

A monthly publication dedicated to providing ideas and education to tax exempt organizations

Employee Fraud and its Effect on Not-for-Profit Organizations

As the economic downturn has deepened in the United States, the number of instances of employee fraud has steadily increased. While fraud can cause serious financial damage to companies in all industries, the damages to not-for-profit organizations can go much deeper.

Seemingly every organization, regardless of location, mission or size has felt the effects of fraud. But while cases may have been handled behind closed doors in the past due to fears of bad publicity and a subsequent decrease in donations, recent changes in IRS regulations require not-for-profits to disclose instances of fraud.

Not-for-profit organizations are particularly vulnerable to fraudulent behavior, due to tighter budgets and a smaller amount of funding available for controls. Economic pressures have led more individuals to commit fraud, while existing controls that may have already been in place have weakened in many cases due to downsizing or layoffs.

The situation does not look to improve in the near future. A study by the Association of Certified Fraud Examiners indicates that more than 80 percent of respondents expect instances of fraud to increase. Thirty-six percent expect it to increase significantly.

According to estimates, fraud cost U.S. businesses \$994 billion as a whole in 2008, roughly 7 percent of all revenue. From a not-for-profit perspective, studies have indicated that as much as a staggering 13 percent of donations to charitable organizations are lost to fraud.

Financial losses are very difficult for many not-for-profit organizations to overcome, but it is the damage to their reputation that often comes with a major fraud case that is even more of a challenge to recover from.

Trust is a major component in any relationship between a donor and a not-for-profit organization; the money that is given is intended to serve a specific purpose. But when that money falls into someone else's hands, that trust is violated and can cause irreparable damage to the organization's reputation with current and future donors.

With any publicized instance of fraud, you can expect giving to decrease as donors become skeptical of the

ultimate destination of their contributions. Without substantial financial reserves, which is not common even when the country is not in a recession, it may be difficult for many organizations to sustain operations. Larger national organization can survive a sudden and possibly prolonged decrease in contributions, but it is much more difficult for local or regional organizations.

It is hard to point out a typical offender, as there are different descriptions of a typical offender depending on the size and scope of the crime. Any employee is capable of committing fraud. If it were easy to pinpoint possible offenders, there would be no instances of fraud. However there are some steps that can be taken to help identify fraudulent behavior, reduce the possibility of an occurrence and encourage a culture of honesty within your organization.

Types of fraud

There are many different types of fraud, but they mainly fall under three main categories:

- **Corruption:** This is seen when someone uses influence to procure a benefit, such as bribery or extortion.
- **Fraudulent statements:** This is often characterized by the falsification of financial statements. Cash larceny and payroll schemes also fall under this category. While these do not make up the largest percentage of fraud cases, these are particularly damaging as they tend to represent the highest monetary loss to the organization.
- **Asset misappropriation:** This occurs as an employee commits theft or misuses an organization's assets. Common examples of this include larceny and skimming of cash.

What can your organization do?

There are many actions that organizations take after being affected by fraud that could have prevented the crime if implemented earlier. These include:

- Conducting surprise audits
- Holding fraud training for executives and employees

Employee Fraud, continued on page 3

What Does FIN 48 Mean to Your Tax-Exempt Organization?

The Financial Accounting Standards Board (FASB) recently announced that FASB Interpretation No. 48 (FIN 48) will begin to apply to financial statement periods ending after Sept. 15, 2009 for all nonpublic entities, including tax-exempt organizations. As nonpublic entities, all tax-exempt organizations must be prepared to implement FIN 48 for the upcoming calendar year end.

FIN 48 is an interpretation to FASB 109, Accounting for Income Taxes, and concerns the uncertainty of tax positions taken by tax-exempt organizations. A tax position taken by an exempt organization may include two universal tax issues: exemption and unrelated business income tax. Under each of these two universal tax issues are a series of overarching tax positions that may apply to your association.

Subset examples of overarching tax positions taken by associations

Over the last two years, RSM McGladrey has developed “The Principled Approach” to FIN 48 analysis. The most recent announcement by the FASB suggests that all nonpublic entities take a principled approach under the FIN. Under the universal tax issue exemption, some overarching tax positions that may be taken by a tax-exempt organization and may contain uncertainty include:

- Assumption that the organization is exempt, without corresponding proof of recognition of exempt status
- Assumption that egregiously high compensatory arrangements or egregiously undervalued asset sales to insiders do not result in prohibited private inurement
- Assumption that management time and focus is not substantial in generating unrelated business income, as opposed to accomplishing its tax-exempt purpose
- Assumption to decide to not file returns in certain state or local jurisdictions where nexus may exist and the organization may not be recognized as exempt in that jurisdiction

Under the universal tax issue unrelated business income tax, some overarching positions that may be taken by an exempt organization and may contain uncertainty include:

- Over-allocating expenses to offset identified taxable income

- Tax positions taken by the organization, contrary to an IRS closing agreement for specific treatment of an item going forward
- Treating an income flow as exempt, when it should be subject to tax
- Decision to not file a return in a specific jurisdiction (state/local/foreign)
- Inappropriate allocations or apportionments of income earned in other tax jurisdictions
- Treating net operating losses from a trade or business activity as valid and/or using them to offset other unrelated business income flows
- Allocations of dual use activities of facilities and personnel are not reasonable
- Assumption that net operating loss carry forwards are valid, even if generated in a closed tax year, and/or adjusting them if examined for validity
- Treating alternative investment income as tax-exempt when it is taxable

What is management's responsibility for FIN 48 implementation?

Tax-exempt organization management is responsible for implementing FIN 48 for its financial statement periods ending after Sept. 15, 2009. Management is required to identify all of the organization's tax positions and review them under a more likely than not standard under the FIN 48 recognition step. Documentation must include the identification of all tax positions taken by the organization for the current period and for all open tax years under the statute of limitations.

After identifying the tax positions, management must determine the certainty that those positions will be sustained in the event of an audit by taxing authorities at the federal and state levels. Management must assume under FIN 48 that each identified tax position will be audited based on its technical merits. In addition, all relevant information must be taken into account during FIN 48's second step, which is measurement.

While the time to implement FIN 48 is now, it is a highly technical area that requires specialized knowledge. Please contact your tax professional for more information.

Financial System Selection Tips

Your financial system is an integral part of the overall operations of your organization that is often taken for granted or not appreciated until issues arise. All financial systems are not created equal and can be optimized to fit your unique needs. Undergoing a thorough selection process is an important initial step in ultimately determining the efficiency and effectiveness of your system.

Do you find yourself asking the following questions?

- Have we outgrown our financial management system?
- Are our auditors advising us to consider upgrading to a more appropriate system with tighter security and a strong audit trail?
- Does our current system have outdated technology with very little research and development being invested into the product?
- Can our financial system easily communicate with other internal systems for optimized efficiency?
- Are our monthly closings and financial reporting taking longer than a day to complete?
- Are we performing duplicate data entry because of a lack for integration?

If you are asking yourself any of these questions, you may want to consider assessing your business requirements and going through a financial system selection process.

Selecting or upgrading your organization's information systems is a crucial and costly decision. You need to understand how your business currently performs, identify business process enhancements and determine how technology can be used to improve your operations. Once this is defined, you can identify the best integrated business solutions in the marketplace and tailor those solutions to meet your exact needs. And just as important, the technology should fit your business, instead of making the business fit your technology.

It is beneficial to consider these steps to ensure a successful selection of a new system:

- Planning and discovery
- Develop solution options
- Develop a Request for Information (RFI)
- Identify business process improvements and developing an initial high-level agenda for vendor demonstrations
- Evaluate vendor responses
- Develop final demonstration agenda
- Develop demonstration rating system
- Facilitate demonstrations
- Final selection

Selecting and implementing new technology within an organization is often a challenging process. A knowledgeable consulting partner can help you sort through the maze of choices, helping you plan, select and implement new software solutions, addressing your risk and security issues, and designing the structure of the new system.

Information systems are a critical resource for your organization — helping you gain a competitive advantage, bolstering staff productivity and enabling your organization to run more effectively. To keep your information strategy aligned with your organization's business goals, you need a long-range plan that addresses current and future systems requirements.

Information technology has been, and continues to be, an integral and defining factor in the day-to-day operations of most successful companies. During this recession, it is critical to maintain a focus on the role technology plays in your company's success and in the creation of value. Too often, that value goes unrecognized until the company suffers a loss. The opportunity for IT to enhance your business is stronger than ever.

Employee Fraud, continued from page 1

- Evaluate your internal and external audits and procedures
- Implement a code of conduct, or if one is in place, consider strengthening it
- Promote employee rewards for whistleblowers and other support programs

Fraud is always going to be a threat to companies spanning all industries, but your organization does not have to be a

victim. By knowing what the causes are for fraud, as well as potential warning signs and effective prevention methods you can thwart illegal activity before it starts.

For a more in-depth discussion on employee fraud and helpful information on how it can be curtailed, read the white paper "The Threat Within: Employee Fraud Detection and Prevention" at www.rsmmcgladrey.com.

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Inside this issue:

- Employee Fraud and its Effect on Not-for-Profit Organizations
- What Does FIN 48 Mean to Your Tax-Exempt Organization?
- Financial System Selection Tips

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