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Memorandum

To: The Commission

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Subject: Commission Policy Statement Regarding Internal Controls

AGENDA ITEM
For Meeting of: 03-22-07

On its Web site, the Commission published for comment two documents concerning internal controls for political committees. One is a Safe Harbor policy that explains the minimum controls a committee must have in place to protect itself from liability for misreporting in the event of the misappropriation of committee funds. The second is an advisory document entitled Internal Controls and Political Committees that suggests control procedures that a committee can adopt to help protect it from either intentional acts or unintentional errors. Ten separate comments were received, some signed on behalf of more than one organization.

In general, the comments were supportive of the draft documents. Some noted their surprise that such controls were not commonplace while others misunderstood the nature of the proposal thinking that the content was mandatory rather than voluntary. Several support the Safe Harbor concept. Many made constructive suggestions that have been incorporated into the current draft. Some of the specific suggestions and criticisms are discussed below. All of the comments are available on the Commission's Web site at www.FEC.gov/law/policy/embezzle.

Committee Staff Size

More than one commenter pointed out that political committees, especially smaller committees, typically are staffed with very few individuals and perhaps only one. In such cases internal controls are not feasible. While that may be true in some cases, unless there is some level of oversight by the Treasurer, the Candidate, or perhaps an

outside accountant, the ideal situation exists for that one person to misappropriate committee funds, and for the misappropriation to go undetected for a lengthy period. One only needs follow the statistics concerning the amounts of money raised and spent in elections to know that each election cycle sets a new record. With ever-larger amounts at stake, there is a need for committees to operate in a more business like manner. The increasing number of embezzlement cases that come to the Commission's attention is evidence of the need for better financial operations. That said; nothing in these proposals requires committees to change anything in their operations. The advisory document is simply a service to the regulated community. Those who believe that none of it is practical for a particular political committee are free to continue to operate as they have or to take one or two of the suggestions and conclude they do not wish to devote the resources to any of the others. Internal controls are much like insurance. Each person is free to decide whether the risk that is covered is worth the cost of the insurance.

Flexibility

More than one commenter encourages the Commission to continue to acknowledge that no one set of internal controls is right for all political committees. It is agreed that just as no one set of procedures is best for any business or government agency, no one set is best for all political committees. The draft has been amended to reinforce the idea that the Commission does not believe that all committees should use the same level and type of internal control. However, the Safe Harbor policy does set some minimums that the Commission expects to see. They include care in establishing bank accounts, an independent review and reconciliation of bank records, accounting records, and disclosure reports, care in the handling of receipts, and care in handling disbursements. These are common sense precautions that all committees should consider.

Miscellaneous Comments

One comment suggests that the Commission assemble a working group from the regulated community to properly devise guidance on the topic of necessary internal controls. Input from the regulated community was the purpose of publishing the proposals for comment and the comments were generally favorable. The same commenter argues that anything beyond advice must be done by regulation. However, the Safe Harbor proposal is an explanation of how the Commission intends to apply its regulations. It is not itself a regulation. The Internal Controls and Political Committees document is simply advice. Finally, the commenter points out that internal control will not stop forgeries or stop a person determined to steal committee funds. It is true that no internal control system is a guarantee that a dedicated thief will not find a way to steal funds from any entity. That is not the purpose of internal controls in general, or the ones in the current proposal. Internal controls are designed to provide *reasonable assurance* that assets are safeguarded. There are no guarantees. However, experience has shown that most misappropriations that the Commission becomes aware of are crimes of opportunity. The purpose of the internal controls in these proposals is to reduce the

opportunity. A secondary goal is the detection of misappropriations that are perpetrated in spite of the controls. Again, there are no guarantees, only precautions.

The attached drafts of Internal Controls and Political Committees and Safe Harbor for Misreporting Due to Embezzlement include many of the suggestions that have been received.

Recommendation

It is recommended that the Commission adopt the internal control guidance and minimum standards contained in the attached document and that both be published on the Commission's Web site.

It is further recommended that this memorandum be place on the Commission's open session agenda for the meeting of March 22, 2007.

Should you have any questions please call me on ext. 1209.

Attachments as stated.

Safe Harbor for Misreporting Due to Embezzlement

The Commission has encountered a dramatic increase in the number of cases where political committee staff misappropriates committee funds. Misappropriations are often accompanied by the filing of inaccurate disclosure reports with the FEC, leaving committees vulnerable to a FEC enforcement action and potential liability for those reporting errors. In response to the rise in this activity, the Commission has concluded that the following internal controls are minimal safeguards a committee should implement to prevent misappropriations and associated misreporting.

This policy does not impose new legal requirements on political committees; rather it creates a safe harbor. If the following internal controls are in place at the time of a misappropriation, and the post-discovery steps described below are followed by the committee, the FEC will not seek a monetary penalty on the political committee for filing incorrect reports due to the misappropriation of committee funds.¹ The Commission will also consider the presence of some, but not all, of these practices, or of comparable safeguards, as a mitigating factor in considering any monetary liability resulting from a misappropriation.²

A. Internal Controls

- All bank accounts are opened in the name of the committee, never an individual, using the committee's Employer Identification Number, not an individual's Social Security Number.
- Bank statements are reviewed for unauthorized transactions and reconciled to the accounting records each month. Further, bank records are reconciled to disclosure reports prior to filing. The reconciliations are done by someone other than a check signer or an individual responsible for handling the committee's accounting.
- Checks in excess of the greater of \$1000 or .5% of anticipated annual disbursements are authorized in writing and/or signed by two individuals. Further, all wire transfers are authorized in writing by two individuals. The individuals who may authorize disbursements or sign checks should be identified in writing in the committee's internal policies.
- An individual who does not handle the committee's accounting or have banking authority receives incoming checks and monitors all other incoming receipts. This individual makes a list of all committee receipts and places a restrictive endorsement, such as: "For Deposit Only to the Account of the Payee" on all checks.

¹ The internal controls set forth here represent the minimum efforts a committee must take to qualify for this safe harbor. The FEC provides additional guidance on internal controls best practices at [\(link\)](#).

² This policy does not absolve or mitigate FEC liability for individuals responsible or complicit in the misappropriations.

- If the committee has a petty cash fund, an imprest system³ is used, and the value of the petty cash fund should be no more than \$500.

B. Post-Discovery of Misappropriation Activity

As soon as a misappropriation is discovered, the political committee:

- Notifies relevant law enforcement of the misappropriation.
- Notifies the FEC of the misappropriation.
- Voluntarily files amended reports to correct any reporting errors due to the misappropriation, as required by the FEC.

³ An imprest fund is one in which the sum of the disbursements recorded in the petty cash log since the last replenishment and the remaining cash always equals the stated amount of the fund. When the fund is replenished the amount of the replenishment equals the amounts recorded since the prior replenishment and should bring the cash balance back to the stated amount. Only one person should be in charge of the fund.

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 control 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. Finally, a system of internal controls, including policies, procedures and budgets, can contribute to the efficient and effective use of committee funds.

As result, effective internal controls provide the triple benefit of assisting the committee in meeting its goals, 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 control 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, volunteer or paid, to establish a system of internal controls that will prevent or quickly detect any misappropriation while getting the maximum benefit from the funds that are available. The amount of money involved in the political process has grown rapidly over the past election cycles and it appears that trend will continue. This trend suggests that, as with any business, as the volume of activity grows, the risks and the need to control those risks grow with it.

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. The cost of inefficient use of committee resources may not be recoverable.

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. A copy can be located at http://www.prescott.edu/faculty_staff/faculty/scorey/documents/sba_2004a.pdf. The Government Accountability Office has published a guide for Government Agencies titled Standards for Internal Control in the Federal Government that explains the components and principles of internal control (<http://www.gao.gov/special.pubs/ai00021p.pdf>). There are also many other organizations that 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 checklists, but flow charts. Much has been written on internal control 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. Of course, effective internal control depends heavily on the separation of key functions among more than one person.

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 who 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 the 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. A simple example would be to assign one person to record transactions and file disclosure reports, while another to review and reconcile them to reports and accounting records.

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 and organizational 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 maintaining some level of separation of duties and independent review is of prime importance. The Treasurer can provide independent review so long as he or she does not process transactions on a day to day basis or prepare disclosure reports.

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 of 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. A political committee should obtain from the Internal Revenue Service an employer identification number ("EIN") in the name of the committee and all committee bank accounts should be in the name of the committee and utilize the committee EIN. Never approve the opening of an account in the name of an individual or using an individual's Social Security Number. 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 with such authority 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 should require the signature of two responsible individuals. The committee will determine the amount over which a check requires two signatures. Larger committees will likely find a larger dollar limit more practical. Committees may wish to consider an amount that is not more than .5% of expected annual disbursements. Facsimile signatures should be prohibited unless controlled by a check-signing machine with a numerical sequence counter. No signature stamps should be allowed.
- D. Debit and credit cards must be carefully controlled since they represent easy access to committee assets. The committee's bank or credit card issuer may be helpful in this regard. It may be possible to place dollar restrictions on cards, both on a per transaction basis and a cumulative limit. Once expenditures are approved, the limit can be re-established. Limits or prohibitions can also be placed on cash withdrawals.

- E. Review the transactions on bank statements and reconcile the 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 review and reconciliation are essential to determining if any errors occurred, unauthorized checks were issued or receipts were stolen. Someone should reconcile the bank statement 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 revealed a number of the misappropriations and the associated false reporting that the Commission has observed in recent years. It is also an excellent technique for discovering errors and omissions that occur accidentally.
- F. Prior to filing each report, a reconciliation between bank and accounting records and the disclosure reports should be undertaken. The use of electronic banking can contribute to the timely reconciliation process and allow reconciliations to be easily done when reports do not coincide with bank statement dates. Access to the electronic banking system should be limited.
- G. 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. A gap in the sequence number indicates a wire transfer that was not recorded. The Commission has encountered situations where the failure to record wire transfers has resulted in substantial misstatements in disclosure reports. Naturally, the reconciliation of the checking accounts to the accounting records and the disclosure reports will help prevent the filing of erroneous reports.
- H. Finally, investigate other control related services that the committee's bank may be able to provide. With electronic banking, information is available instantly that can contribute to a more secure control environment. Also banks may be able to screen checks that are drawn on committee accounts during their processing for compliance with agreed upon criteria.

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 deposit amount on the bank statement. Some committee's 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 to following:
 - Place restrictive endorsements, such as For Deposit Only to the Account of the Payee, on all checks received. Account number can be added but that addition may cause a security concern by providing each contributor the committee's account number..
 - 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. Commission Advisory Opinion 1999-9 (available on the Commission's Web Site) provides guidance concerning the solicitation and receipt of credit card contributions. Although the Opinion was issued in the context of the Presidential Primary Matching Fund program, it is useful guidance for credit card contributions in non-publicly funded campaigns as well.
- D. Prohibit delivery of unopened business mail to employees having access to the accounting records.
- E. Contributions that are received by committee personnel at events and in person should be subject to the same procedures as those received via mail. Lists should be made and the checks submitted to the person(s) doing other contribution processing.
- F. Secure undeposited receipts in a locked cabinet at all times.
- G. Cash refunds should require approval.
- H. Locations where the physical handling of cash takes place should be reasonably safeguarded.

Disbursements

- A. Generally, disbursements should be made with pre-numbered checks, with the exception of petty cash. Using checks for all major cash payments ensures that there is a permanent record of the disbursement. The check should be pre-numbered 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. As noted above, it is good practice to require checks in amounts greater than a specified amount to require two signatures. Additionally, pre-signed 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

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.

- require dual authorization and each wire should be assigned a sequential number to help assure that all such payments have 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 pre-numbered 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 and authorization. It is in a committee's best interest to ensure that invoices that have been properly authorized support disbursements. 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. Some committees find the use of a check authorization form to be useful. The signatures required for such authorizations can vary based on the size and nature of the transaction.
 - 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 or if they are to be delivered by committee staff, require that the person taking control of the checks signs for them. 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. The amount of the replenishment is equal to the difference between the stated amount of the fund and the remaining balance. For accountability, only one person should be in charge of the fund. The amount to be placed in the petty cash fund will need to be determined by the committee based on its operating needs, but should be kept to the minimum amount needed to make small disbursements. A petty cash fund of not more than \$500 should be adequate in most cases. If that proves not to be the case, the committee should review its policies concerning which disbursements may be paid from petty cash. No cash disbursement in excess of \$100 is permitted

Payroll

Many committees use a payroll service for much of the payroll function. 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.

If the committee chooses to handle payroll in-house, 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 person 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 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. As noted previously, invoices should be stamped "paid" and payments should not be made from statements of account unless accompanied by the related bills and invoices. These procedures prevent accidentally paying the same charges more than once. For disbursements that are not normally accompanied by an invoice (e.g., payment on a note or office rent), 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 accounting records are automated. All of the same control considerations that apply to a manual transaction system apply to an automated system. In particular, separating functions so that data files are reconciled to other records by someone independent of the transaction processing and reporting functions is critical. In addition, in electronic systems the selection of software, the training of staff in the use of that software, limiting access to the system, and security of the data are important considerations.

In many cases, the electronic filing software is separate from accounting software. If this is the situation, determine if data can be exported from the accounting software to the filing software. Not only is it more efficient than entering the data twice, it reduces the opportunity for error.

There is an additional safeguard 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 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 and one set of controls is not a good fit for all types of committees, 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 or to prescribe any one set of controls. It is up to each political committee to carefully consider what internal controls are valuable and feasible.