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MEMORANDUM

To: The Commission

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Staff Director

From: Joe Stoltz *JSt*
Assistant Staff Director
Audit Division

AGENDA ITEM
For Meeting of: 10-18-06

SUBMITTED LATE

Subject: Proposed Internal Control Guidance for Political Committees

The Audit Division was asked to prepare a document to be distributed to the regulated community dealing with internal controls. It has been the experience of the Commission that the lack of such controls contributes to what appears to be a growing number of cases where committee funds are misappropriated and, as a result, inaccurate disclosure reports are filed. In addition to intentional acts, inaccurate reporting also results from innocent error that potentially could be identified and corrected before reports are filed by following some of the same internal control practices.

The attached is the result of our efforts. Much of the content is not new, rather it represents common practice. Most of it was gathered from various published sources available on the Internet. The document is meant to be educational, not mandatory.

The Office of General Counsel has provided informal comments and those have been incorporated.

Should you have any questions please contact me.

Internal Controls and Political Committees

Under the Federal Election Campaign Act (FECA) and the Commission's regulations all political committees are required to file accurate and complete disclosure reports. A system of internal controls can contribute to the accuracy of a committee's disclosure reports. While neither FECA nor the regulations require any particular set of internal controls, implementing effective internal controls plays an important role in meeting those requirements, since misappropriation of funds or unintentional error generally lead to the filing of inaccurate disclosure reports. Conversely, a lack of internal control and oversight can create an environment that contributes to misappropriation of funds, a lack of concern for the accuracy of committee accounting records, and misreporting to the Commission. With respect to misappropriations, in recent years the Commission has noticed an increasing number of instances where committee assets are misappropriated, generally by committee staff. In most of these cases, the staff person who engaged in the misappropriation was a trusted individual who was not properly supervised. There were often no systems of internal controls in place that provided an independent check on the activity of those who process the committee's transactions. Absent some basic checks and balances, some people will inevitably give in to temptation.

As result, effective internal controls provide the dual benefit of protecting committee assets and facilitating the filing of accurate disclosure reports. To that end, the Commission has prepared the following discussion to assist committees in protecting their assets and complying with the requirements of the FECA.

We have noted that when the issue of internal controls is raised with political committees, often their representatives respond that they are small operations staffed by volunteers and can't afford elaborate systems of controls. It is, however, in the interest of both the committee and its staff to establish a system of internal controls that will prevent or quickly detect any misappropriation. The responsibility of establishing the necessary control procedures falls to a political committee's treasurer. Internal controls need not be elaborate or expensive to provide reasonable assurance that funds will not be misappropriated. Most importantly, costs associated with recovery from misappropriations, both monetary and non-monetary, are likely to be greater than the cost of prevention.

This guide should not be the only resource that is consulted. In addition to accounting professionals, there are numerous resources that can be found on the Internet. For example the Small Business Administration offers an internal control check list that can be used as a starting point (<http://www.sba.gov/managing/financing/control.html>). The Government Accountability Office has published a guide for Government Agencies titled Standards for Internal Control in the Federal Government that also explains the components and principles of internal control (<http://www.gao.gov/special.pubs/ai00021p.pdf>). There are also many other organizations who have posted their control procedures on the Web ranging from State and local government agencies, to educational institutions, to religious organizations. For example, the Comptroller of the State of Connecticut

(<http://www.osc.state.ct.us/manuals/AcctDirect/contents.htm>) has an Accountability Directive that, in Appendix B, **SECTIONS APPLICABLE TO ALL AGENCY PROGRAMS**, includes not only internal control check lists, but flow charts. Much has been written on internal controls by experts in the field, the material in this document borrows from a number of those sources.

Naturally, no one set of controls will be right for all political committees. Small organizations that have only a few people involved will have very different needs and resources than a large corporate or union Separate Segregated Fund that has a significant staff and access to the internal auditing resources of the connected organization. This document is aimed at the smaller organizations.

What are Internal Controls?

Internal control is a *process* designed to ensure that an organization's goals are met with respect to:

- Effective and efficient operations
- Reliable financial reporting,
- Compliance with laws and regulations, and
- Protection of the organization's assets

The best internal control system can provide only *reasonable*, not absolute, assurance that these goals are met. Any system may be defeated either by accident or intentionally through collusion. However, a well designed system will reduce the risk that errors or intentional acts will occur or go undetected.

The internal control process typically includes the following elements:

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

Although this may sound complicated, in a small organization it is actually very simple. The following describes each of the elements:

Control Environment. At the core of any organization are its people with their individual attributes such as integrity and competence, and the environment in which they operate. There are three key aspects to controlling the environment: 1) Limiting the number of people that have access to any accounting function, assets or records system, 2) Maintaining a separation of functions so that no single individual has complete control over financial transactions, and 3) Providing proper instruction and guidance to relevant staff. Ideally, a committee should utilize the smallest number of individuals needed to accomplish the work and still maintain a separation of duties. These individuals should

have an understanding of importance of control procedures and the role they play in ensuring accurate reporting of all financial activities.

Risk Assessment. The committee must be aware of, and deal with, the risks it faces both monetary and non-monetary. Naturally some assets, such as cash, are more easily diverted than others and the control procedures should take into account the risk that each type of asset presents. Then the committee can establish cost effective ways of managing the related risks.

Control Activities. Control policies and procedures must be established to ensure that risks are minimized. Depending on the size of the organization these procedures may be simple and limited, or complex and more extensive.

Information and Communication. Information and communication systems surround all of these activities. They enable people to gather and share the information needed to conduct, manage, and control operations

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. In many political committees this is a critical part of the equation. Staff and structures change often and sometimes radically. Therefore it is necessary to reconsider the procedures in place to assure they are still effective and appropriate to the current circumstances.

Follow-up. Once a deficiency in internal control is identified, it is incumbent upon committee management to take steps to minimize the risk. After identifying a potential problem, it is expected that action will be taken to reasonably assure that the committee's affairs will be conducted in a manner that meets the internal control goals discussed above.

Selected Procedures for Internal Controls

As alluded to earlier, separation of duties is the key ingredient in any internal control system. Without that separation, it is virtually impossible to be reasonably assured that the organization's internal control goals are met. In a small organization there may be as few as two or three individuals involved in the processing, recording and reporting of transactions. With careful planning and assigning of duties it is possible to establish an elementary internal control system with very few people. If the committee staff is very small and the Treasurer does not process transactions on a day to day basis, the Treasurer may be the key to the system.

The controls discussed below include those over cash and non-cash assets that are readily convertible into cash (e.g., liabilities whose liquidation will require the use of cash, such as accounts payable and notes payable). The areas discussed below represent particular vulnerabilities the Commission has identified based on its regulatory experience. They do not represent an exhaustive list assets to be safeguarded.

Bank Accounts

- A. Limit the number of bank accounts to those absolutely required to manage the committee's business. It may, for example, be more convenient to have separate accounts for the primary and general elections and/or receipts and disbursements. Obviously, the fewer the accounts, the greater the control and the smaller the opportunity for errors or wrongdoing.
- B. Open all accounts in the name of the committee, never an individual. The mailing address should be a committee address and the statements should be delivered unopened to a person not charged with processing transactions. Only the treasurer or his designee should be permitted to open and close bank accounts. Those permitted should be specifically named in writing.
- C. Limit the number of persons authorized to sign checks. In addition, checks in excess of a certain dollar amount (e.g., \$1,000) should require the signature of two responsible individuals. Facsimile signatures should be prohibited unless controlled by a check-signing machine with a numerical sequence counter. No signature stamps should be allowed. Debit and credit cards must be carefully controlled since they represent easy access to committee assets.
- D. Reconcile bank statements to the accounting records each month in a timely manner. Many committees find that the use of one of the commercially available small business accounting software packages is useful in this process. They often include a simplified pre programmed process for reconciling the accounts and locating differences. The reconciliations are essential to determining if any errors occurred, unauthorized checks were issued or receipts were stolen. The statement should be reconciled by someone other than the check signers and those controlling the checking account and processing transactions. The individual responsible for reconciling the account should receive the bank statement unopened. This one step of segregating the processing of transactions and the reconciliation of accounts would have prevented or quickly discovered a number of the misappropriations that the Commission has observed in recent years and the false reporting that resulted. The reconciliations should also be compared to the disclosure reports that are filed.
- E. Require all wire transfers to be pre-authorized by two responsible individuals and immediately recorded in the accounting records. A committee sequential identification number (similar to a check number) is often helpful in recording and controlling wire transfers. The Commission has encountered situations where failure to record wire transfers has resulted in substantial misstatements in disclosure reports filed. Naturally, the reconciliation of the checking accounts to the accounting records and the disclosure reports will help prevent the filing of erroneous reports.

Receipts

- A. Make a list of receipts when the mail is opened. Ideally, the person opening the mail and preparing the list should be independent of the accounting function. A responsible official should periodically (during the monthly bank reconciliation if not more often) compare the list with the recorded amount for the deposit and the bank deposit. Some committees have found using a lockbox service (to independently open mail, record the contributions, and make bank deposits) to perform this part of receipt processing beneficial. Such services may be available through the bank.
- B. The employee responsible for opening the mail should complete the following:
 - Place restrictive endorsements, such as For Deposit Only with the committee account number, on all checks received.
 - Prepare a list of the money, checks, and other receipts.
 - Forward all receipts to the person responsible for preparing and making the daily bank deposits. Cash and check receipts should be deposited intact daily.
- C. If the committee receives contributions via debit and credit card, the same type of information described above for checks and cash should be assembled for those contributions¹. The same verification to bank deposits should also be performed. The procedure will depend on the system that the credit card processor has in place. These control issues should be taken into account before selecting a firm to process the committee's credit card contributions.
- D. Prohibit delivery of unopened business mail to employees having access to the accounting records.
- E. Secure undeposited receipts in a locked cabinet at all times.
- F. Cash refunds should require approval.
- G. Locations where the physical handling of cash takes place should be reasonably safeguarded.

Disbursements

- A. Generally, disbursements should be made with prenumbered checks, with the exception of petty cash. Using checks for all major cash payments ensures that the disbursement is authorized and there is a permanent record. The check should be prenumbered so that it is accounted for properly. This procedure helps to prevent the issuance of a check that is not recorded in the cash disbursement records. Additionally, presigned checks should not be allowed. The use of credit and debit cards should be very carefully controlled and detailed records of the transactions should be required of all users. Avoid using credit and debit cards to withdraw cash. Wire transfers should require dual authorization and each wire should be assigned a sequential number to help assure that all such payments have

¹ Be aware that credit card processing fees may be netted against the contribution amounts when deposited into the committee's accounts. If so, the gross amount of the contributions must be recorded with the processing fees shown as an expense.

been recorded. Wire transfers should be recorded in the accounting records immediately.

- B. If a mistake is made when preparing a check, void the check before preparing a new one. The voided check should then be altered to prevent its use, retained to make sure all prenumbered checks are accounted for, and filed with other checks for a permanent record. The stock of unused checks should be safeguarded and regularly inventoried.
- C. If possible, check signing should be the responsibility of individuals having no access to the accounting records.
- D. Draw checks according to procedures prescribing adequate supporting documentation. It is in a committee's best interest to ensure that disbursements are supported by invoices that have been properly authorized. This documentation should include (1) a proper original invoice; (2) evidence that the goods or services were received; and (3) evidence that the purchase transaction was properly authorized.
- E. All supporting documents should be canceled or marked "paid" once a disbursement is made to avoid double payments. In the past the Commission has observed instances where failure to take these steps has resulted in many costly duplicate payments. Payments should not be made on statements or balance-due billings unless underlying invoices are included.
- F. Mail all checks promptly and directly to the payee. The person mailing the check should be independent of those requesting, writing, and signing it.

Petty Cash.

Use an imprest petty cash fund with one custodian. The imprest fund involves replenishing petty cash only when properly approved vouchers and/or petty cash log entries are presented justifying all expenditures. For accountability, only one person should be in charge of the fund. No petty cash disbursement in excess of \$100 is permitted

Payroll

Many committees use a payroll service to perform much of the payroll function. In many cases where there are more than a few employees. A service can be a very effective way of handling payroll and maintaining a separation of duties within the payroll operation. As an additional benefit, the service will often take care of the preparation and filing of the necessary tax returns, and thereby help avoid errors and associated penalties.

The signing and distribution of the checks must be properly handled to prevent their theft. The controls should include limiting the authorization for signing the checks to a responsible employee who does not have access to timekeeping or the preparation of the payroll, the distribution of the payroll by someone who is not involved in the other payroll functions, and the immediate return of unclaimed checks for redeposit. If a check-signing machine is used, the same controls are required; in addition, the check-signing machine must be carefully monitored.

If the committee has more than a few employees, it is advisable that it use an imprest payroll account to help prevent the payment of unrecorded payroll transactions. An imprest payroll account is a separate checking account in which a small balance is maintained. A check for the exact amount of each net payroll is transferred from the general account to the payroll checking account immediately prior to the distribution of the payroll. The advantages of an imprest account are that it limits the organization's exposure to payroll fraud, allows the delegation of payroll check-signing duties, separates routine payroll expenditures from other expenditures, and facilitates cash management.

Payables

The accounts payable/notes payable procedures are clearly related to the procedures for cash disbursements and payroll. The control concern is to make certain that all liabilities are properly recorded and ultimately paid. There should be a proper segregation of duties over the performance of the functions of comparing receiving reports, purchase orders and invoices and the handling of the actual disbursement functions. For disbursements that are not normally accompanied by an invoice (e.g., payment on a note), the authorization should come from a responsible official.

Computerized Systems

Most political committees are required to file their reports electronically and therefore many of their records are automated. All of the same control considerations that apply to a manual transaction system apply to an automated system. Those include the selection of software, the selection and training of staff, the separation of duties, the limiting of access to the system, security of the data, and reconciliation of data files to other records. However there is an additional requirement that is important and sometimes overlooked. The electronic data must be regularly backed up to avoid a loss of data that can interfere with a committee's ability to file timely and accurate disclosure reports. Regardless of whether such a data loss stems from a hardware failure, a software failure, human error, or a disaster such as a fire or flood, the result is the same. There are several ways to accomplish a data back up. In some instances the software supplier will "host" the data meaning that it resides on the supplier's server and is backed up by the supplier. If back up is to be done locally, it can be accomplished by copying the data to a medium such as a tape or CD and storing the back up off site. Ideally the back up should be done daily.

Conclusion

While no system of internal controls can ever be foolproof, the elements identified above can significantly reduce the opportunity for intentional misappropriation of funds and any related false reporting. Furthermore, many of these internal controls can also reduce the likelihood of inadvertent errors that can result in reporting problems. This discussion of internal controls is not intended to be exhaustive, and it is up to each political committee to carefully consider what internal controls are valuable and feasible.