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DON'T CHANGE SOMETHING, LEARN SOMETHING!

Presented by:


Bob Grossman & Rick Dynoske, GYF Tax Services
Steve Heere & Robin Ryan, GYF Audit Services



Not-for-Profit CPE Seminar Series January 10, 2019




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UBIT CONSIDERATIONS

Understanding Unrelated Business Income



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Understanding Unrelated Business Income (UBI)

- Most Not-for-Profits (NFPs) are founded to provide some public benefit
- Federal law permits NFPs with tax exempt status to engage in some income-producing activity that is “unrelated” to its exempt purpose
- Fairness dictates that activity income be taxed as if it was generated by a taxable entity

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Understanding Unrelated Business Income (UBI)

- Differentiate the organization’s “purpose” from its “activities”
 - ***Purpose:** the sole reason for the organization’s existence, and the basis of its qualification as a tax-exempt entity*
 - ***Activities:** essentially, the organization’s “actions, operations, and undertakings”*

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Understanding Unrelated Business Income (UBI)

- Internal Revenue Service (IRS) Analysis
 - *IRS is interested in how the unrelated income was earned (not how the resultant income was used)*
 - Certain income may be found unrelated even if the income is used in furtherance of the organization's exempt purpose

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Understanding Unrelated Business Income (UBI)

- Nearly all tax-exempt organizations may be subject to UBI rules & UBIT
 - *Religious organizations*
 - *Educational institutions*
 - *Scientific/research organizations*
 - *Social welfare groups*
 - *Advocacy groups*
 - *Veterans' organizations*
 - *Trade/professional organizations*
 - *Labor organizations*
 - *Employee benefit funds*
 - *Fraternal organizations*

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Understanding Unrelated Business Income (UBI)

- Law added in 1950
 - *Intended to curb unfair competitive advantage to tax-exempt organizations over commercial “for-profit” entities*
- Commerciality Doctrine
 - *NFP cannot obtain exemption or it can have its exemptions revoked if it is truly a commercial enterprise*

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Understanding Unrelated Business Income (UBI)

- NFPs can lose tax-exempt status if the IRS determines that the percentage of income coming from business activities unrelated to the tax-exempt purpose is “excessive”
 - *No specific percentage is set out by the IRS in statute or other guidance*

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Understanding Unrelated Business Income (UBI)

- Within limits, UBI can be useful to any organization
 - *No tax unless you are making a profit*
 - *Profit requires affecting revenue with proper expenses*
 - *Tax rate currently set at a flat 21%*

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Understanding Unrelated Business Income (UBI)


- Critical to maintain predominate level of exempt activities to protect tax-exempt statuses
- Failure to do so may result in the loss of traditional funding sources

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UBIT CONSIDERATIONS

Activities Subject to UBIT

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Requirements for Unrelated Business Taxable Income

- All three requirements must be met to make any activity an “unrelated business activity”
 - *A trade or business*
 - *Regularly carried on*
 - *Not “substantially” related to exempt purpose*

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Trade or Business

- Not defined in the Internal Revenue Code (IRC)
- Activity that includes the sale of goods or performance of services
- Intent of activity must be to produce income (i.e., profit motive)

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Trade or Business

- IRS tends to look at IRC Section 162, *Trade or Business Expenses*
- Profit motive thinking follows IRC Section 183 rulings and case law

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Regularly Carried On

- Assessment must be made in comparison to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued

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Regularly Carried On

- Business activities of an exempt organization will ordinarily be deemed to be “regularly carried on” if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations

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Regularly Carried On

- Where income producing activities are of a kind normally conducted by nonexempt commercial organizations on a year-round basis, the conduct of such activities by an exempt organization over a period of only a few weeks does not constitute the “regular carrying on” of a trade or business

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Regularly Carried On

- Example:
 - *The regulation states that the operation of a sandwich stand at a state fair operated by a hospital auxiliary for only two weeks would not be the regular conduct of trade or business, but that the conduct of year-round business activities for one day each week would constitute the “regular carrying on” of trade or business*

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Regularly Carried On

- Where income-producing activities are of a kind normally undertaken by nonexempt commercial organizations only on a seasonal basis, the conduct of such activities by an exempt organization during a significant portion of the season ordinarily constitutes the regular conduct of trade or business

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Regularly Carried On

- Example:
 - *A two-week horse racing meet featuring pari-mutuel betting conducted by an IRC Section 501(c)(3) county fair association is “regularly carried on” because it is usual to carry on such trade or business only during a particular season*

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Regularly Carried On

- In determining whether or not intermittently conducted activities are “regularly carried on,” the manner of conduct of the activities must be compared with the manner in which commercial activities are normally pursued by nonexempt organizations

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Regularly Carried On

- In general, exempt organizations' business activities that are engaged in only discontinuously or periodically will not be considered “regularly carried on” if they are conducted without the competitive and promotional efforts typical of commercial endeavors

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Regularly Carried On

- Example:
 - *The publication of advertising in programs for sports events or music or drama performances will not ordinarily be deemed to be the “regular carrying on” of business*

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Substantially Related

- The primary focus by IRS is whether the activity being reviewed contributes to the exempt purpose of the organization and has a “substantial relationship” to that purpose
- The assessment first examines the organization’s initial organizational documents and its charitable or other exempt purpose
- Always facts and circumstances centric

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Substantially Related

- **Key Court Decisions:**

- *Supreme Court examined the sale of advertisements in a medical journal*
 - The organization argued that the purpose of the ads was to educate the readers about the products of pharmaceutical companies
 - The Court held that the manner of selection and presentation of the ads was not “substantially related” to the organization’s exempt purpose

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Substantially Related

- **Key Court Decisions:**

- *Rulings related to sales in museum gift shops go to the heart of the “substantially related” test and also illustrate the “fragmentation rule”*
 - The IRS can look at a series of items and determine that some items (such as posters or cards depicting paintings) are substantially related and do not generate UBIT, while other items (such as souvenirs of the city in which the museum is located) are not substantially related and do generate UBIT

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Substantially Related

- **Key IRS Rulings:**

- *In PLR 200032050, the Service considered a question which exempt organizations pose from time-to-time:*

- Can an exempt organization rent real estate (debt-financed) to other nonprofit organizations without being subject to UBIT?

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Substantially Related

- **Key IRS Rulings:**

- *PLR 200032050*

- Indicates that one must examine whether the rental arrangement and the activities of the lessee further the exempt purpose of the organization
- An organization whose mission is economic development – to improve the quality of life of individuals and families in the inner city – can rent to organizations such as childcare providers and social service agencies that help it carry out those purposes

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Substantially Related

- **Key IRS Rulings:**

- *PLR 200032050*

- The logic of the ruling also suggests, however, that if this organization were to rent to a qualified (c)(3) organization whose mission was, for example, preserving the environment or religious study, the rental arrangement would not be “substantially related”

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Exclusions

- **Code Section 512** – provides a list of activities that are not considered unrelated business income:
 - *Receipt of dividends, interest, annuity and royalty income, certain capital gains, rental income from non debt-financed real property, income derived from volunteer labor or from the sale of donated goods and a business carried on by its members, students, patients, officers and employees*

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Real Property Rentals

- Income from the rental of real property is generally not subject to UBIT, unless it is debt-financed
- It is subject to UBIT based upon the percentage of average debt over average tax basis for the tax year (not to exceed 100%)
 - *Unless the organization is a “qualified organization”*
 - A school, certain qualified trusts, certain retirement accounts etc.

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Real Property Rentals

- Additional Exclusions
 - *Property substantially related to an organization's exempt purposes*
 - *Defined in the regulations as 85% or more is related-use*
 - *Neighborhood land rule: When the organization intends to use the property for exempt purposes within 10 years and it is in close proximity to other property already being used for exempt purposes*

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Income from Alternative Investments

- Discerning which elements of income are reportable as unrelated business income from partnerships, LLCs, hedge funds, and other types of investments can be daunting and technical
- Schedule K-1s from investments may warrant careful analysis for unrelated business income, losses, expenses, deductions, and credits

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OTHER TAX ISSUES

Form 990-T Income Tax Return



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Form 990-T Exempt Organizations Income Tax Return

- Only required if gross income of \$1,000 or more from an unrelated trade or business
 - *Gross income equals gross receipts minus cost of goods sold*

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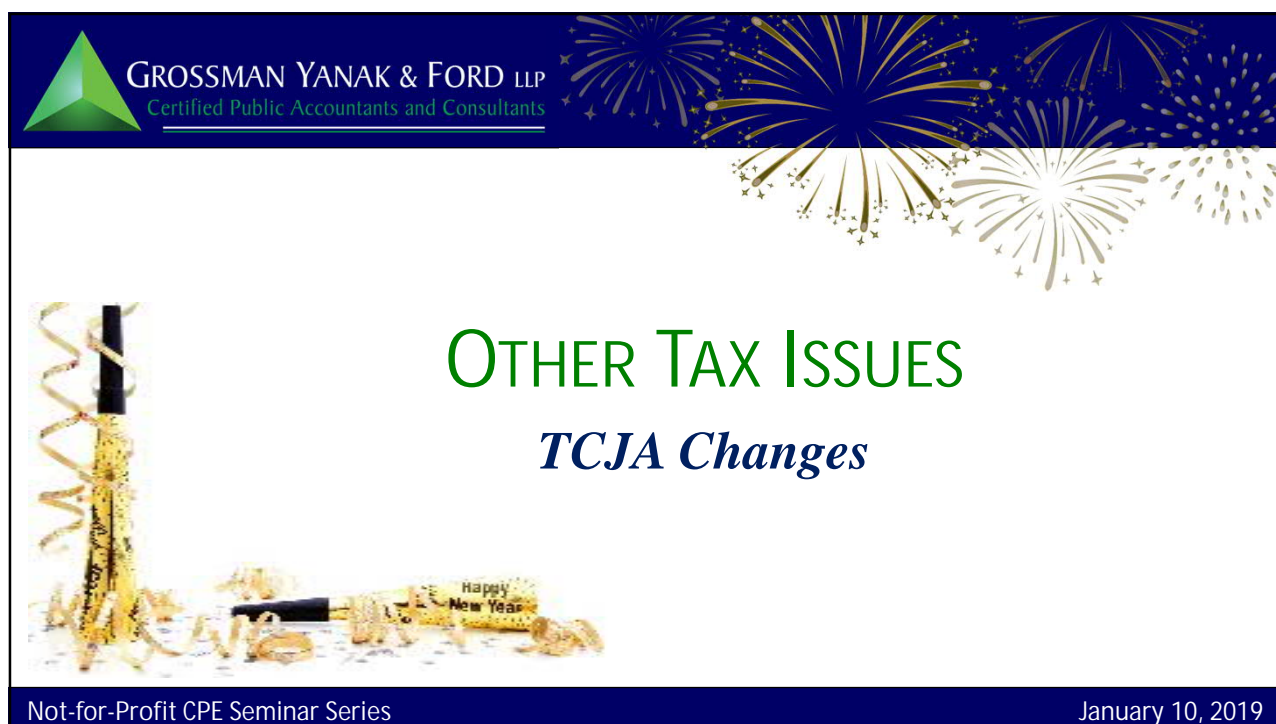
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Form 990-T Exempt Organizations Income Tax Return

- Return is due on 15th day of fifth month after the end of tax year
- Tax due must be deposited electronically using the EFTPS
- Automatic six-month extension allowed, provided tax is deposited by the original due date
- Penalty for late filing – 5% of unpaid tax, up to a maximum of 25%

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The slide features a dark blue header with the Grossman Yanak & Ford LLP logo and name. The background is white with a decorative border of gold and blue fireworks at the top and bottom. In the center, the text 'OTHER TAX ISSUES' is written in green, and 'TCJA Changes' is written in blue. Below the text, there is a photograph of a champagne bottle with a popping cork and a 'Happy New Year' banner.

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OTHER TAX ISSUES

TCJA Changes

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The slide features a dark blue header with the Grossman Yanak & Ford LLP logo and name. The background is white with a decorative border of gold and blue fireworks at the top and bottom. The main text is in blue and green, with a green underline under the phrase 'Don't Change Something, Learn Something!'. Below this, the text 'TCJA Changes' is written in green, followed by a bulleted list of four points.

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TCJA Changes

- Enacted on December 17, 2017
- Generally applicable to all years beginning after December 31, 2017
- Not effective for June 30, 2017 fiscal yearend (except IRC Section 15)
- Effective for June 30, 2018 fiscal yearend

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TCJA Changes

- Flat tax rate of 21% for periods after December 31, 2017
- Net Operating Loss (NOL) changes
 - *Separation of multiple activities and NOLs*

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TCJA Changes

- Net Investment Tax on certain colleges and universities
- Excise Tax on excessive compensation
- Fringe benefits (parking tax)

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UBIT Computation

- Old Law:
 - *Unrelated Business Income = the aggregate of its gross income from all unrelated businesses, less the aggregate of the deductions allowed with respect to all such unrelated businesses*
 - *15% tax rate on first \$50,000 of UBI*

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UBIT Computation



- New Law:
 - *Unrelated Business Income must be separately calculated for each unrelated business and then added together*
 - Requirement is in effect for all purposes, including calculation of NOL deduction(s)
 - *Eliminates 15% tax rate on first \$50,000*
 - *Corporate tax rates (applicable to UBIT) decreased from 35% to 21%*

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QUESTIONS?

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IMPACT OF FRAUD

Introduction

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Fraud, It's Real and It's Here

- 7 years at a cost of \$10,000,000 (averages \$4,000 7 days a week)
- Trusted employee
- Falsified records; transferred cash to personal accounts
- Lavish lifestyle
- Quit when questioned

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Fraud, It's Real and It's Here

- 13 million over 16 years
- Treasury Department employee
- Trusted by employer
- Neighbors questioned lifestyle (cars, furs, Louis Vuitton)

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Fraud, It's Real and It's Here

- Girl Scout troop leader stealing cookie sale proceeds
- 80-year-old woman stealing from St. Vincent DePaul
- Attorney stealing from a Masonic Lodge
- Volunteer stealing from a Haunted House

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Introduction – 2018 ACFE Report to the Nations

- Monetary fraud and financial misconduct are common occurrences in today's economic environment
- Fraud is perpetrated through a variety of schemes
- Proper prevention and detection methods can reduce the likelihood or severity of fraud in an organization

<https://www.acfe.com/report-to-the-nations/2018/>

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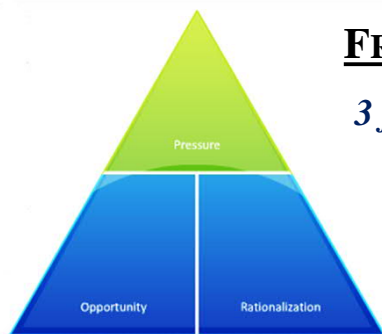
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Introduction – Why People Commit Fraud



FRAUD TRIANGLE (Donald R. Cressey)

3 factors must be present for person to commit fraud:

1. Pressure
2. Opportunity
3. Rationalization

<https://www.acfe.com/fraud-triangle.aspx>

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Introduction – Common Indicators of Possible Employee Fraud

- Increased standard of living
- Aggressive work style
- Financial difficulties/
sudden need for cash
- Excessive control of duties
- Family/divorce/addiction problems
- Negative attitude
(defensive/suspicious)
- Close relationships with customers
and/or vendors

<https://www.acfe.com/report-to-the-nations/2018/>

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Introduction – Why Organizations May Be Targets of Fraud

- Two reasons for organization to be likely target of fraud:
 - *Weak financial internal controls*
 - *Overreliance on trust in long-term employees*
- Smaller organizations are most frequently victimized and suffer the largest proportionate losses

<https://www.acfe.com/report-to-the-nations/2018/>

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IMPACT OF FRAUD

Cost to Organizations



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Impact on Local Organizations

- \$91,000 local NFP set up to help terminally ill children
- \$354,000 local golf resort
- \$200,000 from three local NFP's by one person
- \$236,000 from two local baseball associations
- Reputation...???????...priceless

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Cost to Organizations – Statistics from ACFE Report

REPORT TO THE NATIONS

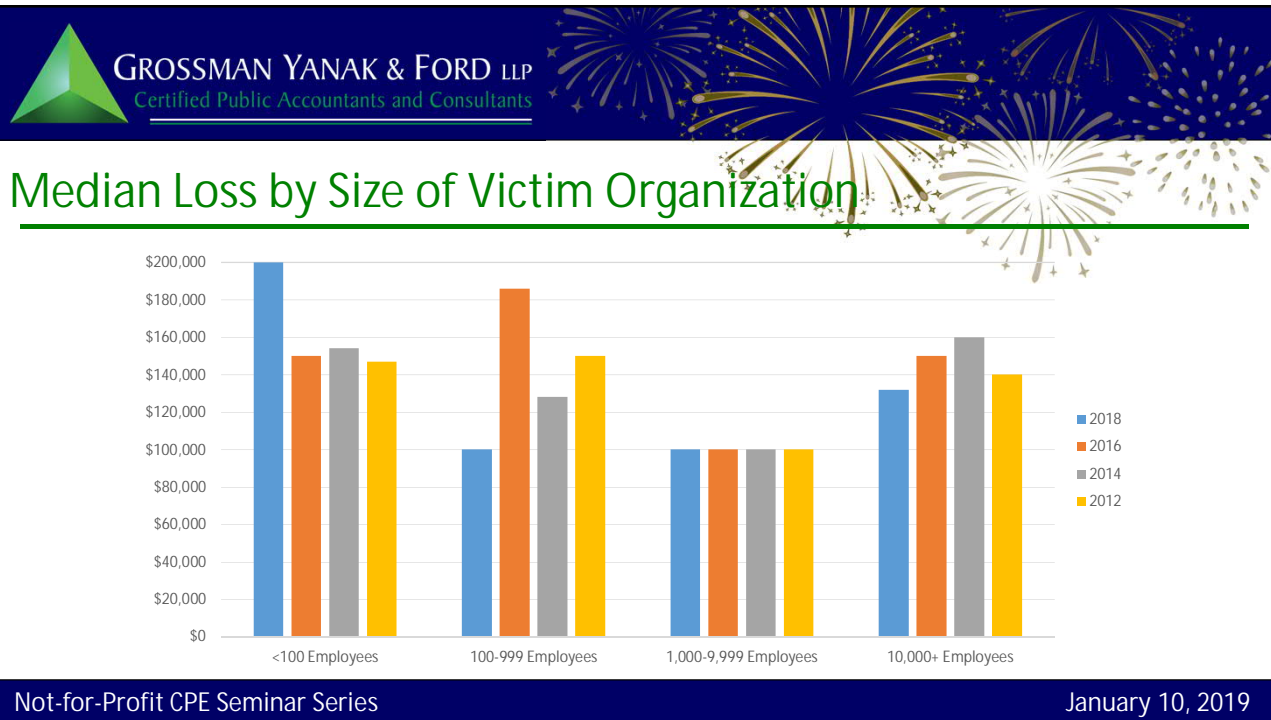
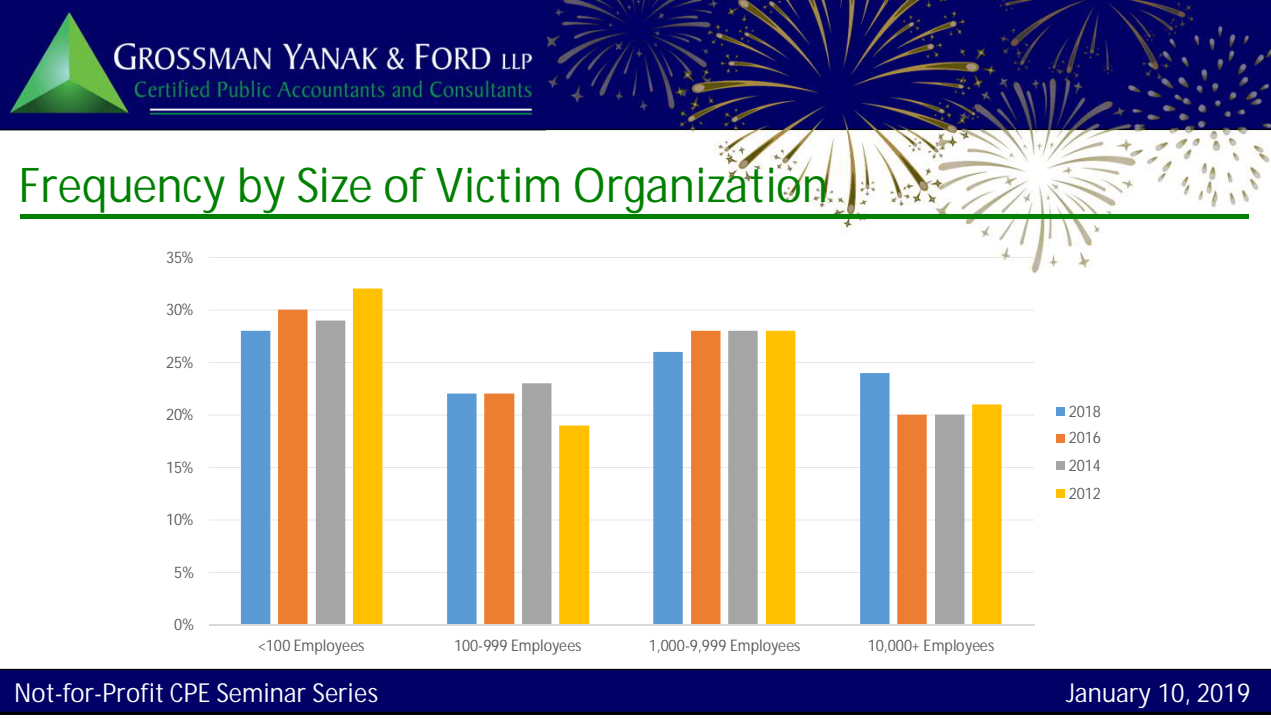
2018 GLOBAL STUDY ON OCCUPATIONAL FRAUD AND ABUSE



<https://www.acfe.com/report-to-the-nations/2018/>

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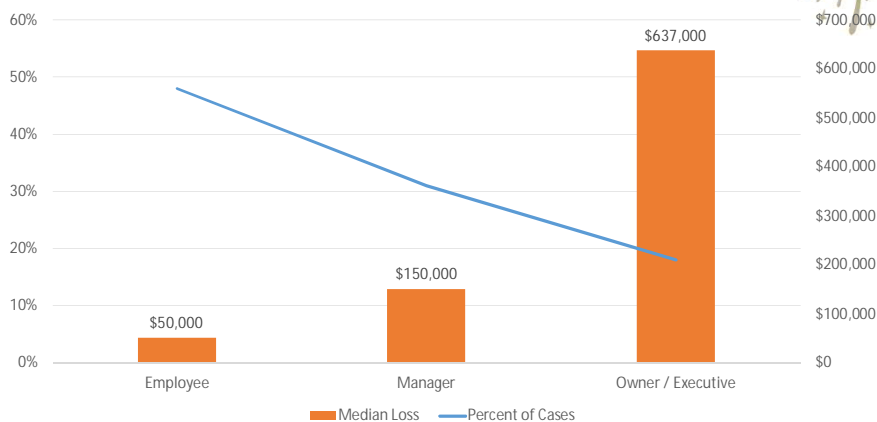
Cost of Fraud – Duration

- Cost of fraud is, in part, a function of the duration
 - *27% of fraud cases were detected within first six months*
 - *Median duration of fraud was 16 months*
 - *30% of fraud cases lasted over two years*
 - *Different detection methods yield different results*
- Cost also depends on the type of fraud perpetrated and by whom

<https://www.acfe.com/report-to-the-nations/2018/>



Cases and Losses by Position of Perpetrator (U.S. Only)





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How Long Has This Been Going On?

- North Shore for-profit company – \$13 million over 16 years
- Non-profit in NW PA – \$70,000 over 7 years
- Non-profit serving terminally ill children – \$91,000 over 5 years
- Three non-profit organizations victimized – \$200,000 over 5 years
- East-end BB and alumni association – \$288,00 over 6 years

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Cost of Fraud

- Little Recovery of Losses
 - *53% of organization victims recovered nothing (some cases still pending)*
 - *Only 15% of the victims recovered everything*
- 58% of victim organizations also pursued criminal charges
 - *Generally, in cases with greater losses*
 - *73% of defendants pled guilty or were convicted*


<https://www.acfe.com/report-to-the-nations/2018/>

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IMPACT OF FRAUD

Techniques and Schemes

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Fraud – Techniques and Schemes

- The ACFE Report identifies three common categories of fraud
 - *Financial Statement Fraud*
 - *Asset Misappropriation*
 - *Corruption*

<https://www.acfe.com/report-to-the-nations/2018/>

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Fraud – Techniques and Schemes

- Asset Misappropriation
 - *Most common (89%) with smallest losses (\$114,000)*
- Corruption
 - *Present in 38% of cases; median losses = \$250,000*
- Financial Statement Fraud
 - *Least common (10%) but largest losses (\$800,000)*

<https://www.acfe.com/report-to-the-nations/2018/>

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Financial Statement Fraud

- Deliberate misrepresentation of financial information via intentional misstatements or omissions
- Committed by misstating assets and revenues and/or liabilities and expenses
- Often does not directly or solely benefit perpetrator

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Financial Statement Fraud – Possible Motivations

- Achieving financing or meeting compliance requirements
- Meeting Board/Funder expectations
- Earning performance bonuses
- Covering up asset misappropriation

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You've Heard of "Cooking the Books"

- Falsifying bank records
- Manipulating inventory records
- Presenting multiple financial statements
- Falsifying debt records
- Appropriate treatment of capital assets

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Financial Statement Fraud – Examples

- Understating or overstating reserves
- Revenue recognition
- Recording fictitious sales and receivables
- Capitalizing rather than expensing costs
- Concealing or failing to disclose liabilities

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Financial Statement Fraud – General Safeguards

- Reduce situational pressures
- Reduce opportunity
- Exhibit integrity from the top
- Analyze income statement relationships and fluctuations

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Asset Misappropriation

- A scheme in which an employee steals or misuses an employing organization's resources (e.g. cash, inventory)
- May involve multiple people, including those outside of the company
- Directly benefits the perpetrator(s)

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Misappropriation, by any other name, is still theft

- Transferring cash to personal accounts
- Falsifying payroll
- Checks written to cash or "petty cash" with no receipts
- Forgery
- Credit card fraud

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Asset Misappropriation – Most-Prevalent Schemes

1. False billings
2. Non-cash
(inventory, customer info, etc.)
3. Skimming
4. Expense reimbursements
5. Check tampering
6. Payroll
7. Larceny

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Asset Misappropriation – General Safeguards

- Strong internal control system
 - *Segregation of duties*
 - *Management review and oversight*
 - *IT controls*
- Fraud hotline

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Corruption

- Generally associated with bribery (the giving or receiving anything of value to influence an official act)
- Often involves collusion between employees and vendor, and can also occur outside of the organization

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Corruption

- Difficult to prevent/detect because it occurs outside of the accounting records – internal controls may be insufficient
- Best deterrent is a knowledgeable and active owner or other appropriate level of oversight
- Competitive bidding and multiple people involved in purchasing can also effectively prevent corruption

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Most Common Fraud Schemes in Nonprofit Organizations

- Cash theft – 46%
- Billing – 40%
- Corruption – 34%
- Expense reimbursements – 29%
- Payroll – 22%

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IMPACT OF FRAUD

Prevention and Detection



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How Could This Happen?!

- Lack of understanding or focus on controls
- Too much responsibility assigned to one person
- Too much trust
- Not enough oversight

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Prevention and Detection – Implementing Controls

- Tone at the top of an organization is paramount
- Controls should be clearly understood by personnel, and personnel need sufficient time to perform the controls
- All personnel should have an avenue for expressing concerns and/or potential issues

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Prevention and Detection – Implementing Controls

- Quality of both the design and effectiveness of a control environment should be periodically monitored and updated
- Custody of an asset should be segregated from recording related transactions, which should be segregated from authorization of a transaction

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Prevention and Detection – Implementing Controls

- The perception of detection can be powerful; it can be accomplished via:
 - *Management oversight*
 - *Internal audit, including an element of surprise*
 - *Hotlines providing the opportunity for employees to report known/suspected issues, along with whistleblower protection*
 - *An active audit committee*

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Prevention and Detection – Risk Assessment

- Should be performed to identify specific areas of organizational focus
 - *Evaluating an organization's current situation*
 - *Determining where fraud could possibly occur*
 - *Identifying controls that could or already do mitigate the risk of fraud*
- Organizations of different sizes tend to have different fraud risks

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Prevention and Detection – Weaknesses in Internal Controls

- ACFE Report attributed primary weaknesses to:
 - *Lack of internal controls (30%)*
 - *Override of existing controls (19%)*
 - *Lack of management review (18%)*

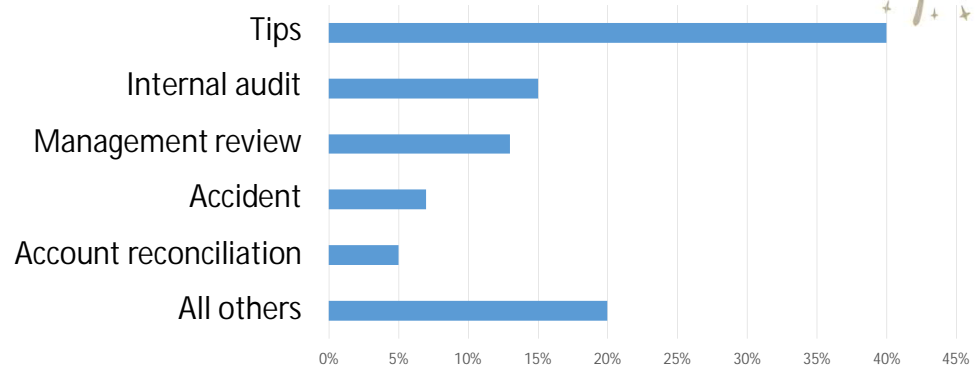
<https://www.acfe.com/report-to-the-nations/2018/>

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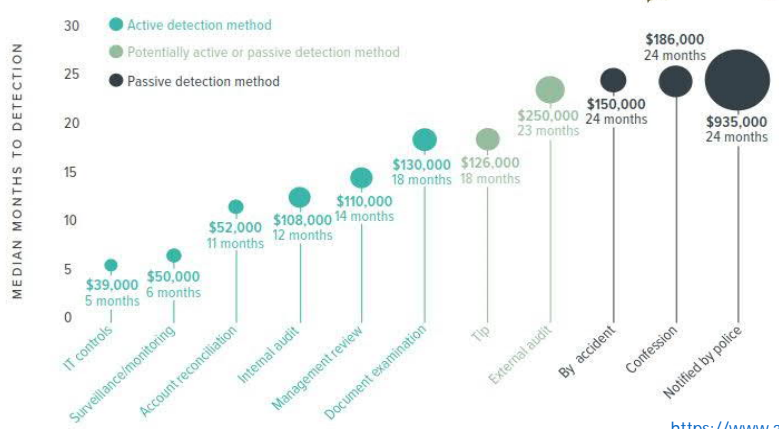
Most-Common Detection Methods



<https://www.acfe.com/report-to-the-nations/2018/>



Median/Loss Duration of Detection



<https://www.acfe.com/report-to-the-nations/2018/>



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Anti-Fraud Controls – Tips/Hotlines

- While tips are the primary means of detection for both large and small companies, they occur more commonly in larger organizations
 - *44% of fraud cases in larger companies versus 30% for smaller companies*
- Existence of hotlines increases the use of tips
 - *Fraud was detected in 46% of cases where a hotline was in place, compared to only 30% without a hotline*

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Anti-Fraud Controls – Tips/Hotlines

- Hotlines provide additional avenues for detection that may not be covered through the internal control system
 - *One half of all corruption cases were detected through a tip*
- Hotlines do not prevent fraud, but can reduce its effects
 - *Losses were 50% smaller at organizations with hotlines*

<https://www.acfe.com/report-to-the-nations/2018/>

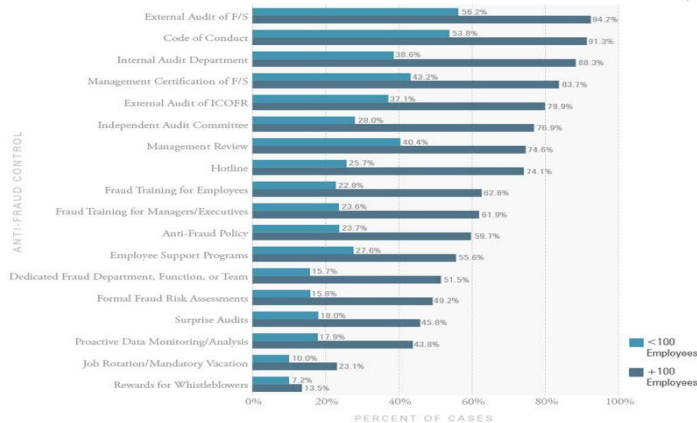
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Anti-Fraud Controls – Large vs. Small Organizations



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Most Common Anti-Fraud Controls in Small Organizations (<100)

- External audit of financial statements
- Code of conduct
- Management review
- Management certification of financial statements
- External audit of internal controls

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Anti-Fraud Controls in Small Organizations

- Other opportunities for smaller organizations
 - *Data monitoring and analysis*
 - *Surprise audits*
 - *Hotline*
 - *Fraud policy/fraud training*

<https://www.acfe.com/report-to-the-nations/2018/>

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Concluding Thoughts

- Anti-fraud controls were measurably effective:
 - *Losses from fraud were 14-54% less with anti-fraud controls in place*
 - *Frauds were detected 33-50% more quickly*
- Many cases also cited a failure in the basic internal control design (lack of internal controls or management review) or execution (override of controls)

<https://www.acfe.com/report-to-the-nations/2018/>

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Concluding Thoughts

- Fraud occurs at organizations of all sizes and industries
- Proactive detection methods are vital to catching fraud and limiting losses
- Many cost-effective anti-fraud controls are overlooked by smaller companies

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Concluding Thoughts

- External audits have a greater detection rate at smaller organizations and often prompt the company to employ other internal controls and detection methods
- Review of existing internal control policies (design and execution) can be worthwhile as anti-fraud control

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Resources

- **ACFE Fraud Resources**
<https://www.acfe.com/fraud-resources.aspx>
- **PANO Standards for Excellence**
<http://www.pano.org/Standards-For-Excellence/Educational-Resources/>
- **Nonprofit Risk Management Center**
<https://www.nonprofitrisk.org/areas-of-expertise/fiscal-oversight-fraud-protection/>

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QUESTIONS?

Thank You for Attending!



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