for safeguarding assets.
- Reviews the means by which resources are used effectively and economically.
- Ascertains that operations and programs have accomplished established objectives and goals.

Within the Diocese of Pensacola-Tallahassee, the internal review function may not always be fulfilled by its paid staff employees, but may be performed by outside skilled entities.

Other Diocesan Personnel

Internal control is the responsibility of **all** personnel in a diocese, whether employee or volunteer. Examples of personnel activities include generating invoices, ordering, reporting expenses, reconciling accounts, preparing time cards or time sheets, and preparing requisitions. Personnel must be made aware of the diocese's mission, code of business conduct, conflict of interest policy and fraud policy.

Volunteers

To the extent volunteers are involved in an organization; they should be made aware of its control consciousness. Personnel who volunteer need to understand the business implications of their activities. While the organization is grateful for their volunteerism, there may be occasions when accepting their help would be inappropriate because of church/personal conflicts of interest or derogatory background checks.

Finance Council

Every parish and school in the Diocese is required to have a functioning finance council. The finance councils of the diocese and all parishes/schools are required to have a significant role in the internal control function and in providing direction, guidance, and oversight to the bishop, pastors and principals. In addition to its advisory capacity, each finance council has specific rights and duties under Canon Law. Members must be objective and competent. To be effective, the finance councils should carry out their responsibilities through sub-committees. Some of the sub-committees at parishes and schools (and diocese wide) may include an audit committee and a financial or project/property review committee.

Membership on the finance council should be diverse with respect to areas of technical competence, covering areas such as accounting, financing activities, real estate, construction, insurance, and investments.

The responsibilities of the possible sub-committees of a finance council at a site may include:

An audit committee would be responsible for reviewing the annual budget, bank reconciliations, the financial results throughout the year (monthly or quarterly), the results of an internal review, the adequacy of the accounting system, the overall adequacy and functioning of the internal control system.

A financial or project/property committee would review the financial feasibility of any construction project or property acquisition. This review should consider any related debt acquisition. Members should be concerned with the quality of construction on purchased property, since quality may ultimately impact the need for future financial outlay. They could also be charged with assessing the need for a proposed project and ensuring the liturgical correctness of the project.

External Auditors

External auditors (independent public accountants) can be helpful in reporting material deficiencies in internal control systems and their use. Reliance solely on external auditors to identify all weaknesses is not recommended unless the auditors are specifically engaged to review the system. There are inherent limitations in the auditing process. For example, audits are based on the concept of selective testing of the data being examined and are therefore subject to the risk that errors and irregularities may not be detected. Also, because of the characteristics of irregularities, including attempts at concealment through collusion and forgery, a properly designed and executed audit may not detect a material irregularity.

101.5 Basic Elements of Internal Control

101.5.1 Honest and Capable Employees

Recent frauds perpetrated within the Church have been committed by employees having a great deal of trust. Certainly, any system is critically dependent on the people who use it. If the people are dishonest or incompetent, even the finest system will not perform properly. Honest and capable employees can and do function effectively even in situations where other elements of internal control are lacking. The following suggestions may help in deterring employee dishonesty and apply to volunteers, as well as, paid employees:

- Require annual week long vacations of employees to help ensure that any fraud requiring their constant attention would be discovered during their absence. This requires cross-training to ensure work continues during such absences.
- If possible, when individuals have spent a substantial amount of time at one level of the funds handling process, these individuals should be transferred to other positions to allow for cross training. Shortly after transfers, take note of any pronounced changes in cash flow that may indicate the improper handling of funds.
- Establish a conflict-of-interest policy and educate personnel to prevent potential abuse.
- Know your personnel. Watch for signs that an employee is spending more than his/her salary would seem to allow.
- As part of the hiring process. Investigate all employees adequately through past employer and background checks **before** their employment begins. For those prospective employees who may handle funds or credit cards and for those being assigned to manage the financial records, a Fair Credit Reporting Act pre-employment credit check is required **before** the employment offer can be made.

- Persons keeping the books must understand basic accounting principles including double entry bookkeeping, the required use of a standard chart of accounts and the use of automated accounting software such as QuickBooks.

105.1.2 Delegation and Separation of Duties

Employees must know what they are to do and what others are responsible for. This is accomplished by developing job descriptions to explain proper delegation and establishing an organizational chart to define lines of authority/responsibility.

Most important is a clear separation of duties. The system should provide for an appropriate segregation of duties between the custody of and the accountability for assets. This segregation should prohibit any one person from performing all aspects of a function. Keeping in mind that controls should not cost more than their potential benefit, but no one person should handle an entire transaction from beginning to end. For example, if one person ordered supplies, received the supplies, wrote a check for payment, and then reconciled the checking account, there is no way to determine if funds or property were being properly handled. As a general rule, any addition of qualified persons to the transaction process will strengthen internal controls and help prevent loss, but additional staff should not be added merely to achieve this goal. Frequently, duties can be reassigned to accomplish many duties requiring segregation without requiring additional personnel. In addition the use of a finance council member who is not involved in the daily record-keeping could oversee the accounting activities.

Other examples of transactions, which should be segregated, include:

- Handling funds and recording the receipt of funds in the financial records,
- Authorizing payment of wages and preparing payrolls,
- Authorizing expenditures, verifying invoices and preparing checks in payment of invoices,
- Preparing and signing checks,
- Counting collections/other receipts and recording deposits in the records or posting to an individual donors' account.

105.1.3 Suitable Documents and Accounting Records

Accounting records and documents must be maintained to provide an audit trail. One major objective of an internal accounting control system is to provide reasonable assurance that the financial records fully reflect all financial transactions that have occurred. The recording of all transactions must be correct as to payee, purpose, quantity and dollar amount, and must be made in the proper accounting period. The supporting documentation should be:

- simple and easy to use to help reduce error;
- as few in number as possible to minimize confusion;
- designed to ensure that they will be properly completed; and
- attached to disbursing documents and properly filed.

105.1.4 Physical Control Over Assets and Accounting Records

The safeguarding of assets is an important aspect of a system of internal control. Accounting records must be protected by physical barriers, such as locked rooms or drawers accessible only to select individuals. The safeguarding of assets, however, is much more than just

establishing physical control. The site must also ensure physical assets are not removed from the parish or school campus without specific authorization. In addition to accounting records, all physical assets should be properly secured. For example, furniture and equipment should be numbered and inventoried.

An important subset of physical controls is security for the information system. It is crucial that access to computer equipment and the computer software necessary to process accounting information be controlled. Computer files should be backed up each time transactions are processed (but not less than weekly) and stored off-site; fireproof safes should be used to store important documents retained on site. Given the rapid changes being made in this information age, management must be cognizant of the importance of emphasizing controls over the use of its information technology.

101.5.5 Independent Verification of Performance

Procedures to reconcile actual transactions with those transactions that have been recorded are another element of internal control. The taking of a physical inventory and the reconciling of a bank account to the general ledger are two methods for such activity.

No one can objectively evaluate his/her own performance effectively, and invariably there will be mistakes made when recording large numbers of transactions. Therefore, administrators must periodically assess the performance of their subordinates to help ensure that any accounting and internal control system is functioning properly. In addition, an independent internal review ~~will~~ must be conducted periodically to evaluate the adherence to and sufficiency of the internal control systems at all diocesan organizations. A report will be generated itemizing the corrective actions needed to properly safeguard the assets entrusted to them.

101.6 Overarching Policies on Fraud, Personal Conduct and Political Activity

A number of policy statements have been developed which address fraud, personal conduct and political activity within the Diocese that apply to all personnel whether clergy, employee or volunteer. They include:

101.6.1 Political Activity Guidelines for Catholic Organizations. Appendix 15 was directly obtained from the United States Conference of Catholic Bishops website and covers the limitations imposed on 501(c) (3) organizations that must be followed to retain the non-profit status granted by the Internal Revenue Service. Administrators, especially pastors, must take specific note of this appendix and understand the ramifications of ignoring its contents.

101.6.2 Diocesan Code of Business Conduct Policy. Appendix 16 was taken from the “CPA’s Handbook of Fraud and Commercial Crime Prevention.” It has been adapted to apply to the sites within the Diocese. It includes definitions of what is considered unacceptable, and the consequences of any breaches thereof. It is intended to apply to those areas of conduct not covered under the Code of Pastoral Conduct for Church Personnel and Volunteers originally promulgated by the Diocese in August 2001. Each employee and significant volunteer within the Diocese of Pensacola-Tallahassee is to be given a copy of this policy when they are hired/appointed/elected. They must sign the acknowledgement form included at the end of the appendix that confirms receipt and affirms that they will follow the policies as stated.

101.6.3 Diocesan Conflict of Interest Policy. Appendix 17 states that all responsible individuals within the Diocese shall, during both working and nonworking hours, act in a manner which will inspire public trust in their integrity, with impartiality and with devotion to the best interests of the organization, its employees and the public. It further prohibits activity leading to private inurement and benefit as defined by the Internal Revenue Service, discusses conflicts of interest and the disclosure of privileged information. Each employee and significant volunteer within the Diocese of Pensacola-Tallahassee is to be given a copy of this policy when they are hired/appointed/elected. They must sign an acknowledgement form included at the end of the appendix that confirms receipt and affirms that they will follow the policies as stated.

101.6.4 Diocesan Fraud Policy. Appendix 18 establishes the organization's fraud policy; defines the varieties of fraud; lists prohibited acts; stipulates action to be taken in the event fraud is detected; states the Pastoral Center's response plan; and concludes with some fraud detection rules to follow. It also includes a suggested form for reporting suspected fraud; lists actual and hypothetical examples of fraud & what could have been done to prevent the fraudulent acts; and provides detailed procedures that may help in preventing fraud and financial abuse.

101.6.5 Diocesan Whistleblower Policy. Appendix 19 provides the reporting process to be followed when it appears that any responsible individual within the organization is reasonably perceived to be involved with (a) improper accounting for funds and/or materials owned and managed by the organization, (b) violations of the Code of Business Conduct (Financial), Code of Conduct for Church Personnel & Volunteers (Personal Behavior), Conflict of Interest Policy and the Fraud Policy of the organization, and (c) other questionable financial dealings.

Summary of Revisions effective August 2014:

Section 101.1 Why are internal controls needed in the diocese: Added statement regarding fraud within the diocese.

Section 101.2 Internal Control: A Definition: Made minor language improvements to better define internal control.

Section 101.3 Realistic Expectations from Internal Control: Made minor language improvements.

- Section 101.4 Relationships and Responsibilities: Changed wording to conform to generic definitions from introduction and made minor language improvements.

Section 101.5 Basic Elements of Internal Control:

- Section 101.5.1 Honest and Capable Employees: Made changes to language regarding prospective employee research before actual hiring.
- Section 101.5.2 Delegation and Separation of Duties: Made minor language improvements.
- Section 101.5.3 Suitable Documents and Accounting Records: Streamlined descriptive language for supporting documentation.

- Section 101.5.4 Physical Control Over Assets and Accounting Records: Strengthened language regarding removal of assets from a site.
- Section 101.5.5 Independent Verification of Performance: Strengthened language regarding internal reviews.

Section 101.6 Overarching Policies on Fraud, Personal Conduct and Political Activity:

- Section 101.6.1 Political Activity Guidelines for Catholic Organizations: Changed wording to conform to generic definitions from introduction.
- Section 101.6.2 Diocesan Code of Business Conduct Policy: Added “Business” to Code of Conduct, changes location of acknowledgement form for policy and improves language.
- Section 101.6.3 Diocesan Conflict of Interest Policy: Changed location of acknowledgement form for policy and improves language.
- Section 101.6.5 Diocesan Whistleblower Policy: Added “Business” to Code of Conduct reference and makes minor language change.
- Section 101.6.6 Policy Acknowledgement Statement: Deleted since superseded by changes to 101.6.2 and 101.6.3.