

Root Out Fraud with Internal Controls

There has never been a more important time for nonprofit organizations to have good internal controls in place. High-profile fraud cases — both in the for-profit and not-for-profit sectors — have resulted in many new regulations and higher donor expectations.

To understand the value of internal controls, you must know the dangers of not having them. These may include misuse of income (either by going against organization policy or donor restrictions),

improper disbursements, forged check signatures, excess payroll or payroll to phantom employees, or misdirected fund-raising proceeds. No matter how large or small your nonprofit is, you can fall victim to some or all of these problems if you're not careful.

What is the impact of fraud?

The effects of fraud can send shockwaves through your entire organization and affect your staff and volunteers in various ways. The most obvious fallout is the financial

strife it can cause. You may lose resources you intended for a specific purpose and not be able to readily replace them.

What's worse is that fraud can tarnish trust across the board. Malfeasance damages not only the trust you have with your employees and volunteers, but also the faith donors place in your nonprofit organization.

“Internal controls can range from basic to elaborate. But even the most basic internal controls will help secure your assets.”

Undetected fraud will grow like a weed if you don't tend to it. And the longer the deceptive deeds go undetected, the larger the sums and broader the schemes become. Put simply: Preventive measures are the best method to curtail fraud. Enter internal controls.

Which internal controls work best?

Internal controls can range from basic to elaborate. But even the most basic internal controls will help secure your assets, so start with the most obvious tactics and work your way up. Your best defense is to set up procedures that

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Root out Fraud with Internal Controls

prevent one person from having too much access to, or power over, your assets. You can achieve this by:

- o Segregating physical custody and accounting duties as much as possible,
- o Endorsing or stamping “for deposit only” on all checks as soon as they arrive,
- o Cutting manual checks only in emergencies,
- o Bonding all employees handling cash,
- o Prohibiting employee loans and cash advances,
- o Requiring managers to receive and review unopened bank and credit card statements,
- o Signing checks only after thoroughly examining supporting documentation, and
- o Asking a board member to review CEO expense reports.

A good place to start implementing these measures is your accounting department. It may be an entity unto itself. So, do a little detective work and find out who handles which duties. Do employees not involved with billing or accounting initially receive customer payments, grants or contracts, or other proceeds? If so, do they record these funds on a

deposit ticket or in a separate place?

A good control to immediately consider: Set up a lock box arrangement with a bank in which payments go directly to it. The bank will provide all the necessary record-keeping information.

Developing a good budget and reviewing budgeted vs. actual results are also great fraud deterrents. If you embark on new programs or expected funds don’t materialize, update your budget immediately. When you do this, variances are red flags that deserve your attention.

Of course, all of the internal controls we’ve discussed will be worthless if management doesn’t follow the rules it has set. Effective business practices always start at the top. So communicate proper

procedures in writing to your management team and hold them accountable for implementation. Their actions will set an example for staff and volunteers.

When should we begin?

Many nonprofit managers mistakenly think their annual audits are guaranteed to detect any fraud. Although auditors do review internal controls, an audit isn’t specifically designed for fraud detection. That’s why you need to stay on top of your internal controls, revisiting and updating them annually or biannually.

This isn’t a comprehensive listing of all procedures that could be appropriate for you, but it should be a good start. We can help you customize internal controls based on your specific needs and compliance requirements. ■



Keep a Close Eye on Cash

One goal of internal controls is, obviously, keeping track of your cash. Your cash disbursement controls help you ensure that your company spends money only with proper authorization. Effective controls will dissuade employees with sticky fingers from trying to pocket cash by requiring all transactions be properly recorded.

The root of these controls can be found in segregation of duties. This means requiring different individuals to authorize payments, sign checks, record payments and reconcile bank statements. Even small organizations can abide by this principle by dividing transactional duties among a bookkeeper or office manager, the executive director and the treasurer.

Cash controls aren’t just about preventing fraud; they can also be an effective means of making sure donations are spent correctly. For example, if you have restricted funds which the donors want to go to specific programs or purposes, cash controls will earmark that money. Otherwise, spending such funds improperly can anger donors and put future contributions at risk. ■

Excess Benefits Can Mean Aggressive Penalties: How to Avoid Intermediate Sanctions

Intermediate sanctions are penalties imposed on recipients of excess benefits paid by exempt organizations. The 1996 Taxpayer Bill of Rights first introduced intermediate sanctions and the IRS subsequently issued final regulations interpreting the law in 2002. Today, nonprofits have a lot more information about how the IRS interprets and applies these penalties.

Beware of excess benefits

An excess benefit is, of course, when a nonprofit overpays someone with influence for benefits it receives from that person. Excess benefits result in intermediate sanctions penalties — which can cause huge damage. For example, individuals receiving them incur an initial penalty of 25% of the benefit amount. And if you don't correct the matter, you'll be subject to an additional 200% penalty. Adding insult to injury, the IRS can assess a 10% penalty on others who were substantially involved in approving the excess benefit — such as board members.

The IRS typically pursues transactions involving excess compensation paid to executive directors who meet the definition of a “disqualified person” — someone who is or was in a position of substantial influence over an exempt organization's affairs within five years before a transaction. Fortunately, now that the IRS has actually pursued excess-benefit cases, it has developed educational programs and shared its nonprofit organization audit emphasis.

First, we know that tax-exempt employee benefits aren't considered excess benefits. Also, reimbursements under an “accountable plan” — one in which specific expenses are reimbursed — aren't excess benefits.

Expenses reimbursed under any nonaccountable plan can be considered excess benefits. These are expense allowances or payments not based on accounting of actual expenses. Because these payments are simply additional compensation, however, if they meet the safe harbor rule, they wouldn't be

considered excess benefits. (See the sidebar “Drop anchor in a safe harbor.”)

Know the various transactions

A below-market interest rate loan from a nonprofit to a disqualified person would be considered additional compensation for purposes of determining whether compensation was excessive. Also, with a loan from a disqualified person to a nonprofit at above the market rate, the excess above market could be an excess benefit.

Loans to disqualified persons must also be true loans to avoid treatment as additional compensation. Agreements must include an unconditional obligation to repay not contingent on a future event. Proof comes in the form of written, signed documentation; an interest rate; collateral; a fixed maturity date; reasonable ability to pay and expectation of payments.

Another kind of transaction that may trigger intermediate sanctions involves trigger attorneys' fees. In 2003, the Intermediate Sanctions Compensatory Revenue Adjustment Act was introduced into the House. It would impose intermediate sanctions on attorneys collecting excess fees from nonprofits. This bill was still pending at the time of this writing.

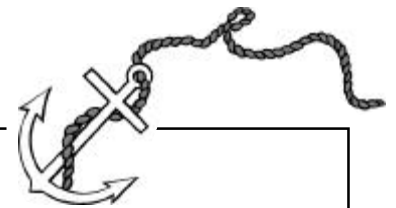
Understand IRS tactics

The IRS develops annual training materials and provides nonprofit auditor

training. The most recent education regarding intermediate sanctions tells auditors to look at:

- o Compensation,
- o Reimbursement of personal expenses,
- o Payment of personal expenses for an individual's family or his or her business,
- o Use of nonprofit-owned real estate,
- o Leases of property from disqualified persons to a nonprofit for excessive sums,
- o Loans to or from a nonprofit, or
- o Payment of royalties to a disqualified person.

The first IRS case on intermediate sanctions (Caracci, 118 TC 399) involved transfer of the assets and liabilities of three home health care organizations, exempt under Internal Revenue Code Section 501(c)(3), to for-profit organizations owned by the individuals who had established the nonprofit health care organizations. Financial records showed



Drop Anchor in a Safe Harbor

Safe harbor for salaries means that compensation will be considered reasonable (the IRS can't treat it as excessive), as long as the organization follows specific procedures to establish the compensation level. These procedures include:

- o Setting up compensation by an independent committee,
- o Requiring the committee to investigate to determine comparable salaries for this position, and
- o Asking the committee to document its conclusions and decision.

The rules clarify that payments under a contract developed when the person wasn't disqualified would not be subject to penalties.

No written safe harbor exists for the other types of transactions that can occur between a not-for-profit and individuals with substantial influence. But the most valuable defense is written documentation approved by an unrelated board or committee that describes a transaction and the reason for it. ■

that the assets were worth less than the liabilities undertaken by the individuals.

The IRS was, however, able to prove to the Tax Court that the assets were actually worth \$5 million more than the liabilities assumed. The court upheld the IRS-assessed penalties.

For determining whether excessive compensation exists, IRS regulations require you to consider total compensation — including amounts based on revenue sharing and certain fringe benefits. But some fringe benefits are excluded, such as those that result in no additional cost to the employer. These might include employee discounts, working-condition amenities and certain transportation and parking benefits.

The cost of a spouse or dependent traveling with the employee would also be excluded if the presence of those persons has a bona fide business purpose. Liability insurance that provides coverage for an employee's service for his or her tax-exempt employer would be excluded, too.

Avoid penalties

Intermediate sanctions are a clear and present danger to all nonprofits. Call us for help reviewing your business practices and documentation procedures to reduce the risk of intermediate sanctions.



How May Recent “Yellow Book” Changes Affect Your Not-for-Profit?

The General Accounting Office has released a new edition of the Government Auditing Standards publication, often referred to as the Yellow Book. The Yellow Book is a major document used for guidance in following Generally Accepted Government Auditing Standards. The standards that were revised in mid-2003 apply to organizations that receive and spend federal funds and are required to have an OMB Circular A-133 audit.

If your nonprofit is required to have one of these audits, the Yellow Book revisions will mean some differences in your next audit. The Yellow Book standards address

auditors' professional qualifications, the quality of the audit and the characteristics of appropriate audit reports.

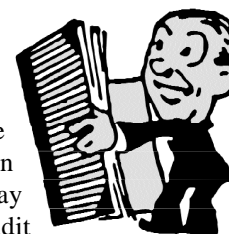
Auditors are specifically required to exercise professional skepticism when performing an audit. If your auditor uses specialists, they must document their qualifications.

The new Yellow Book standards require auditors to report findings on internal control and noncompliance with contract terms and other requirements. They must do this even when disclaiming a report on the financial statements. The

standards also impose additional independence requirements on auditors that may restrict nonaudit services they can provide to your organization.

The standards apply to financial audits and attestation engagements of periods ending on or after Jan. 1, 2004, and for performance audits beginning on or after Jan. 1, 2004.

Visit: www.gao.gov/govaud/yb2003.pdf for more information. ■



Aligning Strategic Planning Goals With Performance-Based Management

Many not-for-profit organizations have developed a strategic plan that identifies various strategic objectives. Some not-for-profit organizations also have developed performance outcome measurement systems, as more and more funding sources are requesting to see this data.

An emerging trend in the management of not-for-profit organizations is to develop a methodology where performance outcome measurements are linked with your strategic planning objectives. Using performance outcome measurements for strategic planning purposes has several benefits, such as:

- Adding more focus, and helping to identify what should be measured (if you are going to measure something, you want to make sure you are making the best use of the effort)
- Providing better information to help improve decision making
- Promoting an organizational focus on goal attainment
- Promoting more efficient program spending
- Promoting an alignment of both strategic and financial planning goals

A management tool that helps to tie all of this together is the balanced scorecard model, which has been in use by Fortune 500 companies, and recently has been adapted to not-for-profit organizations. The balanced scorecard model is an integrated framework for describing and translating strategy through the use of linked performance measures, and enables not-for-profit organizations to identify and measure the variables that make or break performance.

The concept of “balance” in this model refers to the balance between both the financial and non-financial indicators of success, as well as the balance between external perspectives (an organization's consumers, donors, and funding sources) and internal perspectives (an organization's internal operating processes and internal infrastructure skill sets).

When competing for funding in today's environment, not-for-profit organizations need to be able to demonstrate accountability as well as the furtherance of their mission-based goals and objectives. The development of a methodology where performance outcome measurements are linked with your strategic planning objectives will enable your not-for-profit organization to more effectively report the true performance of your organization, as well as how efficiently you achieved those results. ■

Improving Cash Management Helps Avoid Budget Deficits

Many nonprofit organizations find themselves confronting budget deficits because of declining dues, donations, grants and sponsorship funds. Budget deficits have become increasingly common in our spotty economy. Improving your cash management may help you get a better handle on things.

Expedite cash receipts

The sooner your organization can accumulate cash, the better off your cash flow and financial position will be. You can take some proactive measures to expedite cash receipts.

First, move your fund-raising calendar ahead. By sending an appeal in July rather than November, for example, a nonprofit may receive significant cash in late summer.

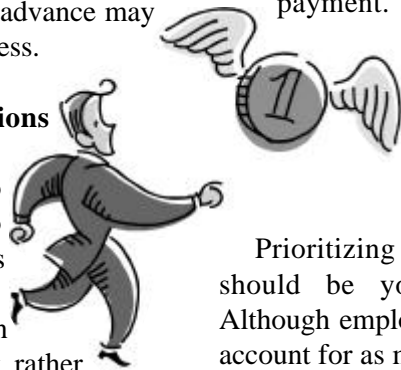
Second, mail or e-mail reminders in November to those who haven't yet given. By doing this, you're more likely to see contributions in December as well.

Finally, try collecting installment donations earlier. Instead of waiting for each payment of a four-quarter gift, contact those donors who are clearly predisposed to giving. Asking for the remaining donation in advance may well speed up the process.

Alter your collections procedures

Another way to increase cash flow is to change collections practices. Send out bills weekly or on completion of a project, rather than at the end of the month. After sending 30-, 45- and 60-day notices, send notices every week.

If you have a grantor giving large, longer-term grants, ask him or her to wire money as time goes along.



Ten New Year's Resolutions to Lower Your Auditing Fees

- Try to schedule the audit outside the auditors' "busy season," after April 15
- Review the trial balance with the auditor prior to year end to identify "hot issues"
- Ask the auditor for a list of schedules you can prepare for them.
- Computerize as many schedules as possible to allow the auditors to import them into their software.
- Make sure the auditors have adequate space in which to work, and access to copiers, fax machines, etc.
- Give the auditors a final trial balance at least a week before the start of the audit
- Have supporting documentation for every balance sheet account.
- Discuss any unusual items or transactions with the auditor prior to the audit.
- Have copies of the Board minutes for the year available.
- Have copies of all new leases, loans, grants, or contracts available. ■

Better manage disbursements

Managing cash outflow goes hand in hand with accelerating incoming cash flow. If you're facing severe deficits, look first to your invoices in an attempt to decelerate your bill payment. You might need to communicate any difficulties to your vendors to negotiate extended payment plans.

Prioritizing your disbursements should be your No. 1 concern. Although employee compensation can account for as much as 60% to 70% of some nonprofits' budgets, bear in mind that most such compensation can't be delayed legally. So be careful, because the IRS has strict rules about when deposits must be made to employee contributory benefit plans.

Don't indiscriminately eliminate departments and functions. Instead, determine where the major expenditures are being incurred and consider alternatives that allow the organization to be effective but more cost-efficient.

If your staff is swamped, you may want to consider outsourcing functions related to payroll, accounting, event planning and publications. On the other hand, you can bring previously outsourced tasks back in-house if you have qualified employees who have the time to perform them.

Create a positive-cash position

Budget deficits can be a huge problem. But these strategies may be just what you need to put your organization in a positive-cash position. Let us help you implement them. Please call us today. ■

Association charged taxes on its UBI

Labor organizations are typically exempt under Internal Revenue Code Section 501(c)(5). The Arkansas State Police Association, however, recently ran into problems regarding an agreement with a for-profit company to publish its official magazine, *The Arkansas Trooper*. The publisher paid the association more than \$25,000 each year and a percentage of the money received from advertising. The association reported this as nontaxable royalty income, but the IRS argued that it was unrelated business income (UBI).

In turn, the association challenged this in Tax Court. The district court and court of appeals agreed with the IRS position that this was UBI. A pivotal issue here was the nonprofit's amount of involvement. Royalty treatment can apply if the nonprofit lends its name and does very little more. But when a nonprofit gets actively involved, it will be considered an agent of the for-profit, subject to taxes.

Marketing with your Form 990

Your annual Form 990 is now a higher profile document than ever before. The fact that anyone can get a copy of your Form 990 from sources such as GuideStar.org has long frustrated many charities, because these forms include personal information about key employees and board members. But Form 990 also allows you to market your organization, because it gives details about your mission and program service accomplishments. Nonprofits vary dramatically in the amount of data they provide here, but this is definitely an opportunity to shine.

Form 990 asks for your primary exempt purpose and specific information for each of your four largest programs, including a description of programs' service accomplishments using measurements such as the number of clients served, units of service or publications issued. It also requires that you describe the activities, as well as current and long-term objectives.

Don't feel constrained by the few lines of space on the form. You may simply state "see attached" and provide more detailed information about your activities, accomplishments, staff expertise and innovations. Volunteer services don't get included as expenses, but you can report them on the form. You may also attach an explanation about everything that you've accomplished thanks to volunteers' generosity. Clearly, a detailed Form 990 can be a great marketing tool for your organization.

Charities that lobby no longer audited

In 2003, the IRS confirmed that it will halt a program in which a sample of charities was audited because they reported lobbying activities. This came after seven nonprofit umbrella organizations pressured the IRS to stop the audits. They requested a meeting after learning that the IRS appeared to be considering audits on some public charities that reported more than \$10,000 in lobbying expenditures. At that time, charities that made the 501(h) election were apparently being targeted for audits.

The IRS confirmed some of the charities' suspicions, but denied specifically singling out charities making that election. It also noted that lobbying expenses, combined with other factors, were one of nearly 20 different sets of criteria the IRS used in selecting audit candidates.

The IRS has agreed to consider changes to the Internal Revenue Manual (the guide for IRS staff) that suggested examiners shouldn't use either the 501(h) election or lobbying by electing organizations exclusively as grounds for examination. The IRS said that charities making this election were actually more likely to be complying with the law. And the agency also agreed to communicate with the nonprofit sector if it decides to implement any future change to its position regarding charities examination and audit selection.

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